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Incidence and Shifting of Taxation

INTRODUCTION

The study on incidence and shifting of taxation is crucial to determine the economic and social effects of a particular tax. Its object is to enquire about the classification of class, group or section, community and individuals who ultimately bear the burden of taxation. When a state imposes a tax, the money has to be paid by someone. Generally, the incidence of tax does not fall on the persons who are directed to pay it but transferred on the shoulders of other persons. Therefore, the person who originally pays the tax may not be actually bearing its money burden. The main problem is concerned with the actual bearer of this tax. In order to understand the problem, it becomes imperative to assess :

(*a*) who pays the tax in the first instance; and

(*b*) who actually bears the burden of the tax.

Keeping in view these factors, the government must have a correct idea of the concept of money burden of taxes. So far as direct tax is concerned, a tax on income cannot be shifted to the shoulders of others but it is expected in the case of indirect taxes. It is a fact that every individual wants to shift his incidence on others as far as he can maintain his purchasing power unaffected.

MEANING OF INCIDENCE

The incidence of a tax refers to the final money burden on a person who ultimately bears it. Whenever, the money burden of a tax finally settles to rest on the ultimate tax-payer, is called the incidence of a tax. Thus, under tax incidence, the problem arises as on whom actually money burden falls. Prof. Hugh Dalton, in this connection writes, "*The problem of incidence is commonly* *conceived as the problem of who pays it. More precisely we may say that the incidence is upon those who bear the direct money burden of the tax.*"[1] Therefore, incidence of a tax which falls on various people can be classified as given on the next page

Incidence of Taxation

- Money Burden
  - Direct
  - Indirect
- Real Burden
  - Direct
  - Indirect

According to Prof. Dalton, direct money burden indicates that the burden of taxation in terms of money lies on a person on which the tax is levied. This means that one who pays the tax, bears the burden also. In other words,he is not supposed to transfer the burden to someone else. Here, the term 'incidence' involves the term 'shifting' also. If a tax is shifted, the incidence does not fall upon the man who shifts it. Suppose, the government levies a tax on sugar, and collects the amount from the manufacturer of sugar, the money burden of the tax falls on the manufacturer of the sugar directly. If the manufacture is able to pass on the money burden of the tax to another person, say, the wholesale dealer by means of raising the price of sugar i.e. shifting the money burden, if the process of shifting continues from wholesaler to the final consumer, the incidence is said to be on the final consumer who ultimately bears the money burden. This is the indirect money burden.

Similarly, the real burden of a tax, according to Prof. Dalton, is the sacrifice which the impression of a tax entails on the tax-payers. Further, direct real burden is the sacrifice of economic welfare which has to be made by the tax-payer as a result of the payment of tax. On the contrary, indirect real burden is the reduction in the consumption of goods by the tax-payer due to imposition of tax. However, *Prof. Dalton* is of the opinion that direct money burden only falls under the scope of the theory of incidence of taxation and other burdens are dealt under the effects of taxation.

Prof. Findlay Shirras defines the incidence of taxation, "*Thus the problems of incidence is the analysis to determine who pays the tax i.e. on whom the money burden of the tax falls or rests.*"[2] Prof. Adam Smith describes that incidence of taxation is meant for the final resting place of their payment. *Richard A. Musgrave states*, "*The concept of incidence is location of the ultimate burden of a tax which starts from the false promise that a tax such has an ultimate burden.*"[3]

According to *Prof. J.K. Mehta*, "*Sometimes incidence is defined as the direct money burden of a tax. The way of defining incidence is satisfactory for most purposes. But it is necessary to note that all direct and monetary burden should not be called incidence. For instance, a tax on tea will directly reduce the income of those who sell the foils in which the tea is packed. Again, a pole tax may reduce the sales and, therefore, the income of the sellers of certain goods. But these burdens, though direct and financial, are not to be called incidence of taxation. They should be included in effect.*"[4]

In short, the opinions of different economists are not similar. Incidence, according to some economists, is concerned with the load of a tax while others make the distinction between incidence

1. Hugh Dalton, 'Principles of Public Finance.'
2. Findlay Shirras, 'The Science of Public Finance.'
3. Richard, A. Musgrave, 'The Theory of Public Finance.'
4. J.K. Mehta, 'Public Finance.'

of a tax when other things are not the same. For instance, *Prof Musgrave* made three types of incidence as :

(*a*) Specific incidence , when a tax is imposed without any change in the expenditure side of government account.

(*b*) Differential incidence, when a tax is levied as a substitute or another tax.

(*c*) Balanced budget incidence, when the government increases its expenditure by the yield of the tax.

Mrs Ursula K Hicks also has classified incidence of taxation into two parts; (*i*) formal incidence and (*ii*) effective incidence of taxation. Defining the incidence of taxation, she says, "*We are concerned in economics with the two concepts of the falling taxes on tax payers, or as called the incidence of taxes. In the first place, there is the statistical calculation of the way in which the revenue collected from any particular tax over a given period (usually a year) namely the difference between the factor cost and the market price of the product on which the tax is assessed, is distributed between the citizens (for convenience, grouped according to their income level) or alternatively, proportion of people's income which goes, not to provide the income of those who furnish them with goods and services, but is paid over to the government body to finance collective satisfactions The result of this calculation may be called the formal incidence of the tax or if we add up the distribution of the revenue from all taxes of the tax structure. The effective incidence indicates the wider effects of various taxes. In order to discover the full economic effects of a tax, we have to draw and compare two pictures one of the economic set up (distribution of consumer's wants and incomes and allocation of factors), as it is with the tax in question; the other of a similar economic set up but without the tax. It is convenient to differentiate between these two pictures as effective and formal incidence of the tax.*"[5]

The Taxation Enquiry Commission of India adopted the definition given by Mrs. Hicks while studying the problem of incidence of taxation in India. The Commission has defined the formal and effective incidence of taxation as, "*Formal incidence is the money burden of taxes resting with the subject on whom the burden is intended by the taxing authority to fall and effective incidence is the real or final distribution of tax burden after its shifting in consequences of changing demand and supply conditions of the taxed commodity or services.*"[6] In this sense formal incidence is what Prof. Dalton calls the money burden of a tax and effective incidence is indirect money burden of a tax. Therefore, formal incidence is a part and parcel of the theory incidence while effective incidence is a part of the study of general effects of taxation.

❑ IMPACT OF TAXATION

Impact of taxation refers to the immediate burden of the tax. The impact of a tax, therefore, is the immediate result of the imposition of a tax on the person who pays it in first instance. However, it is not essential that the person who pays the tax in the first instance will also bear the ultimate or final money burden of a tax. To be more specific, the impact and incidence of a tax may not fall on the same person. The impact of taxation is on the producer while incidence of taxation on the consumer. The impact does not reduce the income of the producer, though it puts pressure on him for a short period whereas incidence is durable and it ends in diminishing the monetary income of the tax-payers.

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5. *Ursula K. Hicks, 'Public Finance.'*
6. *Taxation Enquiry Commission-Report.*

DISTINCTION BETWEEN IMPACT AND INCIDENCE

The following points show the distinction between impact and incidence of taxation :

Distinction between Impact and Incidence of Taxation

Impact	Incidence
(*i*) It is felt by the tax-payer at the point of imposition of a tax.	(*i*) It is felt by the tax-payer at the point of settlement of the tax.
(*ii*) It refers to the initial burden of the tax.	(*ii*) It refers to the ultimate burden of the tax.
(*iii*) It can be shifted easily.	(*iii*) It cannot be shifted.
(*iv*) Evasion of tax is illegal.	(*iv*) Avoidance of tax is not illegal.
(*v*) It is felt by the person from whom the tax is collected.	(*v*) It is felt by the person who actually bears the burden of the tax.
(*vi*) Monetary payment of tax is included in it.	(*vi*) Direct monetary burden is included in it.
(*vii*) Impact can be on a person who cannot shift it.	(*vii*) Burden of tax can easily be shifted on others.

IMPORTANCE OF THE STUDY OF INCIDENCE

We know that the aim of taxation is not merely to raise revenue but also to achieve economic and social justice. However, equity in the distribution of tax burden can only be obtained if it is known who is to bear the burden of the tax. For this purpose, the study of incidence of taxation becomes worthwhile. Without it, the policy of the government in securing maximum social advantage is meaningless. Therefore, its importance is highlighted below :

(*a*) It helps to find out the effect and burden of a particular tax ;

(*b*) It guides for achieving a fair distribution of the tax burden and for understanding the general economic consequences of taxation;

(*c*) It helps to trace out the tax-paying potentialities;

(*d*) It guides which type of taxes should be preferred i.e., direct or indirect;

(*e*) It is useful to measure the purchasing power of the tax-payers.

SHIFTING OF TAXATION

Shifting of taxation is a process by which the money burden of a tax is transferred from one person to anther. Thus, when a person wants to save himself from the burden of a tax and it falls on him as an incidence and places the duty of someone else to pay the tax is known as shifting of tax burden. The incidence of a tax falls on that person who cannot shift it further. Generally, tax shifting is of two types :

(*a*) **Single-point shifting.** When a producer shifts the burden of a tax on his product to the consumer's shoulders. In this case, the producer passes the burden of the tax to the consumer in the shape of higher prices.

(v) **Multi-point shifting.** Here a producer shifts the burden of a tax from one point to several points. In this situation, when government imposes an excise duty on cloth, it is paid by the producer in the first instance but producer further shifts the burden to the wholesale dealer and in turn, shifts to the retailer and finally shifts to the consumer.

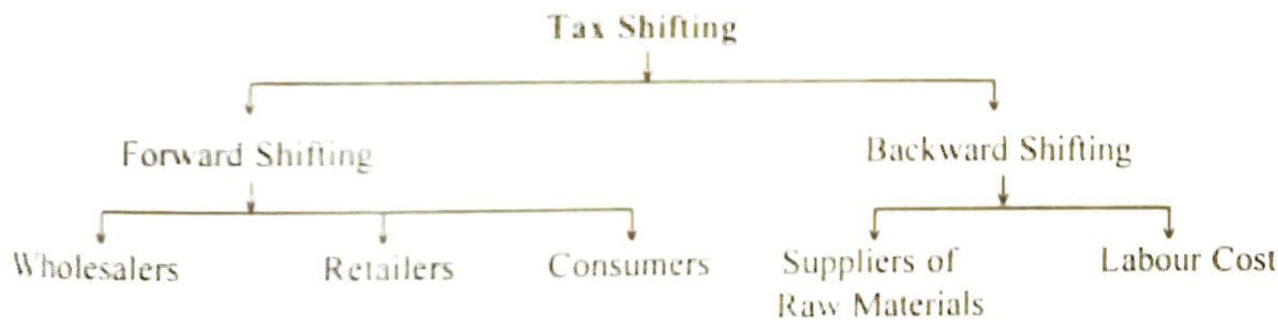
Process of Tax Shifting

There are three main processes of tax shifting as discussed below :

(*i*) **Shifting through Price.** Usually, shifting of a tax is done through price. A seller always tries to raise the price of the commodity to shift the tax burden on the consumer. The shifting process may only occur in the case of price transactions as in a free economy, there is no other vehicle than prices for tax reimbursement. Broadly, it includes all payments made to the different factors of production. The ability of tax shiftings depends upon economic factors. Sometimes, this change in price, however, can be accomplished by a change in the quality of the product, like the producer shifts money burden not by increasing the price but by deteriorating the quality. Again, deliberate effects are made to shift the tax burden to disclose hidden taxes which are really shiftable.

(*ii*) **Shifting through Tax Capitalisation.** This type of shifting occurs when goods are durable and they are subject to a series of successive annual taxes during its life-time. If the whole series of further taxes are to be shifted backward at the time of purchase of a capital good, the further taxes should be capitalised and dedicated in the lump sum from the price offered for the capital goods. However, this type of shifting may be done partially or wholly due to different conditions. For example, when someone wants to buy residential building which will be taxed annually in its life time but the purchaser would ask the seller to deduct this taxable amount from the price of the building. This is called tax capitalisation.

(*iii*) **Shifting of Tax : Forward and Backward.** The shifting of a tax is done through manipulation of price of the taxed commodity. This type of shifting can take place in two directions–forward and backward shifting as explained under :



Forward shifting is a common form of tax shifting which takes place when a producer of a commodity shifts the money burden of a tax onwards to the middleman, wholesaler, retailer and customers. In forward shifting, the price is so raised or the quality and quantity of the commodity are reduced that the entire amount of tax is shifted from the original taxpayer to the consumers.

Backward shifting, on the contrary, occurs when a tax on the commodity is shifted backward to the agents of production. Thus, under backward shifting price remains unchanged and the tax burden is borne by factor inputs. If a tax is imposed on a commodity, the purchaser may take the initiative to accept a lower price. Let us suppose that a tax is imposed on the wholesaler of a commodity. The wholesaler could not secure the higher prices but a tax induces him to force his workers to accept lower wages or force other factors of production to accept lower remunerations.