

CHAPTER ONE

Introduction to Tax and Law of Taxation

- Theories of State and Government
 - Force theory
 - Evolution theory
 - Divine right theory
 - Social Contract theory
- Necessity of Government
- Power of Government /sovereign Power of Government
- Function and Role of Government
 - Individualist/Mechanistic view
 - Individual is at the center and state is created to serve interest of individuals
 - Organic View
 - Individuals do not have separate existence
 - This view does not allow individuals to have separate goals.¹¹ Rather only the state can decide what is best for members of the society and individuals as members of the society are expected to act according to what they are ordered by the state. Hence, there is nothing the individual keeps for themselves away from the state as the state can take whatever it wishes from its members. This view considers national goals more important than the goals of individual citizens.
 - Paternalistic View
 - According to this view, the state has the mandate to make some important decisions, even if the decisions may go beyond the wishes of the majority of current voters.
 - Under this view, it is believed that the policymakers sometimes know what is good for the country and the society better than the average citizen just like what the father knows best for his children. The paternalistic view enables governments to implement policies that restrict the choice of individuals in their own interest and without their consent. In state paternalism, governments are allowed to intervene in citizen activity within their jurisdictions to promote, modify, hinder and/or eliminate that activity with the justification that such intervention is for the benefit of the individuals, groups and the whole society. Dworkin in his article explained paternalism as “the interference with a person’s liberty of action justified by reasons referring exclusively to the welfare, good, happiness, needs, interests or values of the person being coerced. This theory is criticized for denying the humanity of individuals and for failing to recognize the capabilities of individuals of acting in their own best interest and restricting personal freedom.
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 - The Practice: the government must play a role in the economy
- Reasons for Government Participation in the Economy

- o The need to provide Public Goods;
 - non-excludability and non-rivalrness
- o The need to provide Merit Goods
- o The Need for Redistribution
- o The need to correct market failure
 - monopolies, missing markets, information asymmetry, positive externality and negative externality
- Government Policy
 - o Monetary Policy
 - o Fiscal Policy /Public Finance
 - Public Revenue
 - Tax Revenue
 - Non-Tax Revenue
 - o Administrative Revenue
 - o Commercial Revenue
 - o Such as Fee, Price, Fine, Aid, Grants etc.
 - Public Expenditure
 - Public Debt/Borrowing
 - Public Financial Administration
 - Fiscal Adjustment

Any government in the world, past and present, cannot discharge its responsibilities and exercise its powers without raising public revenues. Public revenues are generally divided into tax revenues and non-tax revenues.

- ✓ Non-tax revenues are various sources of revenue for government such as prices, fees, fines, grants or aids borrowing, special assessment and the like
- ✓ Various aspects of tax revenue account for the lion's share of public revenues provided a country does have the necessary legal and institutional framework to raise taxes.

Tax Law (s) is a branch of public law that deals with legal aspects of taxation. Tax law or law of taxation is principles, norms, rules and regulations that govern and determine what to be taxed (transaction, property, income, expenditure, wealth), who to be taxed (taxpayer i.e. individual, entities company, partnership etc.), when and how to be taxed (time and manner of payment), how to be paid and collected. It is a collection of international and national laws as well as substantive law, procedural law and administrative law. It is an interdisciplinary subject that includes law, economics, accounting, public administration and political science. As important sources of public

revenue, taxes are very important part of the daily functioning of a government. The laws that govern taxation may emanate from the three sources namely legislative, administrative and judicial. Most Ethiopian tax laws however emanate from legislative sources.

1.1. Definition and Features of Tax

- No universally accepted definition of tax.
- Taxes are defined from the perspective of tax payer, government or theory

BLACK'S LAW DICTIONARY

Tax: a monetary charge imposed by the gov. on persons, entities or property to yield public revenue. Most broadly, the term embraces all governmental impositions on the person, property, privileges, occupations, enjoyment of the people, and includes duties, imposts, and excises. Although a tax is often thought of as being pecuniary in nature, it is not necessarily payable in money.

"Taxes are enforced proportional contributions from persons and property, levied by the state by virtue of its sovereignty for the support of government and for all public needs. While this definition of taxes often referred to as 'Cooley's definition of taxes characterizes them as 'imposts, charges,' burdens', or 'exactions.

➤ Different writers define tax differently.

According to a writer called Hugo Dalton, an economist "a tax is a compulsory contribution imposed by a public authority, irrespective of the exact amount of service rendered to the tax payer in return, and not imposed as a penalty for any legal offence."

- COMPULSORY CONTRIBUTION: NOT VOLUNTARY. no one can refuse to pay a tax
- Contribution: sacrifice from personal property
- By taxpayer: person, entities
- IMPOSED BY GOVERNMENT/PUBLIC AUTHORITY: THE POWER TO TAX
- NO QUID PRO QUO: unrequited
- FOR PUBLIC PURPOSE

Again to emphasize the compulsory element in tax the author states, “a tax, by definition, is a payment, in return for which no direct and specific quid pro quo (give and take) is rendered to the payer.”

- ✓ From this definition, it is possible to understand that tax is a compulsory charge that is imposed on taxpayers without obtaining their consent. Therefore, failure to pay tax is a criminal offence punishable by law.

However, it is good to take note of the fact that the existence of compulsory nature of the payment may not necessarily make the payment a tax. There is another element that should be fulfilled.

The payment of tax does not entitle the payer to demand direct and definite benefits. However, we should bear in mind that the general public as a taxpayer can demand the government to do something although they cannot demand this individually. The tax collected by the government of a given country is to be used to finance the various objectives of government which will have benefits to the society at large.

- According to Prof. Taylor “taxes are compulsory payments to governments without expectations of direct return or benefit to the tax payer”.
- Prof. Bastable “defined a tax as a compulsory contribution of the wealth of a person for the service of public power”. According to Taussing “the essence of a tax as distinguished from other charges by government is the absence of a direct ‘quid-pro-quo’ between the tax payer and the public authority”.

Dr. Dalton opines that “a tax is a compulsory contribution imposed by the public authority irrespective of the exact amount of service to the tax payer in return and not imposed as a penalty for any legal offence”.

Prof. Adams gave a Comprehensive definition of a tax stressing the various aspects of tax. He say “from the standpoint of view of the state, a tax is a source of derivative revenue, from the angle of the citizen a tax is a coerced payment, from the administrative point of view it is a demand for money by state in conformity to established rules from the point of view of theory a tax is a contribution from individuals for common expenditure.

Another acceptable definition was given by Prof. Seligman; “tax is a compulsory contribution from the person to the government, to defray the expenses incurred in the common interest of all without reference to special benefit conferred”.

A tax is a leakage from the circular flow of income into the public sector. It is paid by individuals, corporations and other associations of individuals. It represents a payment out of the income of the people.

Basic Characteristics of a Tax:

From the above definitions, we can meaningfully derive some basic characteristics of a tax.

1. It is a compulsory contribution. Even though a tax is paid willingly, in a sense it is a compulsory contribution. It only means that no one can refuse to pay a tax, on the general ground that he doesn't derive any benefit from certain state services. A tax is levied on the basis of same predetermined criteria such as equity. Seligman emphasizes that compulsory contribution is enforced without reference to special benefits conferred.
2. The fact that tax is a contribution implies the notion of a sacrifice involved on the part of the contributor.
3. Tax payment is a personal obligation. Prof. Lutz rightly point out that the obligation to pay tax is a personal responsibility of the taxpayer. This personal obligation to contribute to the states support is universal and applies to all. This does not mean that all taxes must be levied on persons or objects of taxation. As a matter of fact, taxes are actually based on a great variety of material things as well as non-material and intangible form of wealth. The meaning is that the primary obligation to pay the tax is a personal obligation.
4. A tax is levied according to certain legal requirements.
5. The amount of tax is not fixed with reference to the exact benefit which a taxpayer receives from public service. In other words there is no element of quid-pro-quo in the payment of tax.
6. A tax is paid out of the income of the taxpayer.
7. The power of taxation is mainly to be used for collecting revenue to the state. Writers like Prof. Lutz are of the opinion that the modern concept of taxation emphasizes positively that it should be used for the purpose of providing public revenue and that it apparently does not give a positive

sanction to the use of the taxing power for the accomplishment of ulterior objects

Objectives, purposes and Function of Taxation

- Revenue generation
- Redistribution of wealth and reduction of income inequality (progressive taxation)
- Regulatory function: regulate and control certain consumption (excise tax), protect domestic industry (custom duty)
- Incentive objective to stimulate flow of resource and investment (tax holiday)
- Reducing Consumption of Harmful and Luxury Products (Excise Tax)
- Encourage Export and Protect Domestic Infant Industry (Custom Duty)
- Reduce Regional Imbalance (Tax Incentive such as Tax Concession, Exemption and Tax Holiday)
- **“Allocation function,” the “distribution function” and the “stabilization function”**

Theories and Canons of Taxation

Taxation involves compulsion and taking personal property of citizen which goes against fundamental right to property. So how do we justify taxation or legitimacy of taxation?

Theories justifying taxation

In assessing why states raise taxation, the first consideration is the justification for a state to raise tax (i.e. the legitimacy of the tax).

In assessing whether tax is justified, numerous theories have evolved over the years, ranging from

- (i) an emergency levy, to fund particular identified state expenditures;
- (ii) (ii) the benefit theory, which implies that all individuals should contribute to the state from which they receive protection and benefits;
- (iii) the social contract, according to which all must contribute to the greater good of the community; and
- (iv) (iv) the sacrifice theory, according to which all individuals should contribute in accordance with the wealth they generated (the precursor to progressive tax rates) in order for the state to redistribute (to some extent) that wealth.
 - a. Absolute Sacrifice, Proportional and Minimal Sacrifice

- (v) Necessity theory of taxation proceed upon the theory that the existence of government is a necessity; that it cannot continue without the means to pay its expenses; and that for those means, it has the right to compel all citizens and properties within its limits to contribute.

The fact that taxes are raised by the state in terms of the enacted law implies that there should be some limitation to tax as well. Three key principles emerge, namely the following:

- taxes should not erode capital. Erosion of capital will lead to reduced income in the future, which ultimately could destroy the productive economy;
- taxes should not exceed that which is needed to fund the public needs. This implies that taxes should fund service delivery and (efficient) administering of those services; and
- however justifiable the tax may be, if it costs more than what the levied tax would collect, it should not be levied. It is critical that the government service be delivered efficiently, as excessive taxation to fund excessive expenditures or inflated government services cannot be justified.

Theories of distribution of tax burden

- How to distribute tax burden among societies?
- **Benefits received** - in proportion to the benefits received by a taxpayer from government expenditure
 - Against features of tax (it makes it voluntary, quid pro quo;
 - Forget the nature of public goods;
 - How to quantify 'benefit'
- Taxpayers should receive benefits from the tax they paid, but, cannot be asked individually

- **(i) Benefit Received Theory:**

- According to this theory, the state should levy taxes on individuals according to the benefit conferred on them. The more benefits a person derives from the activities of the state, the more he should pay to the government. This principle has been subjected to severe criticism on the following grounds:
- **Firstly**, If the state maintains a certain connection between the benefits conferred and the benefits derived. It will be against the basic principle of the tax. A tax, as we know, is compulsory contribution made to the public authorities to meet the expenses of the government and the provisions of general benefit. There is no direct *quid pro quo* in the case of a tax.
- **Secondly**, most of the expenditure incurred by the state is for the general benefit of its citizens, It is not possible to estimate the benefit enjoyed by a particular individual every year.
- **Thirdly**, if we apply this principle in practice, then the poor will have to pay the heaviest taxes, because they benefit more from the services of the state. If we get more from the poor by way of taxes, it is against the principle of justice.
- **Cost of service** - semi-commercial relationship between the state and the taxpayers
 - Tax payers not entitled to benefits/if receive must pay the cost thereof.
- Similar defects with benefits received
- Hard to measure the cost of state services and assigning them to the proper beneficiaries
- Balanced budget policy – a good lesson

- **(ii) The Cost of Service Theory:**

- Some economists were of the opinion that if the state charges actual cost of the service rendered from the people, it will satisfy the idea of equity or justice in taxation. The cost of service principle can no doubt be applied to some extent in those cases where the services are rendered out of prices and are a bit easy to determine, e.g., postal, railway services, supply of electricity, etc., etc. But most of the expenditure incurred by the state cannot be fixed for each individual because it cannot be exactly determined. For instance, how can we measure the cost of service of the police, armed forces, judiciary, etc., to different individuals? Dalton has also rejected this theory on the ground that there is no quid pro qua in a tax.
- **Ability to Pay** - tax burden apportioned according to the relative ability to pay
- Equitable burden distribution
 - Horizontal equity - those with equal means
 - Vertical equity - those with different means
- The widely accepted theory
- How to measure ability to pay?
 - **Wealth:** the amount of accumulated wealth.
 - No more a primary test of ability to pay - the development of money economy
 - But not totally abolished. Still there are taxes on property such as land use fee.
 - **Consumption/expenditure**
 - Favors the miser and would reduce the amount of revenue
 - e.g. VAT, TOT

- **Income:** the income received during any given period of time
- Income is widely used to test ability to pay
- **(iii) Ability to Pay Theory:**
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- The most popular and commonly accepted principle of equity or justice in taxation is that citizens of a country should pay taxes to the government in accordance with their ability to pay. It appears very reasonable and just that taxes should be levied on the basis of the taxable capacity of an individual. For instance, if the taxable capacity of a person A is greater than the person B, the former should be asked to pay more taxes than the latter.
- It seems that if the taxes are levied on this principle as stated above, then justice can be achieved. But our difficulties do not end here. The fact is that when we put this theory in practice, our difficulties actually begin. The trouble arises with the definition of ability to pay. The economists are not unanimous as to what should be the exact measure of a person's ability or faculty to pay. The main view points advanced in this connection are as follows:
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- **(a) Ownership of Property:** Some economists are of the opinion that ownership of the property is a very good basis of measuring one's ability to pay. This idea is out rightly rejected on the ground that if a persons earns a large income but does not spend on buying any property, he will then escape taxation. On the other hand, another person earning income buys property, he will be subjected to taxation. Is this not absurd and unjustifiable that a person, earning large income is exempted from taxes and another person with small income is taxed?
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- **(b) Tax on the Basis of Expenditure:** It is also asserted by some economists that the ability or faculty to pay tax should be judged by the expenditure which a person incurs. The greater the expenditure, the higher should be the tax

and *vice versa*. The viewpoint is unsound and unfair in every respect. A person having a large family to support has to spend more than a person having a small family. If we make expenditure as the test of one's ability to pay, the former person who is already burdened with many dependents will have to pay more taxes than the latter who has a small family. So this is unjustifiable.

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- **(c) Income as the Basics:** Most of the economists are of the opinion that income should be the basis of measuring a man's ability to pay. It appears very just and fair that if the income of a person is greater than that of another, the former should be asked to pay more towards the support of the government than the latter. That is why in the modern tax system of the countries of the world, income has been accepted as the best test for measuring the ability to pay of a person.

Principles of taxation

- How to make the tax system good? Features of good tax system?
 - **Efficiency vs. equity**
- **The following canons** make the system efficient/equitable
- Adam Smith's four canons
- **Equality/ability**; the subjects of every state ought to contribute towards the support of the government, as nearly as possible, **in proportion to their respective ability**.
 - **Every one** who 'have' must contribute
 - The contribution must be **based on their relative ability**
- **Certainty/predictability**; the tax to be imposed ought to be certain and not arbitrary. Well informed about;

- Time of payment,
- Manner of payment,
- Rate, etc.
- Protection against arbitrary or random act
- The taxpayer ought to know the amount, time, manner and rate of payment. To adjust/arrange in advance income and expenditure
- The government also needs to be certain how much tax to collect
- If the tax is 'certain' the taxing authority cannot exploit the taxpayer in any manner.
- **Convenience**; consider the maximum of convenience of the taxpayers
 - Because taxpayer make sacrifice by paying tax. So must be treated with less inconvenience
 - Time - when most likely to have means to pay
 - Place
- **Economy**; minimize costs/bring the maximum part of the collected revenue into the government treasury
 - Administrative costs - incurred to collect taxes
 - Compliance costs - incurred to comply with tax obligations
 - Excess burden
- Other principles (in addition to Adam's)

- **Productivity**; raise enough tax revenue for the expenditure needs of a government
 - Deficit financing - finance through borrowing
 - Better to levy a few productive taxes than unmanageable number of unproductive taxes
- **Elasticity/flexibility**; able to increased/decreased tax as the necessity of the state expenditure comes
 - Increase the rate, base.
- **Diversity/Variety**; comprise multiple types of tax (reasonable). Helpful to;
 - increase government's revenue,
 - address policy matters,
 - mitigate total tax evasion
- **Simplicity**; tax statutes shouldn't be complex. Understandable by average taxpayers without help of experts. Organization,
 - Should be plain, easy understandable
 - Code - coherent, eliminates duplicative provisions, facilitates compliance (taxpayers have all the tax laws before them to consult). Fit to rules endure the test of time.
 - Scattered laws
 - Consolidation - careful organization of separate tax laws with cross references. Rules of general application (general revenue) along with individual tax legislations.

- **Co-ordination/uniformity**; where taxes imposed by various governments
 - Federal countries/fiscally decentralized countries
 - Horizontal/vertical competition - if negative (race to the bottom)
- **Tax neutrality/non-distortionary**: leave before tax behaviour the same/lessen shift of behaviour
 - Presumption- before tax there is optimal (balanced) economic behaviour
 - Broader base, lower rate - instruments
- **Canons/Principles of Taxation By Adam Smith:**
 - **Adam smith**, the father of modern political economy, has laid down **four principles or cannons of taxation** in his famous book "Wealth of Nations". These principles are still considered to be the starting point of sound public finance. Adam Smith's celebrated cannons of taxation are:
 - (1) Canon of equality or ability, (2) Canon of certainty, (3) Canon of convenience, and (4) Canon of economy.
 - **(1) Canon of equality or ability**: Canon of equality, or ability is considered to be a very important canon of taxation. By equality we do not mean that people should pay equal amount by way of taxes to the government. By equality is meant equality of sacrifice, that is people should pay taxes in proportion to their incomes. This principle points to progressive taxation. It states that the rate or percentage of taxation should increase with the increase in income and decrease with the decrease in income. In the words of **Adam Smith**:
 - "The subject of every state ought to contribute towards the support of the government as early as possible in proportion to their respective abilities that is in proportion to the revenue which they respectively enjoy under the protection of the State".

- **(2) Canon of certainty:** The Canon of certainty implies that there should be certainty with regard to the amount which taxpayer is called upon to pay during the financial year. If the taxpayer is definite and certain about the amount of the tax and its time of payment, he can adjust his income to his expenditure.
- The state also benefits from this principle, because it will be able to know roughly in advance the total amount which it is going to obtain and the time when it will be at its disposal. If there is an element of arbitrariness in a tax, it will then encourage misuse of power and corruption **Adam smith** in this connection remarks:
 - "The tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid all ought to be clear and plain to the contributor and to every other person".
 - **(3) Canon of convenience:** By this canon, **Adam smith** means that the tax should be levied at the time and the manner which is most convenient for the contributor to pay it. For instance, if the tax on agricultural land is collected in installments after the crop is harvested, it will be very convenient for the agriculturists to pay it. Similarly, property tax, house tax, income tax, etc., etc., should be realized at a time when the taxpayer is expected to receive income. The manner of payment of tax should also be convenient. If the tax is payable by cheques, the contributor will be saved from much inconvenience. In the Words of **Adam Smith:**
 - "Every tax ought to be levied at the time or in the manner in which it is most likely to be convenient for the contributor to pay it".
- **(4) Canon of Economy:** The canon of economy implies that the expenses of collection of taxes should not be excessive. They should be kept as little as possible, consistent with administration efficiency. If the government appoints highly salaried, staff and absorbs major portion of the yield, the tax will be considered uneconomical. Tax will also to regarded as uneconomical if it checks the growth of capital or causes it to emigrate to other countries, In the words of **Adam Smith:**
 - "Every tax is to be so contrived as both to take out and keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state".
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- **Some other Canons/Principles of Taxation Rather Than Adam Smith:**
- Some writers on Public Finance have formulated **four other important canons/principles of taxation.** They, in brief, are as follows:

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- **(1) Canon of productivity:** The canon of productivity indicates that a tax when levied should produce sufficient revenue to the government. If a few taxes imposed yield a sufficient fund for the state, then they should be preferred over a large number of small taxes which produce less revenue and are expensive in collection.
- **(2) Canon of elasticity:** Canon of elasticity states that the tax system should be fairly elastic so that if at any time the government is in need of more funds, it should increase its financial resources without incurring any additional cost of collection. Income tax, railway fares, postal rates, etc., are very good examples of elastic tax. The government by raising these rates a little, can easily meet its rising demand for revenue.
- **(3) Canon of simplicity:** Canon of simplicity implies that the tax system should be fairly simple, plain and intelligible to the tax payer. If it is complicated and difficult to understand, then it will lead to oppression and corruption.
- **(4) Canon of diversity:** Canon of diversity says that the system of taxation should include a large number of taxes which are economical. The government should collect revenue from its citizens by levying direct and indirect taxes. Variety in taxation is desirable from the point of view of equity, yield and stability.
- **Impact and Incidence of Taxation:**
- **Definition of Incidence of Tax:**
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- One of the very important subject of taxation is the problem of **incidence of a tax**. By incidence of taxation is meant final money burden of a tax or final resting place of a tax. It is the desire of every government that it should secure justice in taxation, but if it does not know as to who ultimately bears money burden of a tax or out of whose pocket money is received, it cannot achieve equality in taxation. If government knows who pays tax, it can evolve an equitable tax system. It can easily tap important sources of taxation and thus can collect large amount of money without adversely affecting economic and social life of the citizens of the country.
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- **Definition of Impact of Tax:**
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- **Impact of a tax** is on person from whom government collects money in first instance. While incidence of a tax is on person who finally bears burden of a tax.
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- **Explanation:**
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- To make it more clear, we take an **example**. Suppose government levies a tax on electric goods in USA. Tax will be paid to Government in first instance by manufacturers of electric goods. Impact of tax is, therefore, on them. If manufacturers of electric goods industries add tax to price and succeed in selling goods at higher prices of electric goods to consumers, burden of tax is thus shifted on to consumers.
- Incidence is Different From Shifting:
- Incidence is final resting place of a tax while **shifting** is process of transferring money burden of tax to someone else. Shifting finally ends in incidence. When a person on whom tax is levied tries to shift tax on to the other, he may succeed in shifting tax completely, partly, or may not succeed at all. Shifting of tax can take place in two directions, forward and backward. If tax is shifted, from seller to consumer, it is a case of **forwarding shifting**.
- **Backward shifting** takes place when consumers do not purchase commodities at increased prices. Sellers are! then forced to cut down prices and bear burden of tax themselves. Backward shifting is thus performed by buyers.
- Incidence and Effect of a Tax:
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- Before we proceed further it seems necessary that we should distinguish the concept of incidence from effect. As stated earlier incidence is direct money burden of a tax. Effect of taxation is repercussions or consequences! of imposition of a tax on individuals and on community in general.
- **Direct Tax and Indirect Tax:**
- There are two main types of taxes (1) **direct tax** and (2) **indirect tax**.
- **Definition and Explanation of Direct Tax:**
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- A tax is said to be **direct tax** when [impact and Incidence of a tax](#) are on one and same person, i.e., when a person on whom tax is levied is the same who finally bears the! burden of tax.
- For Instance, income tax is a direct tax because impact and incidence falls on the same person.

- If impact of tax falls on one persons and incidence on the another, the tax is called indirect.
- For example, tax on saleable articles is usually an indirect tax because it can be shifted on to the consumers.
- Merits of Direct Tax:
 - (i) Direct taxes afford a greater degree of progression. They are, therefore, more equitable.
 - (ii) They entail less expenses on collection and as such are economical.
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 - (iii) They satisfy canons of certainty, elasticity, productivity and simplicity.
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 - (iv) Another advantage of direct taxes is that they create civic consciousness in people. When a person has to bear burden of tax, he takes active interest in affairs of state.
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- Demerits of Direct Tax:
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 - (i) It is easy to evade a direct tax than an indirect tax. Taxpayer is seldom happy when he pays tax. It pinches him that his hard-earned money is being taken by government. So he often submits false statements of his income and thus tries to evade tax. Direct tax is in fact a tax of honesty.
 - (ii) Direct tax is very inconvenience because taxpayer has to prepare lengthy statements of his income and expenditure. He has to keep a record of his income up-to-date throughout the year. It is very laborious for taxpayer to prepare and keep these records.
 - (iii) Direct tax is to be paid in lump sum every year while income which a person earns is received in small amounts. It often becomes difficult by taxpayers to pay large amounts in one installment.
- **Indirect Taxes:**
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 - **Indirect taxes** are those taxes which are paid in the first instance by one person and then are shifted on to some other persons. The impact is one person but the incidence is on the other.
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- Merits of Indirect Tax:
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 - (i) It is not possible to evade indirect tax. The only way to avoid this tax is not to buy taxed commodities.
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- (ii) They are more convenient because they are wrapped in prices. Consumer often does not know that he is paying tax.
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- (iii) Another advantage of tax is that every member of society contributes something towards revenue of state.
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- (iv) Indirect tax is also elastic to a certain extent. State can increase its revenue within limits by increasing rates of taxes.
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- (v) If state wishes to discourage consumption of intoxicants and harmful drugs, it can raise their prices by taxing them. This is a great social advantage which a community can achieve from tax.
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- Demerits of Indirect Tax:
 - (i) A very serious objection leveled against indirect taxation is that it is regressive in character. It is inequitable. Burden of tax falls more on poor people than on rich.
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 - (ii) Indirect tax is also uneconomical. State has to spend large amounts of money on collection of taxes.
 - (iii) Revenue from indirect tax is uncertain. State cannot correctly estimate as to how much money will it receive from this tax
 - (iv) As tax is wrapped up in prices; therefore, it does not create civic consciousness.
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 - (v) If goods produced by manufacturers are taxed at higher rates, it hampers trade and industry and causes widespread unemployment in the country.
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- After discussing merits and demerits of two types of taxes, we come to conclusion that for reducing inequality of income and raising sufficient funds for state, both these taxes are essential, A country should not place exclusive reliance on any one type, but should employ both these forms of taxation.
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- We agree here with **Galdston** when he says:
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 - "**Direct and Indirect taxes** are like two equally fair sisters to whom as Chancellor of Exchequer, he had to pay equal addresses".
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- In recent times, however, there has been a slight change in utilization of both these types of taxes. Every state, in order to reduce inequality of income, is trying to raise major portion of its income from direct taxes.

Classification of Taxes

- Based on **different basis**
- **Direct Vs Indirect**; based on shifting of tax burden/shiftability
- Two **types of tax burden/incidence**
 - **Impact**: Statutory incidence (immediate burden of payment) – the one identified as taxpayer by the law
 - **Incidence**: Economic incidence (ultimate burden of payment) – the one who/which **actually pay** the tax
 - **Shifting**: transferring tax burden
- **Incident shifting** - forward/backward/
 - depending on the **demand/supply in/elasticity** of the product.
- Direct tax – both impact and incidence rest on the same person.
 - levied on the receipt of income -strike the taxpayers' income at the moment of its production. Examples, income tax, property tax,
- Indirect tax – incidence shifting/the ultimate burden bears by another person. Entities identified as taxpayer (under the law) simply serve as agents - for the sake of administration
 - levied on expenditure -strike at the moment when the taxpayer spends income. Examples. VAT, TOT, excise tax, custom duty
- Shifting may not always work (e.g. tax on rental of building)

- Based on how ability to pay assessed/direct taxes assessed directly, while indirect imposed on transactions without directly assessing the taxpayer's ability
- Merits of direct taxes
 - **Create civic responsibility:** taxpayers knew about they pay tax hence conscious about their rights/follow up the government that it is not wasted the income on useless projects.
 - **Economical;** usually collected at source
 - **Reduce income/wealth inequality;** b/c, they provide the most acceptable measure of ability to pay
 - **Certain;** taxpayers know how much they have to pay and the government can estimate the amount of revenue
- Demerits of direct taxes
 - Can be easily **evaded** - (hardly applicable for withholding taxes)
 - Necessity of **detailed assessment** of ability to pay
 - May **violate principle of convenience** – lump sum payments
- Merits of indirect taxes
 - **Less inconvenient;** paid at a time when taxpayers have the means to pay. Paid in small bits

- **Hidden taxes**; not felt by taxpayers/the pain of sacrifice less-paid in form of price.
- **Less chance of evasion**; imposed at the time of consumption
- **Important policy instruments** (encourage saving, reduce the consumption of harmful products, protect domestic investors,
- Demerits of indirect taxes
 - **Uncertain**; the revenue to the government cannot be estimated accurately. Demand shift up on tax/people may reduce their consumption
 - **Do not create civic consciousness**; tax paid in terms of prices
 - **Violate vertical equality** - both the rich and the poor taxed equally
 - **Possibility to promote inflation**; increment of sale price without touching the purchasing power of consumers/unaffordable price
- The two kinds of taxes are mutually complementary and not competitive.
- **Based on rate - four categories'**
- **Proportional**; Flat/fixed rate. Tax liability increases in the same proportion as the increased income.
 - Simple to administer
 - Encourage saving and investment

- The burden of tax falls more heavily on the poorer section of society/the latter make greater sacrifice - violate principle of equity/justice
- Not helpful to reduce income/wealth inequalities
- **Progressive tax**; tax liability increases in an increased proportion as the increased income.
- Tax liability varies with the income change and the rate of tax becomes gradually higher for the increasing income
 - Most popular
 - It is based on the ability to pay principle
 - Promotes equality of incomes and wealth
 - Reduces capital formation/saving – the rich who can save taxed heavily
 - Help to raise more revenue for the government
- **Regressive tax**; tax liability falls in proportion with the increased income/taxed at decreasing rate -the opposite of the progressive tax
 - Promotes saving
 - The poorer sections of society are taxed at higher rates than the richer
- **Digressive**; there is a declining degree of progression as the tax base increase.
- The rate of tax increases up to a certain limit and beyond which a uniform rate is charged - a blend of progressive and proportional taxation.

- The higher income groups make less sacrifice than the lower income groups
- **Based on the measurement of tax base** (specially for taxes imposed on commodities)
- **Specific Tax/adrem**; based on the unit of the good charged/tax is imposed on a commodity according to its weight, size, volume, or measurement.
 - It is easy to levy and more convenient to collect
 - It does not take into the value of the commodity. Consequently, a cheap and a costly object may be taxed at the same rate – not equitable
- **Ad valorem Tax**; based on the value of the good charged/tax is imposed on commodity according to its value (monetary value)
 - It is more equitable
 - May be difficult to know the real value of the commodity at the time of imposing the tax. traders understate the value of the commodities in their invoices
- **Based on number of stages a tax levied**
- Economic process – production, distribution and consumption (producer/manufacturer, wholesaler, retailer and consumer)
- **Single stage tax**: tax imposed only on one stage
- **Multi stage tax**: tax imposed on two or more stages. VAT, TOT, ..

- **Single and multiple taxes (mono/poly tax system)** – based on the number of subjects/items subject to tax