

Effect of Taxation

The effects of taxation cover all the changes in the economy, resulting from the imposition of tax system. Imposing of taxation has certain inputs on the production, consumption investment, employment and similar other patterns. Its presence distorts these patterns and such distortions may be called effects of taxation.

According to Dalton, taxation effect can be studied by grouping it in the following categories.

- (A) Effects of taxation on production.
- (B) Effect of taxation on distribution.
- (C) Other effects of taxation.

Effects of taxation on production

Main effects of taxation on production are:

1. **Ability to work, Save and Invest:** Imposition of taxes reduces disposable income, more bitterly of the poor section, their purchasing power and ability to acquire necessities, comforts and luxuries. This reduces their consumption and therefore the ability to work and save. Investment is a function of saving potential and the resources for investment are curtailed to the some extent with the increase in taxation.

2. **Willingness to Work, Save and Invest:** The effects of taxation on people's willingness to work, save and invest are partly due to monetary burden of the tax and partly due to the psychological state of the tax payers. Willingness to work, save and invest is also affected by the psychology of tax-payer. Taxpayers have a feeling that every tax is a burden. This psychological state of mind of the taxpayers has a disincentive effect on the willingness to work, save and invest. Net effect will depend upon their elasticity of demand for income. Elastic demand will reduce the willingness to work, save and invest

3. **Effects of Taxation on Allocation of Resource:** By diverting resources to the desired directions, taxation can influence the volume or the size of production as well as the pattern of production in the economy. It may, in the ultimate analysis, produce some beneficial effects on production. High taxation on harmful drugs and commodities will reduce their consumption. This will discourage production of these commodities and the scarce resources will now be diverted from their production to the other products which are useful for economic growth.

Similarly, tax concessions on some products are given in a locality which is considered as backward. Thus, taxation may promote regional balanced development by allocating resources in the backward regions.

Effect of taxation on distribution

The effects of taxation on the distribution of income and wealth among the different sections of the society, depends upon two important factors. They are as below:

1. Nature of Taxation
2. Kinds of Taxes

Nature of Taxation

The nature of taxation influences the distribution of income and wealth among the different sections of the society which are discussed as below:

a) Effects of Regressive Taxation on Distribution: Under regressive taxation, the burden of taxation falls more heavily upon the poor than on the rich. Regressive taxation may increase the inequalities on the distribution of income and wealth and hence widens the gap between the rich and the poor.

b) Effects of Proportional Taxation on Distribution: Under the proportional taxation, taxes are levied uniformly upon the rich and the poor. When the tax rate remains the same, it creates inequalities between them. In this way, the burden of taxation falls more heavily upon the poor than on the rich.

c. Effects of Progressive Taxation on Distribution: Under the system of progressive taxation, the tax rates go up with the increase in the income. Thus, in this system, the inequalities in the income and wealth will be reduced. The major portion of the income and the wealth of the rich is taken away by way of higher tax rates. Hence, the progressive tax system tends to reduce the inequalities in the distribution of income and wealth.

Kinds of Taxes

The effects of taxation depend upon the kinds of taxes which are discussed as below:

a) Effects of Direct Taxes on Distribution: Direct taxes take the form of taxation on the income and property. It attempts to reduce the income of the richer sections and transfers the income to the Government. The Government may use these resources to raise the standard of living of the poor. Therefore, all those taxes, which fall heavily upon the higher income groups, can have favorable distributional effects.

b) Effects of Indirect Taxes on Distribution: Indirect taxes are levied on commodities. They fall heavily on the lower and middle-income groups who spend a large portion of their income on commodities. In such a situation, indirect taxes have adverse distributional effects.

However, indirect taxes may be made progressive if the necessities are exempted from taxation or levied on low tax rates, and luxuries are subjected to higher rates of taxes.

Other Effects of Taxation

Under this category, we study the effect of taxation on employment and regulatory effect of taxation.

(a) Effect on Employment: If resources collected via taxes are utilized for development projects, it will increase employment in the economy. If taxes affect the volume of savings and investment badly then recession and unemployment problem will be aggravated.

(b) Effect on Price Stability: The objective of taxation during inflation should be to reduce excess purchasing power in the hands of the people. This can be done by rising existing tax rate and imposition of new taxes during inflation. In this way, it will help to bring price stability.

On the other hand, a reduction in taxation during depression helps to increase the level of economic activity and employment. Hence, the objective of taxation during depression should be to increase the purchasing power of the people by utilizing the tax revenue for the creation of development activities which are employment generating and income generating in character.

(c) Regulatory Effect: Taxation can be used as an instrument to regulate consumption and production. The composition and structure of production can be regulated and planned by using the instrument of taxation. For example, if the government wants to curb the production of a particular commodity, heavy taxation is desirable. Likewise, to stimulate production of certain commodities, tax exemptions and concessions can be given accordingly