56

Incidence of Taxation

I. MEANING OF INCIDENCE

When a tax is imposed on some person, it is quite possible that it may be transferred by him to a second person, and this tax may be ultimately borne by this second person or transferred to others by whom it is finally borne. Thus, the person who originally pays the tax may not be actually bearing its money burden as such. This problem is, therefore, to determine who bears the tax, ultimately. This is known as incidence of taxation.

The concept of "incidence" of taxation has been variously described by different economists. Dalton, for instance, considers incidence as the direct money burden of tax on the person who ultimatly pays it. Incidence, thus, rests on the person who cannot shift the money burden of the tax to any other person. For example, when a sales tax is imposed on Bata shoes, but the company's shop recovers it from the buyers, so the incidence of this tax lies on the buyers since they ultimatley bear its money burden.

Dalton distiguishes between incidence and affects of taxation by putting that incidence is the direct money burden of a tax while its effects are the indirect money burden.

Mrs. Ursula Hicks, on the other hand, talks of formal and effective incidence of a tax. The direct money burden of a tax, she calls it formal incidence, while effective incidence is considered to be the economic effects of the tax in a broader sense. To quote Mrs. Hicks: "The formal incidence means the proportion of people's income which does not form the incomes of those who furnish them with goods and services, but it is paid over to governing bodies to finance collective satisfaction."[1]

According to Mrs. Hicks, the calculation of formal incidence is useful in assessing the question of redistribution of income through taxation. It may also be helpful in economic planning. However, the exact reaction of tax payers to a change in tax or the economic repercussions of a tax cannot be directly ascertained by a mere estimate of the formal incidence. For this, we have to resort to the concept of "effective incidence".

…phenomena unchanged.

Differential tax incidence refers to change in the distribution pattern in the economy caused by substituting one tax for another, total tax revenue being unchanged.

In modern economic literature, it has been observed that "the traditional concept of incidence has been criticised in recent years and new ways of looking at the question have been suggested. It is pointed out that taxation by itself does not cause a reduction in real income available for privae use; it is public expenditure that absorbs real resources. Taxes may be increased or reduced for any number of reasons without changing the level of real public expenditure. Taxation only changes the distribution of income and the incidence of taxation should accordingly be defined as the change in the distribution of real income available for private use." Thus, the concept of differential incidence is much appreciated by modern economists, as it relates to a change in the tax system.

2. IMPACT, SHIFTING AND INCIDENCE

In analysing the problem of incidence of taxation, we come across three distinct but interrelated forms, namely, impact, shifting, and incidence, which correspond, respectively, to the imposition, transfer and settling of the tax. As Seligman[3] puts it, the impact is the initial phenomenon, shifting, the intermediate process and incidence is the result.

The term *impact* is used to express the immediate result of or original imposition of the tax. The impact of a tax is on the person on whom it is imposed first. Thus, the person who is liabile to pay the tax to the government bears its impact. The impact of a tax, as such, denotes the act of impinging.

In short, the term *impact* refers to the immediate money burden of a tax. When a tax is imposed its impact will be on some person who may, however, try to pass it on to some other person. The process of transferring the money burden of the tax is called *shifting*. The process of shifting a tax starts from its impact and ends at the point of incidence.

The term "*incidence*" refers to the location of the ultimate or the direct money burden of the tax as such.[4] It signifies the settlement of the tax burden on the ultimate tax payer. Incidence emerges when the tax finally settles or comes to rest on the person who bears it. It, in fact, is the ultimate result of shifting. Hence, the incidence of a tax is upon that person who cannot shift the burden any further, so he has to himself bear the direct money burden of the tax.

It is, thus, easy to distinguish between the impact and incidence of taxation.

1. Impact refers to the *initial* burden of the tax, while incidence refers to the *ultimate* burden of the tax.

2. Impact is at the point of imposition, incidence occurs at the point of *settlement*.

3. The impact of a tax falls upon the person from whom the tax *collected* and the incidence rests on the person who *pays* it eventually. For example, suppose a tax — excise duty — is imposed on soap. Its impact is on the producers, in the first

instance, as they are liable to pay it to the government. But, the producers may succeed in collecting it from the consumers by raising the price of soap by the amount of tax. In that case, consumers eventually pay the tax and so the incidence falls upon them.

4. Impact may be shifted but incidence cannot. For, incidence is the end of the shifting process. Sometimes, however, when no shifting is possible, as in the case of income tax or such other direct taxes, the impact coincides with incidence on the same person.

3. TAX EVASION AND TAX SHIFTING

Both shifing and tax evasion are the methods of escaping taxes. In tax shifting, the burden of taxes is shifted through the vehicle of price. In tax evasion, however, a person deliberately pretends that he is not liable to tax by showing himself not in possession of goods or services or income subject to tax. Tax shifting is legal as sometimes even the government also intends so while imposing a tax. Further, under tax shifting, though the incidence ultimately falls on somebody, the government receives its due revenue. Tax evasion, on the other hand, is illegal as the evader cheats the government by concealing facts and the latter loses its due revenue.

Apart from the tax dodging, smuggling is also a sort of tax evasion as customs duties are evaded on smuggled goods. Tax evasion is, therefore, an offence and is punishable. There is, however, legitimate evasion of commodity taxes or even income tax, when a person does not buy the taxed commodities or does not earn the income beyond the exempted limt and thus escapes taxes.

4. THE PROCESS OF TAX SHIFTING

The central part of the discussion of incidence lies in the investgation of the shifting of taxation. To discover the actual incidence of a tax, we have to know whether, why, and how a tax will be shifted. Tax shifting is the intermediate process between the impact and the incidence of taxation. Incidence signifies the result of tax shifting. According to Seligman, therefore, the real economic problem lies in the nature of shifting.

As we have seen, the shifting of tax refers to the process of transfer of the tax burden from one person to the other. By means of shifting, it is possible for the tax payer to escape the burden of tax.

Shifting can occur only in connection with the price transcation. Price is the only medium through which a tax can be shifted. (Gift is another medium but not so common.) Thus, shifting is common in commodity taxation. If a tax is shifted, either the price of the taxed commodity will rise, or its price remains the same, with the quality lowered. In the case of most direct taxes, however, shifting is not possible as their impact and incidence will be at the same point; so also there is lack of medium for shifting.

Forward and Backward Shifting

The shifting process can be either forward or backward. A tax is said to have shifted foward if price of the commodity which consitutes the medium for shifting the money burden of tax is ... the price will be

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.

Backward shifting, on the other hand, refers to the process by which the money burden of a commodity tax is shifted from the consumer (or buyer) to the producer (or seller), if the tax is initially imposed on the consumer. Thus, the distinction between foward and backeward shifting rests on who originally happens to be the subject of tax. If originally the tax is imposed on the seller or producer, it is shifted forward and if it is imposed on the buyer or consumer, it is shifted backward. Forward shifting, however, is more common than backward shifting.[1] A buyer sometimes can shift a tax on the commodity he purcahses, at least partically back to the seller in the form of lower prices by restricting his demand. Another example of the backward shifting is the employer's contribution to the Employees State Insurance Fund. A large part of this contribution may be shifted back to the employee in the form of lower wages, if the bargaining power of the labour is weak.

Whether a tax is shifted forward or backward, depends on the relative strength of resistance to transfer the burden. Commodities having inelastic demand will have less resistance to forward shifting, while commodities having relatively elastic demand would have greater resistance to forward than backward shifting.

5. TAX CAPITALISATION

A special type of tax shifting is called "tax capitalisation." The tax capitalisation generally occurs at the time of selling process or exchange or transfer of land or other assets which generate a flow of income and are subject to a series of successive annual taxes during their lifetime. The net flow of regular income from such assets is reduced when the taxes are imposed upon them. Hence the selling value of such assets is reduced when the buyer tries to shift (backward) the burden of the tax to the seller by offering a lower price than its market value, discounting all the future taxes he is liable to pay, at the time of purchase. The buyer, thus, discounts the value of the asset by capitalisation of tax in order to escape it. Such reduction in the price of an asset, as a result of discounting all future taxes estimated upon it, is called "tax capitalisation." Generally, the tax is amortized or discounted through a depreciation of the capital value of a given asset by a sum equal to the capitalised value of the tax. The future tax is capitalised and deducted in a lumpsum from the price offered, as there may be no later opportunity — no price vehicle — for shifting the burden backward once the asset is purchased.[4]

Under tax capitalisation, thus, though the buyer of the asset will pay the tax to government, the seller bears the burden of incidence, as the buyer has at the time of purchasing that asset transferred the whole burden of tax by paying a lower price to the amount of future taxes estimated. Tax capitalisation therefore causes the change in the price of assets. Suppose for example an asset is valued at Rs.10,000 which yields an annual income of Rs. 500. Suppose it is taxed at Rs. 100 per annum or at the rate of 1 per cent ad valorem. The net income is thus reduced to Rs. 400 per annum. Now, if the buyer is willing to invest his savings (in purchasing this asset) at the rate of an annual return of 5 per cent, he would be willing to pay Rs. 8,000 for the asset. Since the capital value of a "Perpetual Annuity" is:

$$\frac{\text{Annual net income}}{\text{Rate of return required}}, \textit{ i.e., } 400/0.05 = 8{,}000$$