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Effects of direct taxation and comparison of indirect taxation

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Abstract. In economic terms (circular flow of income), taxation transfers wealth from households or businesses to the government. This has effects on economic growth and economic welfare that can be both increased (known as fiscal multiplier) or decreased (known as excess burden of taxation). Consequently, taxation is a highly debated topic by some, as although taxation is deemed necessary by general consensus in order for society to function and grow in an orderly and equitable manner through the government provision of public goods and public services, others such as libertarians and anarcho-capitalists are anti-taxation and denounce taxation broadly or in its entirety, classifying taxation as theft or extortion through coercion along with the use of force. Within market economies, taxation is considered as the most viable option to operate the government (instead of widespread state ownership of the means of production), as taxation enables the government to generate revenue without heavily interfering with the market and private businesses; taxation preserves the efficiency and productivity of the private sector by allowing individuals and businesses to make their own economic decisions, engage in flexible production, competition and innovation as a result of market forces.

Keywords. A tax, taxpayer, a direct tax, an indirect tax, government revenue, income, fiscal administration, inflation.

A tax is a compulsory financial charge or some other type of levy imposed on a taxpayer (an individual or legal entity) by a governmental organization in order to collectively fund government spending, public expenditures, or as a way to regulate and reduce negative externalities. Tax compliance refers to policy actions and individual behaviour aimed at ensuring that taxpayers are paying the right amount of tax at the right time and securing the correct tax allowances and tax relief. The first known taxation took place in Ancient Egypt around 3000–2800 BC. Taxes consist of direct or indirect taxes and may be paid in money or as its labor equivalent.

All countries have a tax system in place, in order to pay for public, common societal, or agreed national needs and for the functions of government. Some countries levy a flat percentage rate of taxation on personal annual income, but most scale taxes are progressive based on brackets of annual income amounts. Most countries charge a tax on an individual's income as well as

on corporate income. Countries or subunits often also impose wealth taxes, inheritance taxes, estate taxes, gift taxes, property taxes, sales taxes, use taxes, environmental taxes, payroll taxes, duties and/or tariffs. It is also possible to levy a tax on tax, as with a gross receipts tax.
In general, a direct tax is one imposed upon an individual person (juristic or natural) or property (i.e. real and personal property, livestock, crops, wages, etc.) as distinct from a tax imposed upon a transaction. In this sense, indirect taxes such as a sales tax or a value added tax (VAT) are imposed only if and when a taxable transaction occurs. People have the freedom to engage in or refrain from such transactions; whereas a direct tax (in the general sense) is imposed upon a person, typically in an unconditional manner, such as a poll-tax or head-tax, which is imposed on the basis of the person's very life or existence, or a property tax which is imposed upon the owner by virtue of ownership, rather than commercial use. Some commentators have argued that "a direct tax is one that cannot be shifted by the taxpayer to someone else, whereas an indirect tax can be."

Direct tax is supposed to be borne and paid by the same person. The person who pays the amount of direct tax does not recover all or part of the tax elsewhere. It is in this sense that direct taxation is opposed to indirect taxation. It is the notion of fiscal incidence which allows to analyse who ultimately, weights the burden of a tax, that determines whether the tax is direct or indirect. Direct taxation is generally declarative (established either by the person concerned or by a third party).
An indirect tax (such as sales tax, per unit tax, value added tax (VAT), or goods and services tax (GST), excise, consumption tax, tariff) is a tax that is levied upon goods and services before they reach the customer who ultimately pays the indirect tax as a part of market price of the good or service purchased. Alternatively, if the entity who pays taxes to the tax collecting authority does not suffer a corresponding reduction in income, i.e., impact and tax incidence are not on the same entity meaning that tax can be shifted or passed on, then the tax is indirect.

An indirect tax is collected by an intermediary (such as a retail store) from the person (such as the consumer) who pays the tax included in the price of a purchased good. The intermediary later files a tax return and forwards the tax proceeds to government with the return. In this sense, the term indirect tax is contrasted with a direct tax, which is collected directly by government from the persons (legal or natural) on whom it is imposed. Some commentators have argued that "a direct tax is one that cannot be charged by the taxpayer to someone else, whereas an indirect tax can be."
Indirect taxes have several uses, the most prominent one (same as for direct taxes) is to raise government revenue. Sales tax and value added tax (VAT) play the major role in this, with VAT being more commonly used around the world. The distinction between these two taxes is that sales tax is paid by the customer at the moment of purchase of the final good or service, whereas VAT is a multistage tax imposed on goods and services that is collected in parts at each stage of production and distribution of goods and services in proportion to the value added by each taxpaying entity.
Apart from the role in raising government revenue, indirect taxes, in the form of tariffs and import duties, are also used to regulate quantity of imports and exports flowing in and out of the country. In case of imports, by tariff imposition the government protects domestic producers from foreign producers that may have lower production costs, and thus are able to sell their goods and services at lower prices, driving domestic producers out of the market. After tariff

imposition, imported goods become more expensive for domestic consumers, hence domestic producers are better-off than before tariff imposition.

The difference between direct tax and indirect tax

The main criterion to distinguish between direct tax and indirect tax is whether the tax burden can be passed on. Indirect taxes are levied on goods and services. They only indirectly target the public. With the circulation of goods, most of the turnover tax will be passed on to subsequent links. It is in this sense that the economist Mueller said: “(Indirect tax) ostensibly imposes this kind of tax on someone, but in fact, that person can be compensated by damaging the interests of another person." Below, income tax and property tax, this kind of tax that cannot or is inconvenient for taxpayers to transfer the tax burden to others, are all typical direct taxes. Income tax includes personal income tax, corporate income tax, etc., and property tax includes property tax and inheritance tax, social security tax, etc.

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Direct taxation has a few advantages and also some inconveniences in comparison of indirect taxes. It promotes equality and equity because direct taxes are based on ability to pay of taxpayers and in the case of a progressive tax structure, every person is taxed differently depending on his income. Another advantage of direct taxation is that the government and the taxpayer know the amount they will receive and they pay, even before the collection of the tax. Direct taxation and in particular income tax act as automatic stabilizers. Some direct taxes are easy to collect for the government and the fiscal administration because they are collected at the source. Yet, tax collection can be expensive depending on the efficiency of the fiscal administration. Running the tax collection office have some administrative costs (keeping the records of incomes of the population for example), in particular when different tax rates are applied. Moreover, direct taxes can be evaded (tax evasion affects mainly direct taxes) whereas indirect taxes cannot be evaded (when the taxed transaction occurs, it is not possible to avoid the burden of the tax).

Direct taxes decrease the savings and earnings of individuals and firms. Indirect taxation however make goods and services more expensive (the burden of the tax is reflected in the prices). Contrary to indirect taxation which leads to inflation (increasing of the prices), direct taxes can help to reduce inflation.

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