Classification of Taxes: 4 Types

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This article throws light upon the four main types of taxes charged on taxpayers. the types are: 1. Direct and Indirect Taxes 2. Proportional, Progressive, Regressive and Degressive Taxes 3. Specific and Ad-Valorum Duties 4. Value Added Tax (VAT).

Type # 1. Direct and Indirect Taxes:

On the basis of assessment, rather than on the point of assessment, taxes are classified into direct and indirect.

Direct taxes are imposed by the state upon persons who are expected to bear the burden of these taxes and who are not expected to be able to shift the tax burden to other persons. In other words, in the case of direct taxes, impact and incidence are on the one and the same person.

Indirect taxes are taxes which are imposed upon persons, who are expected to shift the burden of the tax to other persons. In other words, in the case of indirect taxes, usually the impact and incidence will be on different persons.

According to Prof. J.S. Mill **"a direct tax is one which is demanded from the very person who, it is intended or desired, should pay it. Indirect taxes are those which are demanded from one person in the expectation and intention that he shall indemnify himself at the expense of another".**

From this definition of Mill, we can realize that in the case of direct taxes, the taxpayer and tax-bearer is one and the same person. The shifting of the tax burden to another person is not possible or not expected.

Indirect taxes are those in which the taxpayer is not permanently the tax-bearer. However, shifting of the tax burden is intended or desired.

Prof. Dalton also made a distinction between direct taxes and indirect taxes. According to him "direct taxes are really paid by the person on whom it is legally imposed, while an indirect tax is imposed on one parson, but paid partly or wholly by another, owing to a consequential change in terms of some contract or bargain between them".

Prof. Shirras attempted to make a distinction between direct and indirect taxes. "Those levied immediately on the property and income of persons and those that are paid by the consumers to the state directly are called direct taxes". Thus according to Prof. Shirras, income tax, wealth taxes, land tax which are directly paid to the state are called direct taxes".

On the other hand, taxes which affect the income and property of persons through their consumption may be called as indirect taxes. Thus customs duties, excise duties and commodity taxes are indirect taxes.

Advantages of Direct Taxes:

(i) Equity:

Direct taxes are imposed according to the ability of a person to bear tax burden. Hence, it is more equitable than indirect taxes. This tax is based on the principle of progression.

(ii) Certainty:

The taxpayer knows definitely what he has to pay and when and why. This enables the taxpayer to make the requisite provision for payment without causing hardship to his business.

Likewise, the state obtains correct information about the revenue yield from direct taxes, so that it can accordingly plan the financial programmes.

(iii) Economy:

The mode of collection is simple. Tax is collected at source. The cost of collection is lower. There is no wastage. Since each person knows the exact amount paid by him, government is compelled to be economical and careful. Prof. Gladstone observes "if you had only direct taxes, you would have economical government".

(iv) Elasticity:

Direct taxes are more elastic and hence more productive. A slight increase in the rate of taxation will mean a considerable addition to the revenue yield. Moreover, the yield from direct taxes increases with increase in wealth and income.

(v) Another advantage of direct taxes is that, since it is collected at the source, there is less chance of evasion.

(vi) Social Impact:

The taxpayer is directly contributing to the government. So he will be very keen to see that the tax money is not wasted and spend unnecessarily.

Hence, taxpayers take intelligent and keen interest in the financial operations of the state.

Hence, direct tax helps to increase civic consciousness.

(vii) Distributive Justice:

Direct taxes are based on the canon of ability. It is basically tuned as per the principle of progression. Hence, it can be utilized as an important and effective tool to reduce the glaring inequality in the distribution of income and wealth in the society.

Disadvantages of Direct Taxes:

(i) Unpopular:

Direct taxes are paid directly by the people. Generally it cannot be shifted. Hence it is painful to the taxpayers. It is more felt by the people and they are more unpopular.

(ii) Possibility of Evasion:

It is usually said that direct tax is a tax on honesty. It is not evaded only when the taxpayer is honest and tax collecting machinery is incorrupt. Otherwise, it can be evaded through fraudulent practices and by furnishing false assessment of income returns.

(iii) Another difficulty is the necessity of assessment, in all direct taxes. Tax taxpayers have the difficulty in producing the necessary returns and maintaining the proper accounts.

(iv) Direct Taxes tend to be Arbitrary:

It is difficult to arrive at an objective or just base of taxation. If imposed on income, property or any other produce, there must be a valuation of the object charged. This creates opportunities for arbitrary official action.

Moreover, there is every chance for change in the valuation method and rate of taxation, depending upon the political color of the government.

(v) Narrow Base:

A direct tax touches only a section of the community. It is not having wider coverage. The tax belt is very narrow in the case of direct taxes.

The major drawback of direct taxes emerges out of administrative inefficiencies. Bastable concludes the discussion on direct taxes by stating that the defects and merits taken together, direct taxation ought to be a part of every modern financial system and the extent to which it can be applied will depend on the particular condition of the country.

Merits of Indirect Taxes:

(i) Convenience:

Indirect taxes are paid indirectly by the taxpayer. They are not felt in the same degree as direct taxes. It is imposed at the time of purchase of a community, or at the enjoyment of a service.

The tax is hidden in the price of the commodity transacted. Moreover, they are paid in small amount. Hence indirect taxes cause less inconvenience to taxpayers.

(ii) Elasticity:

In times of prosperity, indirect taxes are elastic. The revenue yield from this tax can be increased, when necessity arises. But the principle of elasticity and equity conflict with each other in the case of indirect taxes.

(iii) No Evasion:

Indirect taxes are generally difficult to evade. They are hidden in the price of the commodity purchased. When a person buys a commodity, he will have to pay the tax element. Hence, scope for evasion is very little.

(iv) Wide Coverage:

Indirect taxes fall upon the goods and services. It is possible to tax every member of the community in one way or another. All citizens contribute to the revenue source something. Hence, with the help of indirect taxes, tax system can be made broad based.

(v) It is More Popular than Direct Taxes:

Indirect taxes are paid indirectly. Its incidence is felt by all, who purchase the commodity. Its incidence is felt through an increase in price. Hence, the burden will not be felt heavily as in the case of direct taxes.

(vi) Productivity:

If needed indirect taxes can be made productive. Merely by imposing a few taxes, the government can increase its revenue yield.

(vii) It can Promote Social Welfare:

Indirect taxes can perform a social and economic service to the community. For example, the government can impose stiff rate on articles and drugs which are harmful to the society. Thereby its consumption can be restricted.

(viii) It can be made Progressive:

Indirect taxes can be made progressive by imposing high rates of taxation on luxury goods and comparatively lower rates on comforts and semi-luxury goods. To make it more equitable, articles of mass consumption should be exempted from taxation.

Demerits of Indirect Taxes:

(i) Regressive in Nature:

Indirect taxes on articles of general consumption press more heavily upon the working classes, than on the richer classes.

Such articles are used in larger proportion by the poor. Hence this tax in reality is not equitable.

(ii) Uneconomical:

Indirect taxes are difficult to administer. The cost of collection of indirect taxes is very high. They are to be collected from a large number of people in small amounts.

(iii) They are Extremely Uncertain:

The income from indirect taxes is said to be uncertain. The taxing authority cannot accurately estimate the total yield from different taxes. This is so because demand supply conditions for different goods are influenced by different factors. If the demands for taxed commodities are elastic, the income yield may be less and vice versa.

(iv) Social Significance:

Indirect taxes do not promote any civic consciousness. It is collected in small amount through middle men and traders. They are not felt very much by the taxpayers. Hence nobody takes much interest in the affairs of the government.

(v) Inflationary in Nature:

Another demerit of indirect taxes is that they generate inflation in the economy. It leads to sharp rise in prices of commodities.

Direct and indirect taxes are complementary to each other and a modern government relies on both for its revenue. Both can be made use of depending on its suitability and efficiency in particular circumstances.

In certain circumstances, it will be better to impose direct taxes; where as in some other situation indirect tax will have better advantages. In the case of realization of equity and efficiency, both taxes are needed.

If a government fully relies on direct taxes, then the tax burden will solely depend upon one group of taxpayers. The low income groups will be exempted from the tax liability. In such a situation, taxpayers will try to evade their income tax.

The tax evading group can be brought under the purview of tax belt, if this evaded income is appraised indirectly at the time when it is spent. Likewise, the lower income may be taxed lightly by imposing small percentage of taxes on essential consumer goods. Hence, both taxes are needed for a balanced tax system.

Prof. De Macro observed that the co-ordinated action of direct and indirect taxes makes possible a more elastic tax system capable of bringing about a more delicate and precise distribution of taxes. Both types of taxes have relative merits and demerits. They are complementary rather than competitive.

For the reduction of inequality in income distribution both taxes should be adopted. Likewise, increased revenue requirement can be met by both types of taxes. An ideal tax system should consist of a judicious combination of both types of taxes. A proper balance should be maintained between direct and indirect taxes.

There is no virtue attached to any particular proportion as the ideal balance. It depends upon the economic condition of the country concerned and revenue requirements.

In this context, Prof. Gladstone observes **"direct and indirect taxes are like two attractive sisters, between whom he was perfectly impartial without one being superior to the other".** Hence, a country's tax system should consist of both direct and indirect taxes in the needed proportion.

Direct and Indirect Taxes: A Comparative Analysis:

Direct and indirect taxes are compared on the basis of allocation of resources, distributive effect and administrative point of view.

(i) Allocative Effect:

In terms of Allocative effect, direct taxes are considered superior to indirect taxes. It simply means that if a given amount of money is to be collected through taxes, the burden or sacrifice involved would be greater in the case of indirect taxes, than direct taxes. The indirect taxes place consumers in worse position than direct taxes. This can be illustrated with the help of the indifference technique (Figure No. 4.6).

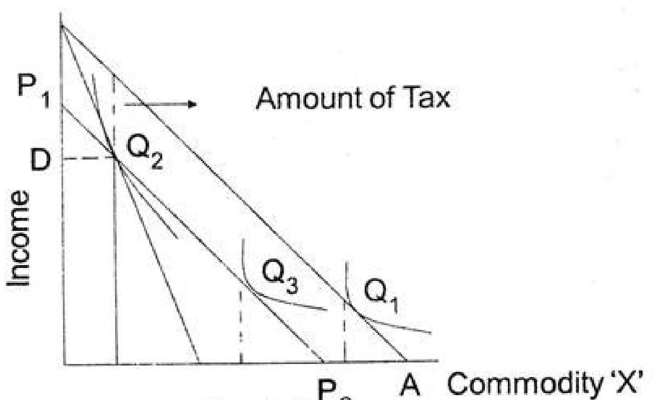

Fig. 4.6

Allocative Efficiency of Direct and Indirect Taxes and PA price line. The indifference curve C_1 touches the price line PA at the point Q_1 Therefore the consumer with QP amount of in-come will be able to purchase QA quantity of commodity 'x'.

His pre-tax equilibrium is represented by the point Q_1 at which the price line is tangent to his indifference curve IC_3. Now a commodity tax is imposed and the price increases by the full amount of the tax.

The post taxed price line is PA_1, and the consumers equilibrium is at Q_2 which is the point of tangency between his indifference curve IC_2 and the price line PA_1 The consumer can purchase only OR now, instead of ON, by spending an amount equal to PD. Of this amount tax equals SQ_2, the vertical distance between PA_1 and PA.

The consumer is on a lower indifference curve IC_2. Now suppose that the same amount of tax yield (SQ_2) is raised by way of direct taxes, say for example income tax instead of commodity tax.

The consumers income will be reduced by the tax amount, i.e. PP_1 ($=SQ_2$). Since the price of the commodity remains unchanged, the new price line will be P_1A_2, which is parallel to PA. This shows that the consumer's disposable income is now QP_1, which can buy ON amount of quantity.

Under the circumstances the equilibrium position will be changed to a point on the price line P_1A_2, to the right of Q_2, say at Q_3, where the indifference curve IC_3 is tangent to the price line. The new equilibrium places the consumer at a higher indifference curve than before.

The inference is that an equal yield indirect tax reduces consumer's welfare by larger magnitude than a direct tax. Hence it can be concluded that direct tax is less harmful in its effect on allocation of resources than indirect tax.

(ii) Administrative Aspect:

On the basis of administrative cost and efficiency, direct and indirect taxes can be compared. In the usual parlance direct taxes are not imposed on low incomes because of administrative point of view. Direct taxes make it necessary to check and scrutinize the each taxpayers account. This is a herculean task. For this purpose a large number of employees are needed.

It involves a complex and efficient administrative machinery to look after the tax structure. Whereas cost of collection of indirect taxes is smaller than direct taxes. In direct taxes are collected not from the innumerable buyers and sellers of goods, but from the businessmen and wholesalers. The collection cost and administrative cost is comparatively low in indirect taxes.

Prof. Prest supported indirect tax on the ground of administrative cost and provided the following justification for indirect taxes.

For instance, when there are large numbers of small, independent, producers or illiterate people, who are incapable of maintaining accounts and when most of the people are living at subsistence level, indirect taxation may be more desirable than direct taxation. Hence, in an underdeveloped country, indirect taxation is good.

(iii) Distributive Aspect:

It is a commonly accepted fact that direct taxes possess certain inbuilt mechanism to achieve redistribution of income in favour of the poor class. Direct taxes are generally progressive in nature.

Hence they fall more heavily on the rich than on the poor. On the other hand indirect taxes fall on all incomes and hence they are generally regressive in character hence, argument goes in favour of direct taxes as an effective tool to reduce income inequality.

However, the fact is that if indirect taxes are made selective they can also contribute towards reducing the glaring inequality in income distribution. By taxing heavily on those articles of consumption, consumed by rich people and exempting those articles consumed by poor communities, the tax structure can be made more equitable.

Prof. Prest observes **"over a wide range, direct and indirect taxes are alternative methods of achieving any particular redistribution of income on which the government of the day may be bent".**

(iv) Stabilization Aspect:

Direct taxes act as automatic stabilizers during periods of economic fluctuation. In inflationary period, they go up more than proportionately with an increase in GNP, whereas during periods of recession they decline more than proportionately to the decline in GNP.

Thus direct taxes possess built-in- flexibility. But indirect taxes do not possess such flexibility, because consumption tends to rise or fall less than proportionately in income.

(v) Economic Growth Aspect:

In developing economies, indirect taxes contribute more to economic growth by curtailing conspicuous consumption and undesirable investments. Whereas high rates of income and corporate taxes may discourage investment and growth.

Type # 2. Proportional, Progressive, Regressive and Degressive Taxation:

On the basis of method, that is the rate of taxation; taxes are classified and compared into proportional, progressive, regressive and degressive.

Prof. Taylor defined proportional, progressive, regressive and degressive taxation as follows:

(a) Proportional Taxation:

"A schedule of proportional tax system is one at which the rate of taxation remains constant as the tax base changes". In other words when the rate of taxation remains the same for all incomes (or property) large or small, then we have proportional taxation.

The tax is fixed as certain percentage of the income or the price or value of an item. Prof. Taussing describes proportional taxation as simply the fiscal principle of taxation which holds that the existing distribution of property and income should not be disturbed by taxation.

Taylor observes that this taxation unquestionably carries simple implications of justice and equality. In this system amount of tax payable is calculated by multiplying the tax base with tax rate. For example, the rate of income tax may be 20% on all incomes, or rate of wealth tax may be 10% for all incomes.

The following hypothetical table and graph explain the point more clear:

(b) Progressive Taxation:

"A schedule of progressive tax system is one in which, the rate of taxation increases as the tax base increases". That is if the rate of taxation increases as the income (or property) increases, then we have progressive or graduated taxation.

Moreover, a tax is progressive, if it is graduated in such a way that the rate of tax rises, more sharply than the increase in income or capital. The amount of tax payable is calculated by multiplying the tax base, with the tax rate.

The hypothetical table and graph given below explain the concept more clearly:

(c) Regressive Taxation:

"A schedule of regressive tax rate is one in which the rate of taxation decreases as tax base increases". In other words, if the rate of taxation diminishes as the income or property increases, we have regressive taxation.

Taxes that are unrelated to the taxpayer's ability to pay are regressive. The amount of tax payable is calculated by multiplying tax base with tax rate.

The hypothetical table and graph given below illustrate the point clear:

Tax Base	Tax Rate	Amount of Tax Payable
Rs: 10,000/-	12%	Rs. 1200/-
Rs: 20,000/-	9%	Rs. 1800/-
Rs: 30,000/-	7%	Rs. 2100/-
Rs: 40,000/-	6%	Rs: 2400/-

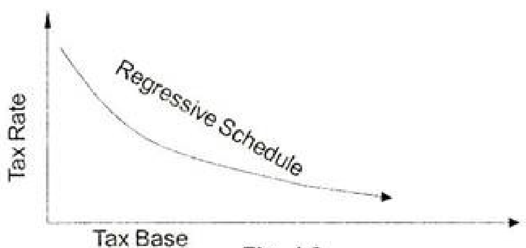

Fig. 4.9

(d) Degressive Taxation:

If the rate of taxes increases, faster than income or property but towards a fixed maximum rate, which it can never exceed, it is known as degressive taxation. Degression is a special case of progression where the acceleration of the tax rate decrease as the tax base increases. These types of taxes are mildly progressive, but not very steep.

Hence high income do not make due sacrifice. In degressive taxation a tax may be slightly progressive up to certain limit, after that it may be charged at a flat rate. Here also the amount of tax payable is calculated by multiplying the tax base with tax rate. The hypothetical table and graph makes the definition clear and under-standable.

Tax Base	Tax Rate	Amount of Tax Payable
Rs: 10,000/-	10%	Rs. 1000/-
Rs: 20,000/-	11%	Rs. 2200/-
Rs: 30,000/-	12%	Rs. 3600/-
Rs: 40,000/-	13%	Rs. 5200/-
Rs: 50,000/-	13%	Rs: 6500/-

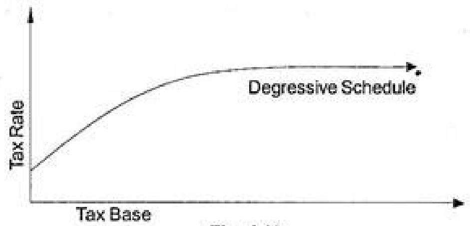

Fig. 4.10

Type # 3. Ad Valorem and Specific Duty:

1. Ad-valorem Duty:

When a tax is levied on the basis of the value of a commodity or property it is known as Ad-valorem duty. This duty is expressed as a percentage of the value of a commodity. In this case irrespective of the weight and size of the commodity, tax is charged purely according to its value.

Several imported commodities are charged according to this value. For example, an import or export duty is levied at the rate of 20 paisa per rupee or 2% of the value of goods. Ad-valorem duties impose greater burden on the richer income group. Hence in the case of distribution of tax burden, it satisfies the canon of equity. Advolrem duty encourages the production of low priced goods.

However, Ad-valorem duty has the following drawbacks. It is very difficult to know the real value of a commodity, at the time of imposition of a tax. Moreover, there is wide scope for tax evasion, when traders understate the value of the commodity.

Some fiscal theorists argue that Ad-valorem duty lead to price rise and they generate inflationary pressure. It is also stated that Ad-valorem duties are difficult to administer. Disputes regarding valuation may frequently arise in this case.

2. Specific Duties:

When a tax is imposed on a commodity as per its weight, it is called specific duty. Specific duties are expressed as definite sums to be paid for the definite weight of a commodity. For example, when the excise duty is imposed as rupees ten per quintal or excise duty on cloth as ten paise per meter, it is a case of specific duty. In both the cases, weight and length is used as the basis of taxation.

The most important advantage of specific duty is that it is easy to levy and very convenient to collect. However, specific duties result in higher revenue, only when there is an increase in the physical volume of output.

Hence, any improvement in quality of output will not fetch additional revenue to the government. Specific duties tend to be regressive. It fails heavily on cheap varieties of goods which are consumed by the lower income group. It leads to production of expensive varieties of commodities.

Type # 4. Value Added Tax (Vat):

Value added tax (VAT) belongs to the family of sales tax. It is of recent origin. This tax has been adopted as an important tool to impart greater flexibility to the revenue base of an economy. VAT is not a tax on the total value of goods being sold. It is a tax on the value added to the good by the last seller. The seller therefore is liable to pay a tax not on the gross value, but on net value.

Net value means gross value minus value of material purchased from other firms. The salient feature of VAT is that it falls on the value added at each stage from the stage of production to retail stage. The Jha committee defined VAT as a tax on all goods and services, the special characteristics being that it falls on the value added at each stage, from the stage of production to the retail stage.

However, in practice, VAT is charged on each taxpayer after deducting from the tax payable on his output, the tax he has paid on his input. Thus it gives a comprehensive system of commodity taxation to a country.

VAT possesses certain advantages. It eliminates some of the problems associated with double taxation. Moreover, it helps to reduce the tax evasion done under the sales tax system. Another argument in favour of VAT is that it will not adversely affect the allocation of resources between different industries. It is simple to administer and satisfies the canon of economy.

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