Incidence of Taxation

Taxes are not always borne by the people who pay them in the first instance. They are often shifted to other people. Tax incidence means the final placing of a tax. Incidence is on the person who ultimately bears the money burden of tax. According to the modern theory, incidence means the changes brought about in income distribution by changes in the budgetary policy.

Impact and Incidence: The impact of a tax is on the person who pays it in the first instance and the incidence is on the one who finally bears it. Therefore, the incidence is on the final consumers.

Incidence and Effects: The effect of a tax refers incidental results of the tax. There are several consequences of imposition of tax, for example, decreased demand.

Money Burden and the Real Burden: The money burden of a tax is represented by the total amount of money received by the treasury. For example, the consumer has to spend Rs. 50 more on sugar monthly, it is the money burden that he has to bear. But if he has to reduce his consumption of sugar it means there is a reduction in economic welfare. This inconvenience, pinching, sacrifice or in short the loss of economic welfare is the real burden of tax.

THEORIES OF TAX SHIFTING AND INCIDENCE

1. **Earlier Theories:** The earlier theories may be classified into:

   (a) Concentration or Surplus theory: According to concentration theory, each tax tends to concentrate on a particular class of people who happen to enjoy surplus from their products.

   (b) Diversion or Diffusion theory: The diffusion theory states that the tax eventually got diffused in the entire society. That is, the final placing of tax is not one but multiple. The process of diffusion took place through shifting or through process of exchange.

2. **Modern Theory:** According to modern theory, the concentration and diffusion theories are partially true. Actually there are both concentration and diffusion of taxes according to the conditions present. The modern theory seeks to analyse the conditions which bring about concentration or diffusion.

FACTORS DETERMINING TAX INCIDENCE

(a) Elasticity: While considering incidence we consider both elasticity of demand and elasticity of supply. If the demand for the commodity taxed is elastic, the tax will tend to be shifted to the producer but in case of inelastic demand, it will be largely borne by the consumer. In case of elastic supply, the burden will tend to be on the purchaser and in the case of inelastic supply on the producer.

(b) Price: Since shifting of the tax burden can only take place through a change in price, price is a very important factor. If the tax leaves the price unchanged, the tax does not shift.

(c) Time: In short run, the producer cannot make any adjustment in plant and equipment. If, therefore, demand falls on account of price rise resulting from the tax, he may not be able to reduce supply and may have to bear the tax to some extent. In the long run, however, full adjustment can be made and tax shifted to the consumer.

(d) Cost: Tax raises the price; rise in price reduces demand and reduced demand results in the reduction of output. A change in the scale of production affects cost and the effect will vary according as the industry is decreasing, increasing or constant costs industry. For instance, if the industry is subject to decreasing cost, a reduction in the scale of production will raise the cost and hence price, shifting the burden of the tax to the consumer.

(e) Nature of tax: The incidence of taxation will definitely depend on the nature of tax. For example, an indirect tax's burden is fall on the consumer.

(f) Market form: Another factor determining the incidence of taxation is the market form. Under perfect competition, no single producer or single purchaser can affect the price; hence shifting of tax in either direction is out of the question. But under monopoly, a producer is in a position to influence price and hence shift the tax.

DISTINCTION BETWEEN DIRECT AND INDIRECT TAXES

A direct tax is not intended to be shifted, whereas an indirect tax is so intended.

Taxes on commodities are generally called indirect taxes as they completely or partially shifted consumers. But it should be remembered that all the commodity taxes are not indirect taxes. A tax is said to be indirect if its burden is shifted finally to the consumer.

Direct tax is the tax in which the commodity is taxed by the government, yet its price remains unaffected or changed. In this case the tax is not shifted to consumer and the tax will be called direct tax. If the tax is shifted, the tax is indirect, otherwise indirect.

MERITS AND DEMERITS OF DIRECT AND INDIRECT TAXES

Merits of Direct Tax:

1. **Equitable**, i.e., the principle of progression is applied
2. **Economical**, i.e., the cost of collection is small
3. **Certain**, i.e., the direct tax can be calculated with a fair degree of precision
4. **High degree of elasticity**, i.e., the direct tax can be raised much easily
5. **Civic consciousness**, direct tax creates civic consciousness among tax-payers
6. **Reduction of inequalities**, i.e., the objective of direct tax is to reduce economic inequalities by taxing higher income earners at progressive tax rates.

Demerits of Direct Tax:

1. **Inconvenient:** for the tax payer to pay and file the income tax return
2. **Unpopular tax system**
3. **Tax evasion is common**
4. **Unarbitrary tax rates**

Merits of Indirect Tax:

1. **Convenient:** for the tax payer to pay and it requires no filing of returns
2. **No tax evasion**
3. **Unified tax rate**
4. **Beneficial social effects** (in case of harmful drugs and intoxicants)
5. **Capital formation**
6. **Re-allocation of resources**
7. **Wide coverage**

Demerits of Indirect Tax:

1. **Uncertain**
2. **Regressive**
3. **No civic consciousness**
4. **Inflationary**
5. **Loss of economic welfare**

INCIDENCE OF SOME TAXES

Taxes on Personal Income:

1. Income tax, super tax and excess profit tax are all direct taxes and generally cannot be shifted.

2. However, the business is in a strong position and can shift a part of his tax burden to his customers. But this situation is rarely present and the income tax payer must bear the burden of tax.

3. If the income tax is extremely heavy, it may discourage saving and investment. However, it will mainly depend on whether the tax falls on average income or marginal income, the effects would be adverse. If the increase in tax is fall on marginal income, it will mean a positive discouragement to the earning of that income.

Corporate Tax:

1. Corporate tax discourages investment, level of national income and employment.

2. A corporation tax, by reducing the earnings of the existing firms, discourages the entry of new firms into the industry which may result in a monopoly or a semi-monopoly for the existing firms with all the attendant evils.

3. A part of corporate tax may be shifted to the buyers through a price rise.

Tax on Profits:

1. Some economists are not of the view that the tax on profit should be shifted to buyers. It should be borne by the seller who pays it.

2. The second view does not subscribe with the above approach. It is argued that normal profit is a part of the cost and when the entrepreneur is able to influence the price, the tax is generally shifted to the consumer.

3. However, the tax on profit in the form of a licence duty will be borne by the producer.

Wealth Tax:

1. Wealth tax is imposed on value of a person's stock of wealth

2. By enabling the government not to raise the income tax rates too high, the wealth tax encourages investment in modern industries

3. Another obvious effect of wealth tax is the reduction of economic inequalities by reducing the size of inherited wealth

Property Tax:

1. The wealth tax is imposed on the net worth of the individual. Whereas, the property tax is levied on the gross amount of assets' value

2. There is no shifting of tax and the incidence is on the person on whom the tax is levied. However, the tax on productive property may be shifted to consumers.

Land Taxation:

1. The value of land depends on two sets of factors:

   (a) Natural factors like the fertility of the soil, the situation of the land, some other natural conditions, and
   (b) Investment of capital in drainage schemes, anti-erosion measures, irrigation facilities and other measures necessary to increase and sustain productivity

2. The tax on the first set is a tax on economic rent and has a tendency to fall on the owners

3. But when the owner can vary his investment when the tax increases, he can shift the tax burden to the consumer.

Tax on Buildings:

1. If the tax is imposed on the owner, he will try to raise the house rent and thus shift the tax to the occupier or tenant. But he cannot do this during the currency of the lease.

2. A heavy tax will check building activity and the remuneration of the builder and of other people engaged in the trade may fall

3. The tax may fall partly on the owner, partly on the builder and partly on the occupier

Death Duty:

1. Death duty may take two forms, i.e., Estate Duty and Succession Duty

2. The Estate Duty is levied on the total value of the estate (i.e., movable and immovable property) left by the deceased irrespective of the relationship of the successor

3. The succession duty varies with the relationship of the beneficiary to the deceased. It takes into consideration individual share of the successor and not the total value as in the estate duty.

Tax on Monopoly:

1. The monopoly tax may be:

   (a) Independent of the output of the monopolised product, or
   (b) It may vary with the output, i.e., increase or decrease with the output

2. When the tax is independent of the quantity produced, it may either be lump sum tax on the monopolist or a percentage of the monopoly net revenue (profits). In both cases it will be borne by the monopolist and he cannot shift the same to the consumer, because the monopolist is already on a price with maximum beyond which his profit will decline

3. In the second case, the price of the commodity or incidence of taxation will depend on the elasticities of supply and demand, and the influence of laws of returns.

4. Taxing of the commodity, therefore raises the price which will tend to reduce the demand

5. If, however, the demand is inelastic, it cannot be appreciably reduced and the tax will be borne by the consumer.

6. If the demand is elastic, the consumers may buy less when the tax has raised the price. Instead of facing a decline in demand the monopolist may reduce the price and decide to bear the tax himself.

Commodity Tax:

1. Taxes on commodities may take several forms:

(a) Tax on manufacture or production of a commodity called excise duties,
(b) Tax on sale of a particular commodity known as sales tax, and
(c) Import or export of commodities known as custom duties.

2. The commodity tax is tended to be shifted to the consumer and from consumer to the producer

3. Tax on production tends to raise the prise and will therefore be normally borne by the consumer

4. But the consumption tax is likely to check consumption and tends to be shifted backward to the producer.

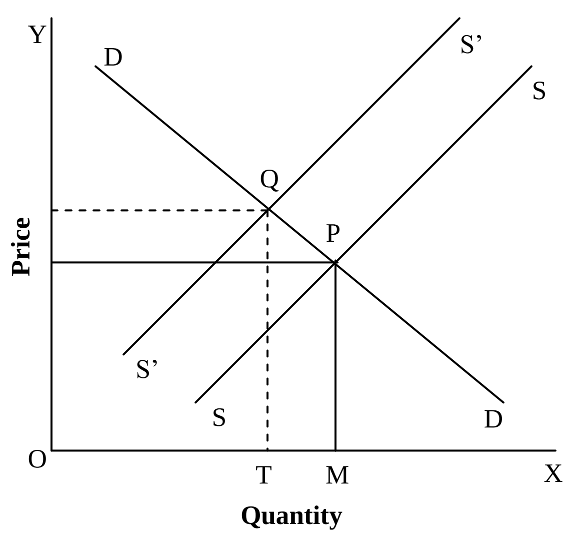
5. Therefore, the tax on commodity will be partly borne by the producer and partly borne by the consumer

6. The portions of commodity tax to be borne by the producer and consumer depends on the degree of elasticity of demand and supply:

Elasticity	**Incidence**
Elastic demand	More tax burden on the supplier / producer
Inelastic demand	More tax burden on the buyer / consumer
Elastic supply	More tax burden on the buyer / consumer
Inelastic supply	More tax burden on the supplier / producer

7. As a rule, the consumer bears a smaller part of the tax when the demand is more elastic than the supply

8. This may happen that the price may not rise at all. This is because the consumers have been able to discover an untaxed supply of the commodity or substitute. In this case, the tax burden will fall on the producer.



9. DD and SS intersect at point P and MP is the price determined. Now suppose a sales tax per unit is levied. As a result the supply curve of the commodity will rise upward equal to the tax per unit. The new supply curve will be S'S'. The distance between the two supply curves represents the tax per unit of the commodity. S'S' cuts the demand curve DD at Q and, therefore, now TQ is the price determined which is higher than the old price PM by RQ. Hence RQ is the burden of tax borne by the consumer even though the tax per unit is LQ. Therefore, RL (LQ – QR) is the burden of the tax borne by the seller or he has RL price less than before (PM being the first price).

10. Therefore the commodity tax is distributed between the buyers and sellers according to the ratio of elasticities of demand and supply:

$$\frac{RL}{RQ} = \frac{\textit{Burden of the tax on the seller (producer)}}{\textit{Burden of the tax on the buyer (consumer)}}$$

$$Ed = \frac{\textit{Proportionate decrease in quantity demanded}}{\textit{Proportionate increase in price}}$$

$$= \frac{MT}{OM} \div \frac{RQ}{MP}$$

$$= \frac{MT}{OM} \times \frac{MP}{RQ} \text{ ---------------------------------- } (i)$$

$$Es = \frac{\textit{Proportionate decrease in quantity supplied}}{\textit{Proportionate decrease in price}}$$

$$= \frac{MT}{OM} \div \frac{RL}{MP}$$

$$= \frac{MT}{OM} \times \frac{MP}{RL} \text{ ------------------------------------- } (ii)$$

$$= \frac{\textit{Elasticity of Demand (Ed)}}{\textit{Elasticity of Supply (Es)}}$$

$$= \frac{(i)}{(ii)}$$

$$= \frac{\frac{MT}{OM} \times \frac{MP}{RQ}}{\frac{MT}{OM} \times \frac{MP}{RL}}$$

$$= \frac{RL}{RQ}$$

11. In the above equation, RL is the burden of the tax on the seller and RQ is the burden of tax on the buyers. Hence:

$$\frac{RL}{RQ} = \frac{\textit{Burden of tax on the seller}}{\textit{Burden of tax on the buyer}}$$

$$= \frac{\textit{Elasticity of demand (Ed)}}{\textit{Elasticity of supply (Es)}}$$

Sales Tax:

1. The sales tax is levied on the turnover, profits or no profits. It covers a wide variety of commodities.

2. the sales tax may make heavy inroads into profits which may lead to retrenchment in the staff and management, restrict enterprise and employment and hamper utilisation of resources.

3. thus, its incidence may fall upon employees, management and landlords.

Import Duties and Export Duties:

1. Import Duties are generally borne by the home consumer

2. if the demand for the imported product is elastic and the supply is inelastic and the foreign producer has no alternative market, then in such a case the burden of tax may be shifted to foreign seller. This situation is rarely present.

3. export duty is borne by the exporter. The price in the world market is fixed and no individual exporter is in a position to influence the world price.

4. there are certain exceptional situations in which the purchaser may bear the burden of export duty. For example, the supplier or the producer has the monopoly of the supply of a commodity.

EFFECTS OF TAXATION ON PRODUCTION, CONSUMPTION AND DISTRIBUTION

Effects on Production:

1. Production is affected by taxes in two ways:

(a) By affecting the ability to work, save and invest
(b) By affecting the desire to work, save and invest

2. A tax on necessaries of life, will obviously affect the workers' productivity and hence reduce production. A heavy tax on income tends to reduce the ability to save and invest on part of individuals. A decrease in investment is bound to affect adversely the level of output in the country

3. normally taxation induces people to work harder, earn more, save more and invest more to increase their income and enjoy the same income after tax

4. some taxes has no adverse effects, for e.g., import duties, tax on monopolists, etc.

5. high marginal rates of income tax are likely to affect adversely the tax payers' desire to work, save and invest

6. the reaction varies from individual to individual. It depends on the individual's elasticity of demand for income. When it is fairly elastic, the tax will lessen his desire to work and save

7. entrepreneurs may avoid the production of goods which are taxed. There is likely to be a diversion of resources from some sectors of economy to others

Effects on Income Distribution:

1. The effects of taxes on income distribution depends on the type of taxes and rates of taxes

2. taxation of goods of mass consumption is regressive and redistributes incomes in favour of rich.

3. but if such commodities are exempted and luxuries are taxed, and the taxation is made progressive, then the income will be redistributed in favour of poor.

Effects on Consumption:

1. By imposing tax on a consumable good which is injurious to health, its consumption can be checked.

2. similarly the tax on luxury goods can decrease their consumption and resources diverted to the production of mass consumption