6. Economic Effects of Taxation

Q:| Discuss the Economic Effects of Taxation on Income wealth and Consumption?

(A) Economic Effects of Taxation :-

Taxation has both favourable and unfavourable effects on distibution of income and wealth. A Progressive Taxation reduces income inequality and a Regressive Taxation increases income inequality. Heavy Taxes on Luxury and Non-essential goods have favourable effect. But Taxes imposed on Necessary and essential goods have Unfavourable effects.

(B) Economic Effects on Income and Wealth :-

Taxation have great economic effects on Income and wealth. Progressive Taxation helps to reduce gap between rich and poor. But it have Unfavourable effects on the ability to work, Save, investment and Production Capacity. Government of India, has reduced maximum rate of Taxation to 30% to reduce Negative effects of Taxation.

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© Effects On Consumption :-

1. Increase Price of goods and Services :-

Due to taxation, Price of several goods and services increases which reduce Purchasing Power of Consumer. Thus Taxation directly reduce Consumption of People.

2. Income Effect of Taxation :-

Direct Taxes reduce Disposable income of People.

Disposable Income = Total Income - Direct Tax.

But Indirect Taxes reduce Purchasing Power of People. Revenue of the government increased due to Taxation.

3. Substitution Effect of Taxation :-

Taxation increase the burden of Tax-Payers by Paying High Prices. So tax-Payer divert his demand to its Cheaper Substitutes available in the market.

4. Taxation effect on Allocation of Resources :-

Taxation reduce income, Purchasing Power and Consumption of People. Every individual has limited money resources and he allocate money for different uses. Thus Taxation affect their allocation of resources directly and indirectly.

5. Taxation Effect on Consumption During Inflation and Depression :-

"General rise in the Price level is called Inflation".

During Inflation, Purchasing Power of People gets reduced. By raising Tax rate or imposing of New Taxes will Control the Consumption and Inflation. Thus Taxation Helps to bring stability during Inflation.

During Depression, Purchasing Power of People gets reduced due to Low Income. Here government reduce taxation which increase income and Purchasing Power of People.

6. Regulatory EFFect of Taxation on Consumption

Government impose Taxation to regulate Production and Consumption. Consumption can be regulated by imposing Tax on Production.

As Income = Consumption + Saving

$$Y = C + S$$

So any Change in Consumption will have direct affect on Saving, investment, and Production.

Q:2 Explain the effects of Taxation on Saving, Consumption and Allocation of Resources?

OR How does Taxation affect ability and willingness to work, Save and Investment?

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(A) Effects of Taxation on Saving, Investment and Production :-

All taxes have Negative effective on People's Saving Capacity. Taxation reduce disposable income which reduce Savings.

Generally Effects of Taxation are —

1. Effects on the Ability to Work, Save and invest :-

Taxation reduce disposable income of the Tax-Payers. This will reduce Purchasing Power for various goods and Services. As Consumption of Necessary goods reduce, the ability to work will decline which again affect on Saving and Investment.

Government impose heavy taxes on harmful goods like- Liquor, tobacco, Cigarettes etc. because Consumption of harmful goods reduce ability to work.

Taxation reduce income of Tax-Payer. It also reduce Saving of Tax Payer which result in Less investment and Less Production.

2. Effects on the Willingness to Work, Save and Investment :-

Taxation also affect on the Willingness to work, Save and Invest. Taxation brings money burden as well as psychological burden on Tax-Payer.

Taxes which are imposed temporary do not bring adverse effects on tax-payer.

e.g Kargil Tax imposed for a year.
Tax on Lottery income etc.
But if taxes are Permanent, it will reduce willingness to work and save and invest.

3) EFFects OF Taxation on Consumption

Same Points from Q:1 – C Part.

Q:3 Explain Redistributive Taxation ?

(A) Redistributive Taxation :-

According to Classical economists, Taxation is source of collecting Revenue. But according to Modern economists, Taxation is a tool for redistributing income among various sections of Society. Taxes are used to transfer income from rich to Poor.

"Taxation is a Process for transferring income From rich to Poor is called Redistributive Taxation".

Progressive taxation Put more burden on rich as compare to Poor. The main Purpose of redistributing income is to reduce income Inequalities.

(B) A Redistributive Fiscal Policy include:-

- Progressive Direct Taxation.
- Public Expenditure on Social security, Job Creation
- Expenditure on old age Pension,
- Expenditure on Health Care, Food Distribution.
- Expenditure to increase Aggregate Demand.
- Increase Employment and Investment etc.

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(c) Limitation of Redistributive Policy :-

1) Progressive Taxation results in Tax Evasion and create Black money.
2) Taxation affect Peoples ability to work, save and invest
3) Taxation affect Peoples Willingness to work, save and invest.
4) Redistributive Taxation may result in Deficits, Public borrowings and High rate of Interest.
5) Government uses Redistributive Policy to achieve their Political goals of winning elections. So they Provide more Subsidies. This results in Excessive Consumption and Inflation. This also reduce Value of money.

Q:4 Explain Anti- Inflationary Taxation ?

Anti-Inflationary :- Modern Government has to incur huge expenditure to satisfy Collective wants of economy. Here Taxation plays a very important role for Providing funds to government.

Due to Large Public expenditure and Excessive Consumption there is always Possibility of Inflation. To reduce Aggregate Demand, Anti-Inflationary Taxation is used.

Anti-Inflationary Taxes are in the form of Higher Direct Tax or Indirect Taxes.

Anti-Inflationary Taxes helps government to reduce

Excessive Consumption and divert these resources for growth and development of Country.

Anti-inflationary taxes are Used to reduce Consumption but Redistributive Taxation are Used to reduce Saving through Direct Tax.

Funds raised through Anti-inflationary taxation are Used for increasing Production Capacity of economy.

According to Classical economist —

" All taxes are Anti-Inflationary and all Public Expenditure are Inflationary "

According to Modern economist —

" All taxes are not anti-Inflationary and All Public Expenditure are not Inflationary ".

To decide whether a Tax is anti-inflationary or Public Expenditure is Inflationary, the stage of economic Progress of the Country is very important to Consider.

During Normal Conditions, any Tax which reduce Consumption and increase investment is Anti-Inflationary Tax.

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