TAXATION

3rd SEMESTER

TOPIC:

UNION LIST – STATE LIST – TAX RATES OF TAXATION

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Effects of Taxation on Distribution

There are two aspects of an economy:

- Income Generation
- Income Distribution

Income generated in society if not distributed properly will create inequality in the distribution of income and wealth. It will give rise to the creation of two classes that is the class of the rich and the class of the poor.

The gap between rich and poor will lead to class conflict which may prove disastrous to the society. Every government in the world tries to bridge this gap by imposing higher taxes on the richer section of the society and the proceeds realized from such taxes are distributed among the poorer section of the society by way of providing social amenities to them.

The effects of taxation on the distribution of income and wealth among different sections of the society, however, depend upon two factors: nature of taxes and tax rates and kinds of taxes.

1) Nature of Taxes and Tax Rates

By nature, taxation may be proportional, progressive or regressive. The nature of taxation also implies as how the burden of taxation is distributed among different section of the community.

A tax is called as proportional, if all the tax payers pay the same proportion of their income as tax. A tax is said to be progressive, if larger is the tax payers income, the greater is the proportion that he pays as tax. A tax is regressive, if larger is the tax payee's income, the smaller is the proportion, which he pays as tax.

a) Effects of Regressive Taxation on Distribution

If regressive taxation is followed, the inequalities may increase in the distribution of income and wealth, as the burden of taxation will fall more heavily on the poor than on the rich.

A toll-tax is regressive as the amount of the tax is the same for the rich and the poor, while the utility of money, which is paid in tax, is greater for the poor than the rich. A regressive tax thus tends to widen the gap of inequality.

b) Effects of Proportional Taxation on Distribution

Under proportional taxation, inequalities would continue as before, if the income remains the same. However, if the income changes in unequal proportions, the inequalities in income will increase.

c) Effects of Progressive Taxation on Distribution

Under the progressive system of taxation, inequalities would be reduced, because a higher proportion of the income and wealth of the rich would be taken away by taxes than that of poor. Hence, a sharply progressive tax system tends to reduce inequalities in the distribution of income and wealth.

Sharper the progression, greater is the tendency to reduce inequalities. Obviously, progressive system is desirable in order to bring about a more equitable distribution wealth. However, the tax system should be based on the principle of ability to pay. The higher the income of a person, the greater would be his ability to pay taxes and vice-versa.

People who get unearned income should be taxed at higher rate than poor because of their greater capacity to pay taxes. The progressive tax system may be designed in such a way that it may not have adverse effects on production.

In other words, tax system should be progressive to the highest income group, the middle income groups should be subjected to lower tax rates and the low income groups should be exempted from taxation.

1) Tax Rates

While fixing the rates of taxes, progression should be kept in mind. Higher taxes should be imposed on the richer section of society and revenue realized from the rich should be utilized for the benefit of the poorer section of the society by way of providing social amenities to them. In other words taxes should be progressive because sharper the progression, greater is the tendency to reduce inequalities.

2) Kinds of Taxes

Whether the effect of taxation is progressive, proportional or regressive in nature depends upon the kinds of taxes.

There are two kinds of taxes: direct tax and indirect taxes.

a) Indirect Taxes and Distribution

The burden of indirect taxes, like taxes on commodities is regressive in nature.

The commodities on which indirect taxes are imposed are widely consumed by the poor and they have to spend larger proportion of their income on such goods than rich. That is, propensity to consume is higher for the poor than that of rich. Hence, the burden of indirect taxes, like the tax on foodstuff, raw tobacco, cheap alcohol, etc., falls more heavily upon the poor than upon the rich.

However, the indirect taxes may be made progressive if the necessities are exempted from taxation and luxuries are subjected to higher rates of taxation so that the tax rates would be higher for the high priced goods. But it should be noted that purchase of luxury goods is optional. Hence, the rich can avoid the payment of these taxes by not purchasing such goods or by contracting their demand to some extent.

Therefore, indirect or commodity taxes in general are and regressive nature. Thus, inequalities of income and wealth can not reduced by these taxes.

b) Direct Taxes and Distribution

To bring about equitable distribution of income and wealth, all taxes which fall heavily or exclusively upon the richer section of society can have favorable distribution effects.

All direct taxes which are based on the principle of progression and ability to pay may have desire distributional effects.

Effects of Taxation on Stabilization

Economic stability may be judged by the behavior of prices. This does not mean that prices should remain static. Conversely there should be a normal rise in price because a normal rise in price is a sign of healthy economy.

Problem, however, arises whenever there are price fluctuations. These price fluctuations may be known as abnormal economic situations prevailing in the country. Economic stability also implies stability in the economic activity, output and employment. It also refers to the avoidance of inflationary and deflationary conditions.

Every government tries to overcome these problems through fiscal measures which is the safest and the durable course adopted by any government to control such situations.

There may be two abnormal economic situations:

- Inflation
- Deflation

Classification and choice of Taxes

Direct and Indirect Taxes:

Taxes are sometimes referred to as direct or indirect. The meaning of these terms can vary in different contexts, which can sometimes lead to confusion. In economics, direct taxes refer to those taxes that are paid by the person who earns the income. By contrast, the cost of indirect taxes is borne by someone other than the person responsible for paying them.

For example, taxes on goods are often included in the price of the items, so even though the seller sends the payments to the government, the buyer is the real payer. Indirect taxes are sometimes described as hidden taxes because the purchaser of goods or services may not be aware that a proportion of the price is going to the government.

I. Direct Taxes:

A direct tax is **paid by a person on whom it is levied.** In direct taxes, the impact and Incidence fall on the same person. If the impact and incident of a tax fall on the same person, it is called as direct tax. It is borne by the person on whom it is levied and cannot be passed on to others. For example, when a person is assessed to income tax or wealth tax, he has to pay it and he cannot shift the tax burden to anybody else.

In Ethiopia, Government levies the direct taxes such as income tax, tax on agricultural income, professional tax, land revenues, taxes on stamps and registrations etc. From the above discussion, it can be understood that the direct taxes levied in Ethiopia take the form of taxes on income and property.

II. Indirect Taxes

Under indirect taxes, the impact and incidence fall on different persons. It is not borne by the person on whom it is levied and can be passed on to others. For example, when the excise duty is levied on the manufacturer of cement, he shifts the burden of tax to the consumers by raising the selling price. Here the impact of excise duty falls on the manufacturer and the incidence on the ultimate consumers. The person who is required to pay the tax does not bear its burden. Thus, indirect taxes can be shifted.

Differences between Direct and Indirect Taxes:

Direct and Indirect taxes differ among themselves on the following grounds:

1. Shift ability of the Burden of Tax: In the direct taxes, the impact and incidence fall on the same person. It is borne by the person on whom it is levied and is not passed on to others. For example, when a person is assessed to income tax, he cannot shift the tax burden to anybody else, and he himself has to bear it. On the other hand, in the case of indirect taxes, the impact and incidence fall on different persons. It is not borne by the person on whom it is levied.

The burden of the tax can be shifted. For example, when the manufacturer of cement pays excise duty, he can shift the tax burden to the buyers by including the tax in the price of the cement.

2. Principle of Ability to Pay: Direct taxes conform to the principle of ability to pay. For example, now people having income above Birr.150 pm, only is liable to pay income tax.

But, indirect taxes are borne and paid by the weaker sections of the society also. As such, these taxes do not conform to the principle of ability to pay.

3. Measurement of Taxable Capacity:

In the case of direct taxes, tax-paying capacity is directly measured. For example, the taxable capacity for income tax is measured on basis of the income of the individual. On the other hand, in the case of indirect taxes, taxable capacity is measured indirectly.

The luxurious articles are levied at the higher rate of taxes on the assumption that they are purchased by the rich people. However, low rate is charged on the articles of common consumption.

4. Principle of Certainty: Direct taxes ensure the principle of certainty. Both the Government and the taxpayer know what amount is to be paid and the procedures to be followed .

But in the case of indirect taxes, it is not possible. The taxpayer does not know the amount of tax to be paid and the Government cannot predict the quantum of revenue generated from the indirect taxes.

5. Convenience: Direct taxes cause much inconvenience to the taxpayers since they are to be paid in lump sum. But the indirect taxes are paid by the consumers in small amounts as and when they purchase the commodities.

Moreover, the taxpayers need not follow any legal formalities in the payment of tax. Thus, indirect taxes are more convenient to them.

6. Civic Consciousness: People felt the burden of direct taxes directly. The taxpayer is conscious of his contribution to the Government and interested in knowing whether the tax paid by him is properly used or not. In this way, it creates civic consciousness among the taxpayers. But indirect taxes do not raise such consciousness among the taxpayers, because they pay the taxes indirectly.

7. Nature of Taxation: Direct taxes are progressive in nature. The rates of taxes go up with the increase in the tax base i.e. income of a tax payer. But rich and poor irrespective of their income equally pay indirect taxes. Thus, they are regressive in nature.

8. Removal of Disparity in Income and Wealth: Since the direct taxes are progressive in nature, they reduce the disparities of income and wealth among the people to a considerable extent.

But indirect taxes have a negative effect. Actually they are widening the gap between the rich and poor when they are levied on the goods of common consumption.

9. Examples: The examples for direct taxes are income tax, wealth tax, gift tax, estate duty etc. The examples for indirect taxes are customs duty, excise duty, sales tax, service tax etc.

THAK YOU