CHAPTER II

MEANING AND CHARACTERISTICS OF TAXATION

Public Revenue

Sources of public revenues

Government has played an important role in the socio economic development of society. Social development may be in the form of raising the level of living and social welfare in the form of providing social amenities to the people. Social amenities are in the form of education, health and sanitation, utilities like electric supply, water supply etc, and recreation facilities.

The process of socio-economic development requiring huge expenditure cannot be carried unless the government has the perennial source of income. Every government has two important sources of revenue. These are:

(a) Tax sources, and

(b) Non-tax sources.

What is a Tax?

Tax is one of the most important sources of revenue to every government. In the earlier days, payment of taxes was optional. A choice was given to the people to pay the tax and to avail the benefit of social amenities in the form of education, health and sanitation, utilities and recreation facilities. Naturally, everyone interested in availing social amenities used to evaluate the benefit derived by him in exchange for the tax to be paid by him. But the option in the payment of tax created lot of problems for the government in fulfilling their obligations to society. Hence, in modern times, option was withdrawn and tax became a compulsory contribution by every citizen to the government to enable the government to fulfill its commitments towards society.

Every Government imposes two kinds of taxes:

(1) Direct taxes, and

(2) Indirect taxes

A tax, in the modern times, therefore is a compulsory levy and those who are taxed have to pay the sums irrespective of corresponding return of services or goods by the government. It is not a price paid by the tax-payer for any definite service rendered or a commodity supplied by the government. The tax-payers do get many benefits from the government but no tax-payer has a right to any benefit from the public expenditure on the ground that he is paying a tax. The benefits of public expenditure may go to anyone irrespective of the taxes paid. Therefore, we may say that taxes are compulsory payments to government without expectation of direct return or benefit to the tax-payer.

Objectives of Taxation

Initially, governments impose taxes for three basic purposes: to cover the cost of administration, maintaining law and order in the country and for defense. But now government's expenditure pattern changed and gives service to the public more than these three basic purpose and it restore social justice in the society by providing social services such as public health, employment, pension, housing, sanitation and other public services. Therefore, governments need much amount of revenue than before. To generate more revenue a government imposes taxes on various types. In general objective of taxations are:

1. Raising revenue: to render various economic and social activities, a government needs large amount of revenue and to meet this government imposes various types of taxes.

2. Removal of inequalities in income and wealth: government adopts progressive tax system and stressed on canon of equality to remove inequalities in income and wealth of the people.

3. Ensuring economic stability: taxation affects the general level of consumption and production. Hence, it can be used as effective tool for achieving economic stability. Governments use taxation to control inflation and deflation

4. Reduction in regional imbalances: If there is regional imbalance with in the country, governments can use taxation to remove such imbalance by tax exemptions and tax concessions to investors who made investment in under developed regions.

5. Capital accumulation

Tax concession or tax rebates given for savings or investment in provident funds, life insurance, investment in shares and debentures lead to large amount of capital accumulation, which is essential for the promotion of industrial development.

6. Creation of employment opportunities

Governments might minimize unemployment in the country by giving tax concession or exemptions to small entrepreneurs and labor intensive industries.

7. Preventing harmful consumptions

Government can reduce harmful things on the society by levying heavy excise tax on cigarettes, alcohols and other products, which worsen people's health.

8. Beneficial diversion of resources

Governments impose heavy tax on non- essential and luxury goods to discourage producers of such goods and give tax rate reduction or exemption on most essential goods. This diverts produce's attention and enables the country utilize to utilize the limited resources for production of essential goods only.

9. Encouragement of exports

Governments enhance foreign exchange requirement through export-oriented strategy. These provide a certain tax exemption for those exporters and encourage them with arranging a free trade zones and by making a bilateral and multilateral agreement

10***. Enhancement of standard of living***

The government also increases the living standard of people by giving tax concessions to certain essential goods.

Characteristics of a Good Tax System

(1) Tax is a Compulsory Contribution

A tax is a compulsory payment from the person to the Government without expectation of any direct return. Every person has to pay direct as well as indirect taxes. As it is a compulsory contribution, no one can refuse to pay a tax on the ground that he or she does not get any benefit from certain public services the government provides.

(2) The Assesses will be required to pay Tax if is due from him

No one can be forced by any authority to pay tax, if it is not due from him. Suppose, if there is a tax on liquor, the state can force an individual to pay the tax only when he drinks liquor. But, if he does not drink liquor, he cannot be forced to pay the tax on liquor. Similarly, if an individual's income is below the exemption limit, he cannot be forced to pay tax on income. For example individuals earning monthly salary below birr 150 cannot be forced to pay tax on income.

(3) Taxes are levied by the Government

No one has the right to impose taxes. Only the government has the right to impose taxes and to collect tax proceeds from the people.

(4) Common Benefits to All

The tax, so collected by the Government, is spent for the common benefit of all the people. In other words, when the government collects a tax, its proceeds are spent to extend common benefits to all the people. The Government incurs expenditure on the defense of the country, on maintenance of law and order, provision of social services such as education, health etc. Such benefits are given to all the people-whether they are tax-payers or non-taxpayers. These benefits satisfy social wants. But the Government also spends on subsidies to satisfy merit wants of poor people.

(***5) No Direct Benefit***

In the modern times, there is no direct relationship between the payment of tax and direct benefits. In other words, there is absence of any benefit for taxes paid to the Governmental authorities. The government compulsorily collects all types of taxes and does not give any direct benefit to tax-payers for

taxes paid. For example, when taxable income is earned by an individual or a corporation, he or it simply pays the tax amount at the specified rate cannot demand any benefit against such payment.

(6) Certain Taxes Levied for Specific Objectives

Though taxes are imposed for collecting revenue for the government to meet expenditure on social wants and merit wants, certain taxes are imposed to achieve specific objectives. For example, heavy taxes are imposed on luxury goods to reduce their consumption so that resources are directed to the production of essential goods, such as cheaper variety of cloth, less costly goods of mass consumption, etc. Thus, taxes are levied not only to earn revenue but also for diversion of resources or saving foreign exchange. Certain taxes are imposed to reduce inequalities of income and wealth.

(7) Attitude of the Tax-Payers

The attitude of the tax-payers is an important variable determining the contents of a good tax system. It may be assumed that each tax-payer would like to be exempted from taxpaying, while he would not mind if other bears that burden. In any case, he would want his share to be within the general level of tax burden being borne by others. In other words, it is essential that a good tax system should appear equitable to the tax-payers. Similarly, overall burden of the tax system is of equal importance. The attitudes of the tax-payers in this regard are influenced by a host of other factors like the political situation such as war or peace, natural calamities like floods and droughts, economic situations like prosperity or depression and so on.

(8) Good tax system should be in harmony with national objectives

A good tax system should run in harmony with important national objectives and if possible should assist the society in achieving them. It should try to accommodate the attitude and problems of tax payers and should also take into consideration the goals of social and economic justice. It should also yield adequate revenue for the treasury and should be flexible enough to move with the changing requirements of the State and the economy.

(9) Tax-system recognizes basic rights of tax-payers

A good tax system recognizes the basic rights of the tax-payers. The tax-payer is expected to pay his taxes but not undergo harassment. In other words, the tax law should be simple in language and the tax liability should be determined with certainty. The mode and timings of payment should be convenient to the tax-payer. At the same time, a tax system should be equitable between tax-payers. It should be progressive and burden of taxation should be equitable on all the tax-payers.

Principles of taxation

A tax system (that is, the set of all taxes) for achieving certain objectives chooses and adheres to certain principles which are termed its characteristics. A good tax system therefore, is one of which designed on the basis of an appropriate set of principles, such as equality and certainty. Mostly, however, objectives of taxation conflict with each other and a compromise is needed. Therefore, usually economists select some important objectives and work out the corresponding principles which the tax system should adhere to. The first set of such principles was enunciated by Adam smith (which he called Cannons of Taxation)

Canons of Taxation

The four canons of taxation as prescribed by Adam Smith are the following:

(1) Canon of Equality

This canon proclaims that a good tax is that which is based on the principle of equality. In other words subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion of their respective abilities, that is, in proportion to the reserve which they respectively enjoy under the protection of the State. It implies what the income which a person enjoys under the protection of the State, should be taxed on the proportional rate of taxation. But modern economists do not agree with Adam Smith. They advocate progressive taxation to observe the canon of equality. In other words, they advocate progression should be the basis for imposing taxes.

(2) Canon of Certainty

This canon is meant to protect the tax payers from unnecessary harassment by the 'tax officials'. It implies that the tax-payer should be well informed about the time, amount and the method of tax payment. According to Adam Smith, "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, ought all to be clear and plain to the contributor and to every other person." Adam Smith was also of the view that the government must also be certain of the amount which it derives from a particular tax. Thus this canon is equally important both for the individual and the state.

(3) Canon of Convenience

The third canon of Adam Smith is that of convenience. According to Adam Smith, "every tax ought to be so levied at the time or in the manner in which it is most likely to be convenient for the contributor to pay it." In other words, taxes should be imposed in such a manner and at the time which is most convenient for the tax-payer, i.e., the best time for the collection of land revenue is the time of harvest. Similarly, taxes on rent of houses should be collected when it is most convenient for the contributor to pay.

(4) Canon of Economy

The fourth canon is the canon of economy. This canon implies that the administrative cost of tax collection should be minimum, i.e., the difference between the money, which comes out of the pockets of people

and that which is deposited in the public treasury, should be as small as possible. Administrative cost of tax collection should be minimum because levying of a tax may require a great numberof officers, whose salaries may eat up the greater part of the produce of the tax, and whose pre-requisites may impose another additional tax upon the people. Hence, the administrative cost should be minimum.

In addition to the above four canons given by Adam smith, the following other canons have been advanced by Basable and other economists

(***5) Canon of Productivity***

The canon of productivity advocated by Bastable implies that taxes should be productive. The productivity of a tax may be observed in two ways. In the first place, a tax should yield a satisfactory amount for the maintenance of a government. In other words, the tax should be such that it procures a considerable amount of revenue for the expenditure of the government, Secondly, the taxes should not obstruct and discourage production in the short as well as in the long run.

(6) Canon of Elasticity

Bastable also laid stress on the principle of elasticity. The canon of elasticity implies that yields of taxes should be increased or decreased according to the needs of the government. The government may need funds to face natural calamities and other unforeseen contingencies. It may need funds to finance a war or for development purposes. The government resources can be raised quickly only when the system is elastic.

(7) Canon of Diversity

The canon of diversity put forward by Bastable implies that the tax system should be diverse in nature. In other words, in a tax system, there should be all types of taxes so that everyone may be called upon to contribute something towards the revenues of the state. Thus, the governments should adopt multiple tax system.

(8) Canon of Simplicity

The canon of simplicity implies that a tax should easily be understood by the tax-payer, i.e., its nature its aims, time, of payment, method and basis of estimation should be easily followed by each tax-payer. In other words, the tax imposed on the tax-payers should be so simple that they are able to guess easily the aim of its imposition and they are not confronted with accounting, administrative or any other difficulties.

(9) Canon of Expediency

This canon implies that the possibilities of imposing a tax should be taken into account from different angles, i.e. its reaction upon the tax- payers. Sometimes it is seen that tax may be desirable and may be

productive and may have most of the characteristics of a good tax, yet the government may not find it expedient to impose it, for example, progressive agricultural income tax, but it has not been imposed. So far in the manner it should have been imposed.

EFFECTS OF TAXATION

Taxation these days is not used as means of raising revenues only, but it is an important instrument for achieving socio-economic objectives, such as, regulation of consumption and production, controlling booms and depression, promoting economic growth and removing inequalities of income. The economic effects of taxation may be good as well as bad. Therefore, the government should not keep only the revenue considerations in mind, but the economic effects of taxation should also be considered. To put it in the words of Dalton, "The best system of taxation from the economic point of view is that which has the best, or the least bad economic effects." Effects of taxation can be analyzed in terms of production, distribution and stabilization.

Thus, in this we will discuss the economic effects under the following three heads:

- Effects of taxation on production
- Effects of taxation on distribution
- Effects of taxation on stabilization

I) Effects of Taxation on capacity to Work, Save and Invest

a) Capacity to Work

Capacity to work depends on the health and efficiency possessed by the people. Health is related to the level of consumption which is determined by the money income of the assessee. Imposition of higher tax reduces the purchasing power of the tax payer and his ability to obtain the necessaries, comforts and luxuries of life. This effect is most strongly felt by the poorer people. When the tax burden falls upon the poor, it curbs the consumption of necessaries and comforts which lowers the standard of living and thus efficiency and ability to work of poor people is adversely affected by taxation. For the rich, however, the ability to work is not so much affected by taxation because taxation on rich may only curb his luxurious consumption and this may not affect his efficiency and ability to work. Therefore, heavy taxation on the poorer section of the community has been strongly objected by most of the economists. Therefore, to maintain the health efficiency and ability to work of the people, system of progressive taxation should be duly implemented by the government. In other words, taxes on low incomes and on those articles which are largely consumed by less well to do sections of the community should be avoided in the interest of production. This will keep the health and efficiency intact without additional work load on them.

b) Capacity to Save

Capacity of the people to save depends on the tax policy followed by the government. Ability to save is adversely affected by taxation as taxes fall on income and savings depend on income. When income is

reduced by taxation, savings automatically decline. Ability to save is affected adversely in the case of those who have a higher marginal propensity to save. It is the rich who possesses a high marginal propensity to save since their incomes exceed their expenditure. Taxes falling on the poor have no effect on their ability to save as they have no margin to save out of their low incomes. Since the rich are accustomed to a very high level of living, they maintain their expenditure and pay taxes out of their savings. Hence their ability to save is greatly reduced. This affects investment and capital formation in the economy. Therefore, to maintain the capacity of the people to save the government should provide tax incentives to the rich and spend the tax income on the poor to enhance their ability to save.

c) Capacity to Invest

Capacity to invest depends on the resources available for investment that is savings. It is clear from the above discussion that savings are reduced by taxation. When ability to save is adversely affected by high taxes, ability to invest of those who take investment decisions is automatically reduced. These are the people having a high entrepreneurial ability. Such people are generally the people in the higher income group. The government has to pay a major role in exploiting the capacity to invest of the tax payer by adopting an appropriate tax policy. The government should exempt earnings from investment to encourage savings and capital formation.

II) Effects of Taxation on the will to Work, Save, and Invest

a) Effects on the Will to Work

Will of the people to work depends on the nature of taxes. Each individual tax has its specific effects. However, some taxes by their very nature have the least or no bad effect on the willingness to work e.g., estate duty excess profit tax etc. Likewise, reasonable rates of income tax, sales tax, etc, have no bad effects on the desire of the people to work hard. Conversely, unduly high rates of income tax, wealth tax and commodity taxes adversely affect the desire of the people to work hard.

b) Effects on the Will to Save

Will of the people to save depends on the volume of income, volume of tax and the tax policy pursued by the government. If a tax payee has limited income and is hardly sufficient to meet his/her day to day requirements it will be difficult for him to save anything. Some people save for their old age and many times they save to improve their social prestige. So in order to enhance the will of the people to save, the government should provide tax incentives to the people.

c) Effects on the Will to Invest

Will of the people to invest depends on savings. If savings are taxed, nothing will be left with the people for investment purposes. To enhance the will of the people to invest, the government should devise such a tax policy which provides tax incentives to those who divert their savings towards investment. Investment also depends on the treatment of income from investment-under tax laws. If earnings are exempted from tax net, people will divert most of their savings towards investment. People will also save

and invest if they have full knowledge about the avenues available for investment and the tax incentives associated with each of these channels of investment.

III) Effects of Taxation on the Composition and Pattern of Production

The effects of taxation on the consumption and pattern of production depend upon allocation of resources. When higher taxes are imposed on some industries, resources will shift from the high taxed industries to low taxed industries. Likewise, when a tax rebate is offered, it will encourage allocation of resources in favour of developing industries. Similarly, there will be reallocation of resources from high taxed regions to the low taxed regions. High rate of tax on goods of harmful consumption has a beneficial impact as the production of these goods will be diverted to low-taxed essential goods. Taxes may thus change the pattern of production in an economy. A high tax on the production of luxuries may improve the production of necessaries. Some taxes, however, have no effect on diversion of resources; example, taxes on windfall gains, high land values, monopoly profits and non-differential taxes such as income-tax, etc have no effect on consumption or pattern of production.

Effects of Taxation on Distribution

There are two aspects of an economy:

1. Income Generation
2. 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. For instance if A's income is $500 and B's income is $1,000 and both are taxed at the rate of 10% the net income of A and B, after tax payment, would be $450 and $900 respectively. The burden of taxation falls heavily on A than on B. Hence, the burden of taxation is higher on the poor than on the rich.

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 higherfor 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. Shiftability 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.

2.4 Single Vs Multiple Tax System

- **On the basis of volume (Single and Multiple tax)**

Single tax:- It refers to the system in which the taxes are levied only on the 'item' or 'head of tax'. There is only one kind of tax, which constitutes the source of public revenue.

Multiple taxes: - It refers to the system in which the taxes are levied on various items.

- **On the basis of method**

Proportional taxes: - A system that taxes everyone at the same rate, regardless of his or her income brackets. It is amount increase with the increase in income and decreases with the decrease in income.

Progressive taxes: - It is the tax which varies with the change in income of the different individuals. The rate of tax is gradually higher for the increasing incomes and lower for the decreasing incomes.

Regressive tax: - Under it, the larger the income of tax-payer, the smaller is the proportion that he contributes. A schedule of regressive tax rate is one in which the rate of taxation decreases as the base increases.

SHIFTING AND INCIDENCE OF TAXES

Meaning of Impact

The impact of a tax is on the person who pays the money in the first instance. In other words, the man who pays the tax to the government in the first instance bears its impact. The impact of a tax is, therefore, the immediate result of the imposition of a tax on the person who pays in the first instance. It corresponds to what is often, but erroneously called the "original incidence" or the "primary incidence" of a tax. The impact of tax as such, denotes the act of imposing.

Impact of a tax, therefore, refers to the immediate burden of the tax and not to the ultimate burden of the tax.

Meaning of Shifting

Shifting of a tax refers to the process by which the money burden of a tax is transferred from one person to another. Whenever there is shifting of taxation, the tax may be shifted forward or backward.

Meaning of Incidence

Incidence of a tax refers to the money burden of a tax on the person who ultimately bears it. In other words, when the money burden of a tax finally settles or comes to rest on the ultimate taxpayer, is called the incidence of a tax. The incidence of tax remains upon that person who cannot shift its burden to any other person, i.e., who ultimately bears it.

Thus, there are three distinct conceptions- the impact, the shifting and the incidence of a tax, which correspond respectively to the imposition, the transfer, and the settling or coming to rest of the tax. The impact is the initial phenomena, the shifting is the intermediate process, and the incidence is the result.

Distinction between Impact and Incidence

The impact refers to the initial burden of tax while incidence refers to the ultimate burden of the tax. Impact is felt by the tax payer at the point of imposition of the tax, while the incidence is felt by the tax payer at the point of settlement or rest of the tax.

The impact of the tax is felt by the person from whom the tax is collected, while the incidence is felt by the person who actually bears the burden of the tax.

Impact of a tax can be shifted, but the incidence of a tax can not be shifted.

Thus, impact of the tax is always on the person who is responsible by law to pay the tax amount to the Government treasury, in the first instance. Incidence may fall on somebody from whom the manufacturer ultimately recovers the amount, provided he shifts the tax.

Tax Shifting

Shifting of a tax refers to the process by which the money burden of a tax is transferred from one person to another. Shifting can occur only in connection with the price transaction. Price is the only vehicle through which a tax can be shifted. Thus, shifting is common in commodity taxation. If a tax is shifted, the price of the taxed commodity increases. Whenever, there is shifting of taxation, the tax may be shifted forward or backward.

Types of Tax Shifting

Tax shifting may be of two types: forward shifting and backward shifting.

Forward Shifting

A tax is said to have shifted forward if price of the commodity which constitutes the medium for shifting the money burden of tax is increased. Under complete shifting; the price will be higher by the full amount of tax. In forward shifting of commodity taxation, the money burden of a tax is transferred from the producer or seller to the consumer or buyer when the tax is initially imposed on the producer. Thus, forward shifting is possible with regard to all indirect taxes which are generally passed partly or shortly to the buyer of goods.

Backward Shifting

Backward shifting refers to the process by which the money burden of commodity tax is shifted from the consumer or buyer to the producer or seller, if the tax is initially imposed on the consumer. In other words, it is a typical situation in which the tax burden is shifted backward, that is, from the buyer of good to the seller of goods under the following conditions:

Backward shifting is applicable in the case of property tax only. Backward shifting is effected when the buyer of property shifts the entire tax burden to the seller of property. The shifting is done by buyer of property by way of capitalizing the value of tax by the life of the property and deducting it out of the total value of the property.

Factors Influencing Shifting and Incidence

From the foregoing analysis, we find that their area number of factors which influence tax shifting and incidence. These factors are mentioned below.

(i) Elasticity of Demand. The elasticity of demand for commodity taxed exercises a very important influence in determining incidence. If the demand for the product taxed is perfectly elastic, i.e., if the demand curve is a horizontal straight line, price cannot be raised at all, because the slightest rise in price will largely reduce the demand for the product. Hence, the incidence will be wholly on the seller. On the contrary, when the demand is perfectly inelastic, the incidence will be wholly on the buyer. In between these two extremes, the incidence of tax will be shared between the buyer and the seller. Thus, with given supply, the larger the elasticity of demand, the smaller will be the incidence on buyer and larger on seller; while, the lesser the elasticity of demand, the larger will be the incidence on buyer and small on the seller.

(ii) Elasticity of Supply. Because price is determined by the interaction of both demand and supply, it follows from the similar reasoning that the incidence of tax on a commodity will be wholly on the buyer when supply is completely elastic and will be wholly on the seller when supply is completely inelastic. With varying degrees of supply elasticity, the incidence will be shared between the buyer and the seller. With given demand schedule, the incidence will be larger on buyer and smaller on seller the greater the elasticity of supply of the product taxed, while the-reverse will be the order of incidence when the elasticity of supply is lesser and lesser.

(iii) Market Conditions. Shifting of tax is also influenced by the conditions of market for the product taxed. If the product is sold in the perfect market which is characterized by many sellers and perfectly elastic demand curve, the price cannot be changed by the seller and, hence, tax cannot be shifted. On the other and, when the product is sold under monopolistic conditions, he can manipulate the price by withholding supply of the product and, hence, can shift the tax at least to some extent.

(iv) Magnitude of Tax. Shifting depends on the magnitude of tax levied. If the amount of tax is very small, it is generally not shifted but absorbed by the seller, because it does not much reduce his profit. The seller, moreover, may absorb it in the hope that he will be able to attract more customers in the event of other sellers trying to raise the price in their trial of shifting the tax. However, if the magnitude of tax is considerably large, absorption of tax is more likely to reduce the profit of the seller and, hence, he will try to shift it either backward or forward. He may also shift the tax forward by lowering the quality of product without raising the price of it.

(v) Coverage of Tax. Another important factor that influences shifting and incidence is the extent of coverage of the tax. If the tax is more general in natural, falling on wide range of commodities, it may be easily shifted. For example, if a tax levied on bathing soap is general in nature, covering all its kinds and brands, it will be readily shifted. But if the tax is imposed on only one brand of soap with the exclusion of others, the tax may not be possibly shifted. Hence, shifting of tax is easier for more general taxes than non-general taxes.

(vi) Substitutability of Product. It follows from the above argument that taxes imposed on a commodity which has no substitutes or has only poor substitutes can be easily shifted to the buyer, because the buyer will not find an alternative product to satisfy his demand and, hence, he will be ready to purchase the same even when the price is increased by the amount of the tax. But if the product taxed has good substitutes, the raising of price is not possible for the fear of losing customers and, hence, the seller will himself bear the burden of tax instead of trying to shift it.

(vii) Public Policy and Tax Laws. If the Govt. wants that the business enterprise should not raise the price of the product in the event of shifting the tax burden forward, the seller /producer/ business enterprise should bear the burden himself or itself. Tax laws, may legally prohibit shifting of tax through controls, restriction on prices and e.t.c

Tax Evasion and Tax Avoidance

Tax Evasion

Tax evasion is the general term for efforts by individuals, firms, and other entities to evade the payment of taxes by breaking the law.

Tax evasion means fraudulent action on the part of the taxpayer with a view to violate civil and criminal provisions of the tax laws. It can be defined as "tax evasion implies the activities involving an element of deceit, mis-representation of facts, and falsification of accounts including downright fraud".

Thus, it may be said that the tax evasion is tax avoidance by illegal means i.e. tax evasion is against the law and is an unsocial act.

There are two forms of tax evasion. They are as follows:

1. Suppression of income, and
2. Inflation of expenditure.

Examples for Tax Evasion: The following are the examples for tax evasion:

1. A trader makes a sale for Birr.20, 000 and does not account it, in his books under sales. He is evading tax.
2. An individual lends his money of Birr.50, 000 to another person at 20% interest per annum and does not include this income in his total income.
3. Under-invoicing of sales and inflation of purchases.
4. A manufacturing business employs 30 workers but include 2 more additional namesake workers (not in actual) in the muster roles. The sum shown as paid to such additional namesake workers will amount to evasion.

Human intelligence devices new methods of evasion and the Governments are constantly trying to remove the loopholes in the tax laws.

Causes of tax evasion

- High rates of taxation;- Prevalence of high tax rates is the first and foremost reason.
- Complexity of tax laws;- Complicated tax laws are another reason for tax evasion. The tax laws contain a number of exemptions, deductions, rebates, relief, surcharges and so on.

  So, such complication in tax-laws is also a root-cause for the tax evasion.

- Inadequate Information as to Sources of Tax Revenue:-Lack of adequate information as to the sources of revenue also contributes to tax evasions. In Ethiopia, small businessmen and farmers rarely maintain any accounts of their income.
- Lack of publicity;-Lack of publicity of information of a person's return or assessment, is yet another reasons for tax evasion.
- Moral and Psychological factors;- moral and psychological factors have also been pointed out as responsible for tax evasion.
  - Every person should realize his responsibility towards the govt.
  - Unfortunately, all citizens do not realize their duties to the govt. and the necessity of paying the correct amount of taxes and paying them in time.
- officers of the department should be men of integrity;- Lack of integrity in some of the officers of the department is also responsible for tax evasion

Methods/Sources of Tax Evasion

Omission to report taxable income.

- One of the methods of tax evasion is the omission of the tax-payer to report taxable income to taxation authorities.
- Under law, every individual, sole proprietorship, partnership firms and corporations have to furnish their income tax returns in time in case his or her total income from all sources exceeds the maximum exemption limit.
- But many people do not supply any such information to the govt.
- They cheat their govt. by concealing facts with regard to their income and wealth returns.

Maintenance of multiple set of books of accounts.

- Many big business houses have been showing some baseless transactions of expenditure to lower down their tax burden.
- Most of the business people are maintaining double set of books of accounts by tax evaders.
- One set of books of accounts is for personal use and another for tax purpose.

Opening accounts under dummy names.

- Tax evaders have been opening number of bank accounts under dummy names.

Deduction of personal expenses as business expense.

- Some employees of big business houses regularly deduct their personal expenses from office.
- For example, an officer using official transportation for personal purposes.
- By treating personal expenses as business expenses, people increase business expenses thus lowering the profit of the enterprise.

Omission to report several incomes from irregular sources.

- Many individuals are in receipt of different types of income from different irregular sources.
- For example, people receive interest on deposits in the banks or dividend on shares.
- But they rarely report such income to the taxation authorities.

Understatement of receipts.

- Receipts received from credit sales add to the total income of the business man.
- This addition to the income due to credit sales, increases his tax liability.
- Hence, he takes such steps as to underestimate his receipts so that he could reduce his tax liability.

Over-estimation of business expenses.

- A person who evades the payment of tax, over estimated his business expenses by showing more salaries to employees as compared to actual amount paid.

Tax avoidance – An Overview

- Tax avoidance is method of reducing ones tax liability by making use of loopholes in tax law.
- Therefore, tax avoidance is not illegal.
- But whatever be the method an assessee adopts whether it is avoidance or evasion, the consequences of his action is the same.
- i.e., loss of revenue to the state and increase in the burden of the tax on other tax-payers.
- Thus, tax avoidance is the art of escaping taxes without breaking the law.

Examples for Tax Avoidance:

Suppose a taxpayer's total income exceeds the maximum tax-free amount, then he has to pay the tax on such excess amount. But if he invests the excess amount in any of the approved schemes for which there is a relief in the tax law, he can save on tax altogether.

2. An individual sells his let out house property (long-term capital asset) for Birr.2,00,000 making a capital gain of Birr 60,000. This capital gain would normally be taxed. But, if he invests the sale proceeds in a particular mannerstipulated by law, he need not pay any tax.