Impact, Incidence and shifting of Taxes

Impact of taxes

The term impact is used to express the immediate result of or original imposition of the tax. The impact of a tax is on the person on whom it is imposed first. Thus, the person who is Habile to pay the tax to the government bears its impact. The impact of a tax, as such, denotes the act of impinging.

Incidence of taxes

Incidence means the final resting place of a tax. The incidence is on the man′ who ultimately bears the money burden of the tax.

There are different concepts of incidence of taxation given by different economists:

Dalton classifies incidence of taxation:

Porf. Dalton classifies incidence of tax into tow categories, money burden and real burden.

a) **Money burden**: the money burden classified into two, direct money burden and indirect burden.

According to Dalton, Direct money burden indicate that the burden of taxation in term of money lies

On a person which the tax is levied. This means that one who pays the tax also bears the burden

B) **Real burden**: the real burden also classified into direct and indirect real burden of a tax.

The incidence of tax involves the shifting. If a tax is shifted, the incidence does not fall upon the person who shifts it. For example, suppose a government impose tax on sugar at the sugar manufacturing, so the money burden of the tax falls on the manufacturer of the sugar directly.

If a manufacturer enable to shift money burden of the tax to other person, say, the wholesale dealer by means of raising the price of sugar i.e. shift 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 ultimate bears the money burden, this Dalton calls the indirect money burden.

Mrs. hicks classified the concept of incidence into two parts;

1. Formal incidence : It means proportion of tax payer income that have been shifted to the government. This amount is being used by the government without directly benefiting the tax payer. The formal incidence of tax is the amount of tax collected by the government.
2. Effective incidence: It refers to the effects of taxation on the economy. It will include the all the advantages and disadvantages which a economy drives from the tax system.

Distinguish between impact and incidence of taxes

1. Impact refers to the initial burden of the tax, while incidence refers to the ultimate burden of the tax.

2. Impact is at the point of imposition, incidence occurs at the point of settlement.

3. The impact of a tax falls upon the person fr6m whom the tax is collected and the incidence rests on the person who pays it eventually

4. Impact may be shifted but incidence cannot. For, incidence is the end of the shifting process. Sometimes, however, when no shifting is possible, as in the case of income tax or such other direct taxes, the impact coincides with incidence on the same person.

Shifting of taxes

Shifting means the process of transfer, i.e., the passing of the tax from the one who first pays it to the one who finally bears it. It is through this process of shifting that the incidence of a tax comes finally to rest somewhere. The process of shifting may be slow or may be only partially effective so that the burden of a tax may not fall entirely on the person, who is intended to bear it.

Shifting of taxes

- To what extent burden of tax fall on buyer and seller depends upon many factors
  - Nature of Tax
  - Elasticity of demand
  - Elasticity of supply
  - Nature of market
  - Cost conditions

Nature of tax

- Shifting of tax depends upon the nature of tax; whether a tax is the part of fixed cost or variable cost. If it is a part of fixed cost and is independent of volume of production, such taxes are not shifted in the short period. In long run also producer can bear the burden of tax if he is not incurring losses .In the situation of loss tax will become the part of average cost.

Elasticity of demand

- If the demand for the commodity is elastic, more burden will be borne by the producer, because commodity elastic demand will have low demand if price increases

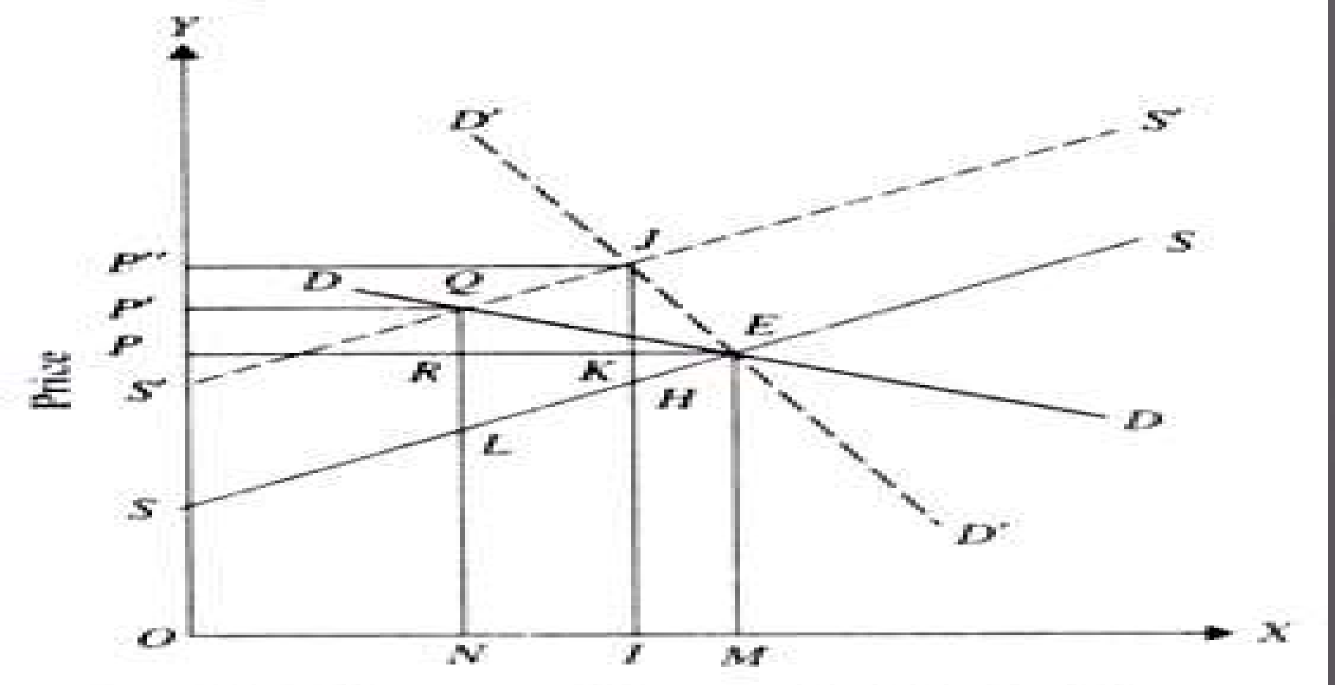
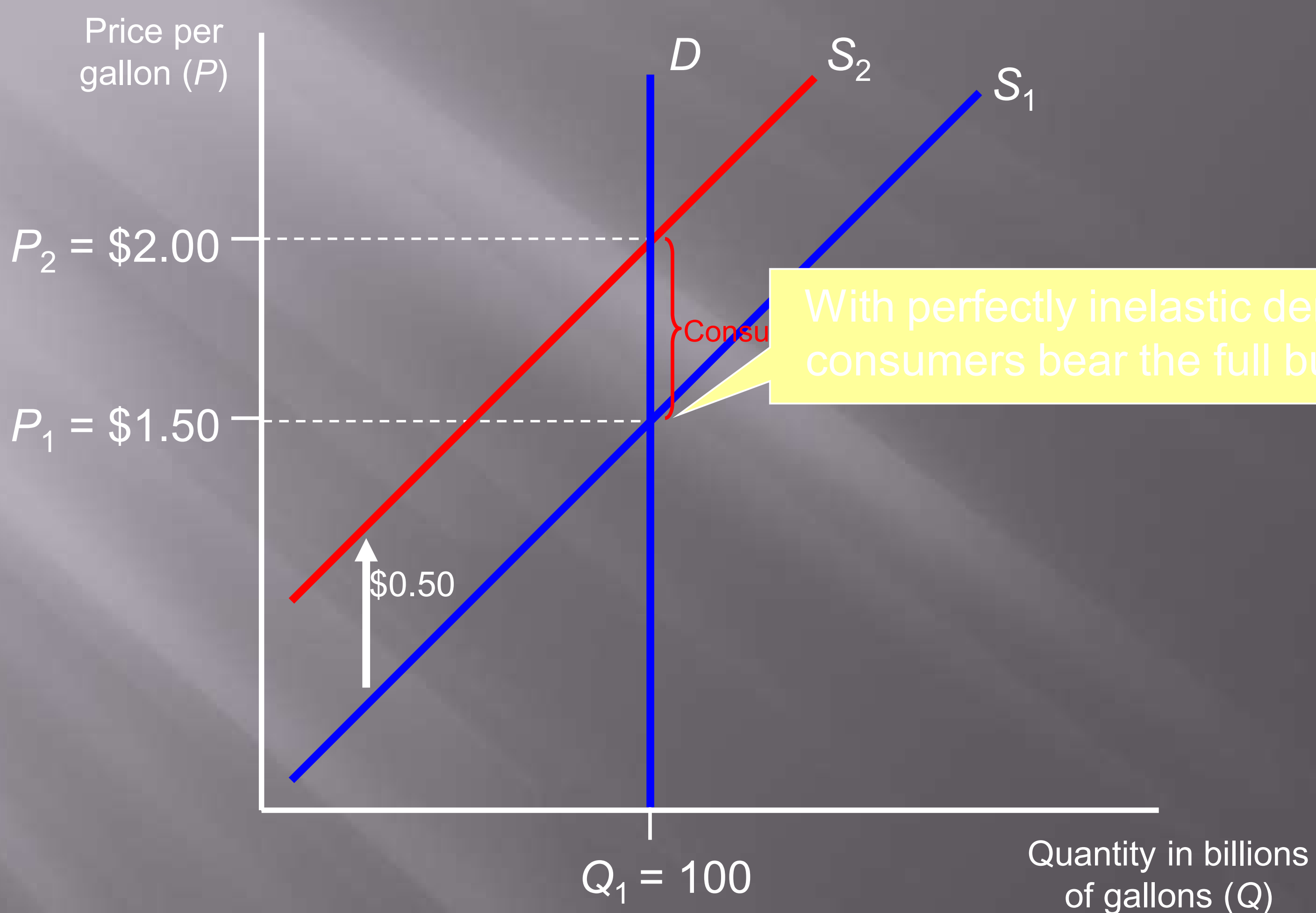


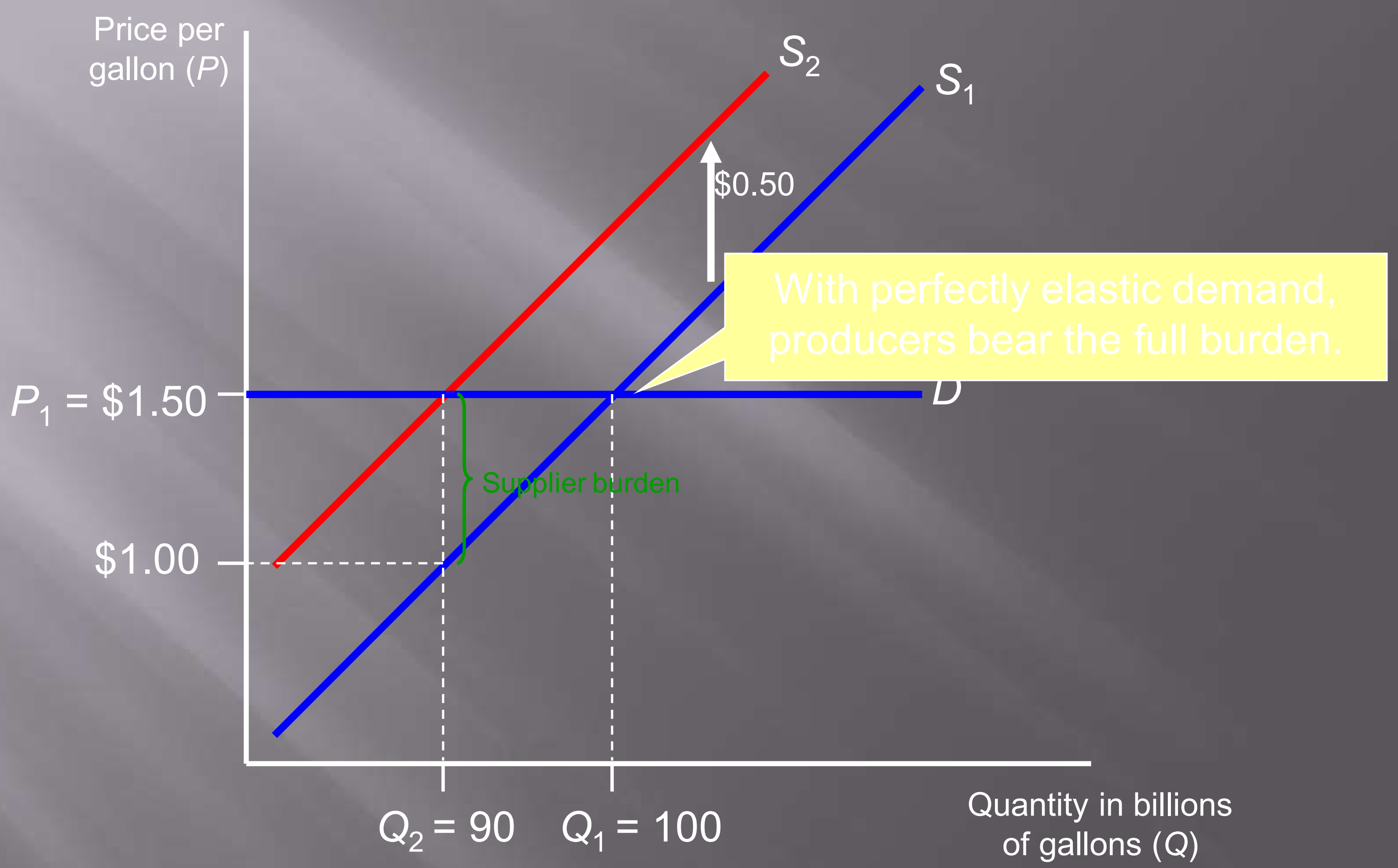
Fig. 32.2. Elasticity of Demand and the Incidence of the Tax

- **Perfectly inelastic demand**

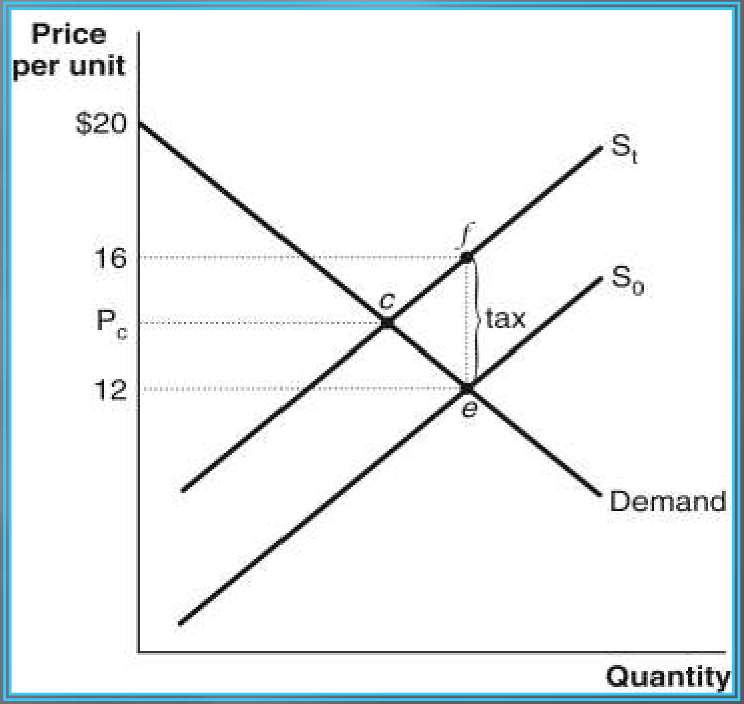
- **Entire Burden of tax is shifted to buyer. No burden is shared by producer.**

- **Perfectly Elastic demand**
- With perfectly elastic demand, the price that consumers face cannot change, since they will simply purchase other substitutes, hence consumers do not bear the burden of the tax.

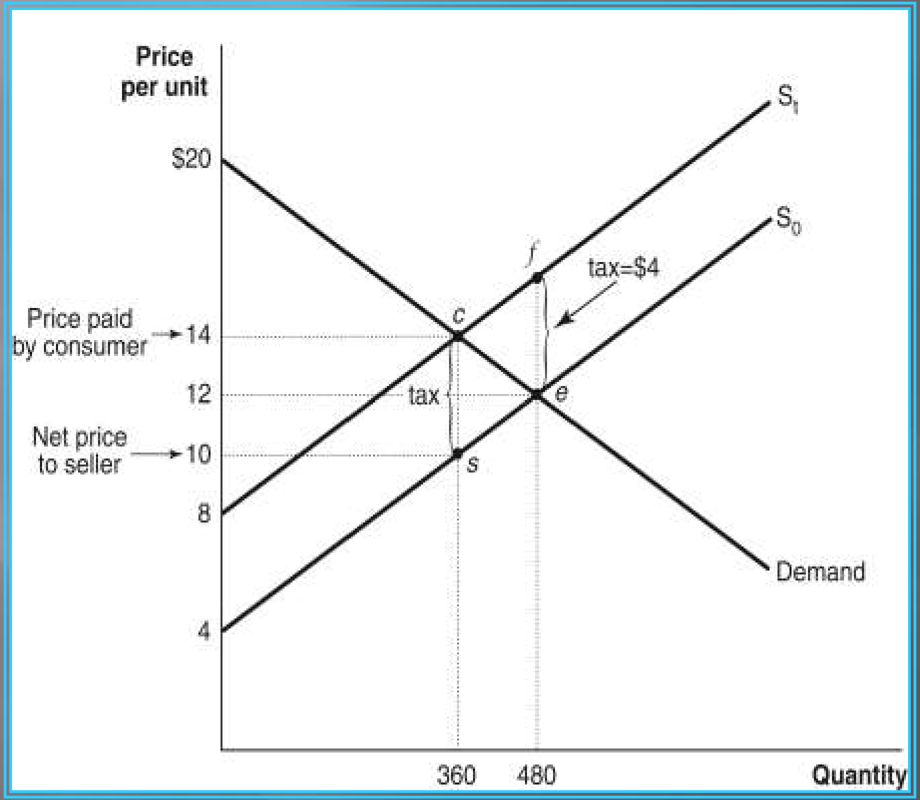

Price per gallon (P)
D
S2
S1
P2 = $2.00
P1 = $1.50
Consu
With perfectly inelastic demand, consumers bear the full burden.
$0.50
Q1 = 100
Quantity in billions of gallons (Q)


Price per gallon (P)
S2
S1
$0.50
With perfectly elastic demand, producers bear the full burden.
D
P1 = $1.50
Supplier burden
$1.00
Q2 = 90
Q1 = 100
Quantity in billions of gallons (Q)

In this situation , burden of tax on the buyer and seller depends on the ratio between elasticitiy of demand and elasticitiy of supply



❖ Elasticity of supply



Perfectly elastic supply

- n this case of elastic supply curve, the incidence of tax on the buyers is greater than that on the sellers.

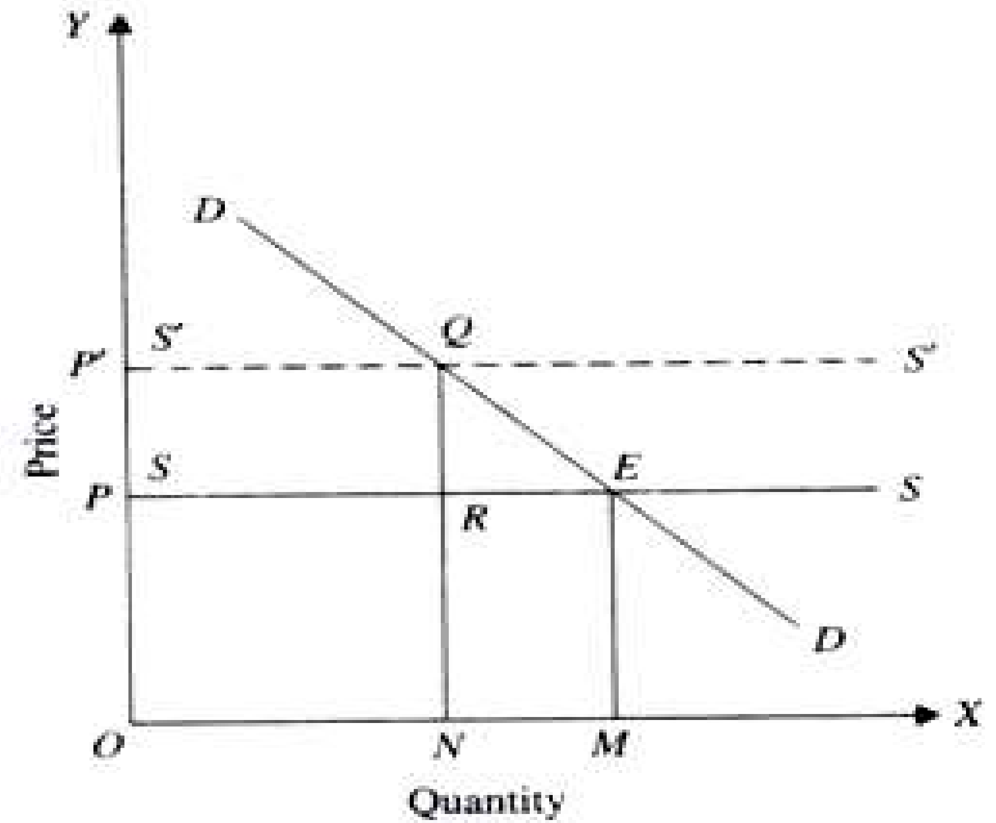


Fig. 32.6. *Incidence of Tax in Case of Perfectly Elastic Supply*

Incidence of tax in case of relative inelastic supply curve

- **In this situation , burden of tax on the buyer and seller depends on the ratio between elasticitiy of demand and elasticitiy of supply**

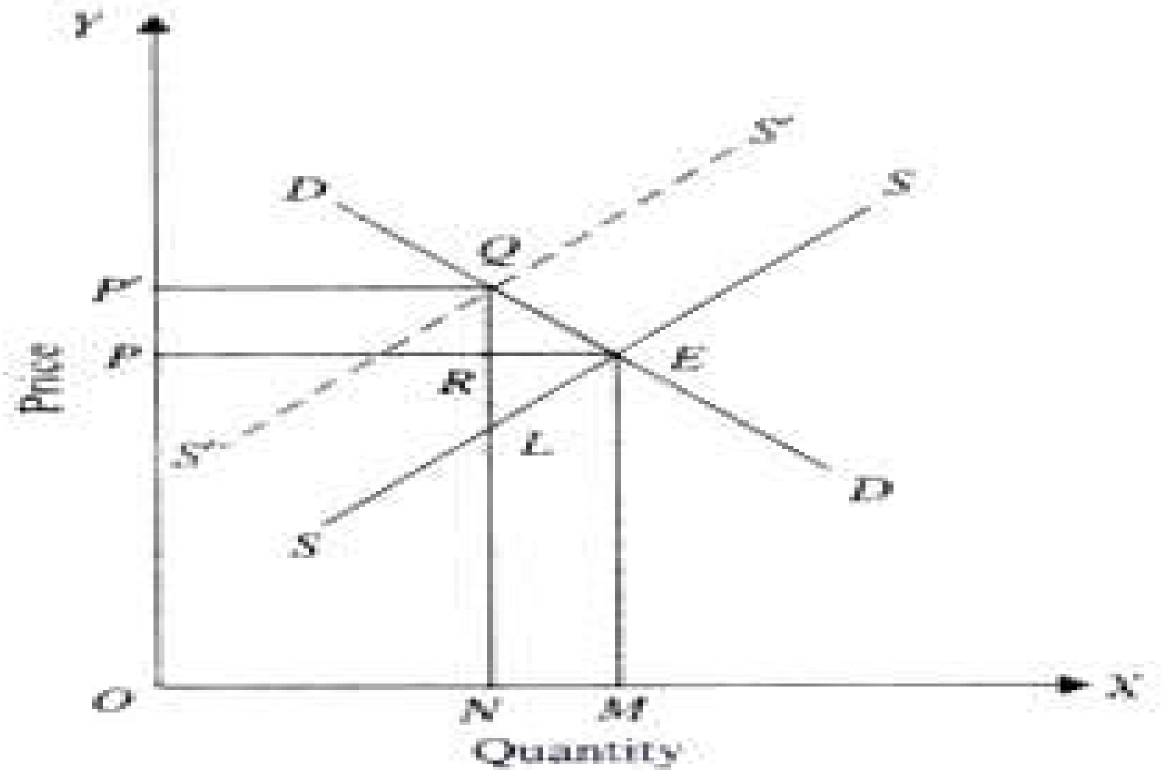


Fig. 32.7. *Incidence of a tax in Case of a relatively Inelastic Supply*

Incidence of an Indirect Tax and Cost Conditions of the Industry:

- 1) Increasing Cost Industries,
- (2) Constant Cost Industry,
- (3) Decreasing Cost Industry.

Increasing cost industry

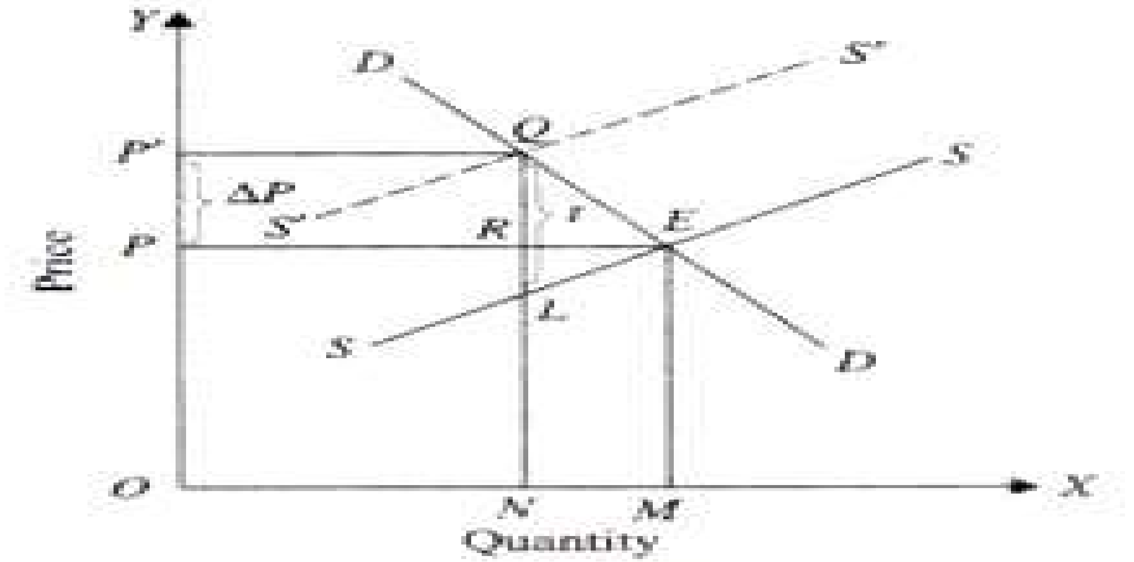


Fig. 32.8. *Incidence of a Unit or Specific Tax in Case of Increasing Costs*

Decreasing cost industry

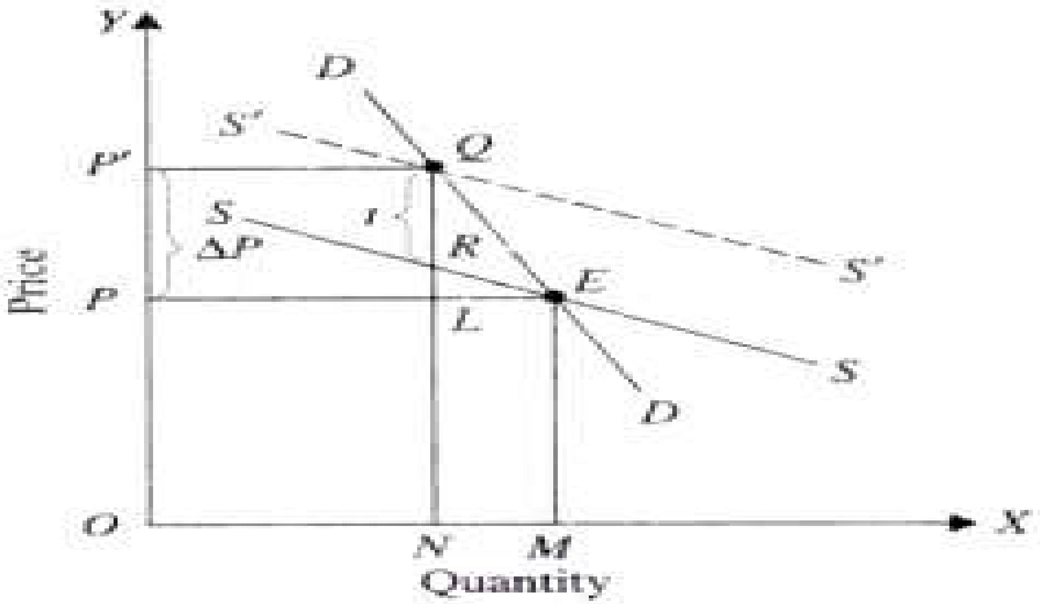


Fig. 32.9. *Incidence of a Unit Tax in Case of Decreasing Costs*

Constant cost industry

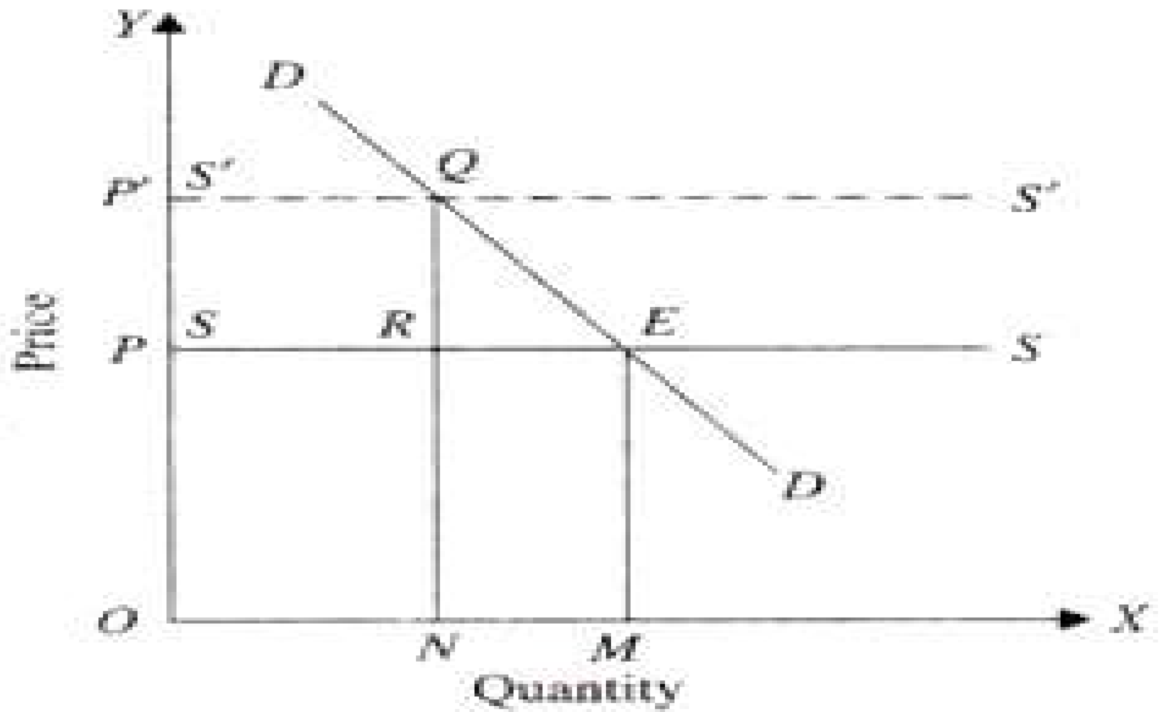


Fig. 32.10. *Incidence of a Unit Tax in Case of Constant Costs*

Conclusion:

- 1. The incidence of a unit tax on the buyers will be less than the amount of the tax when the commodity is being produced under increasing cost conditions.
- 2. The incidence of tax on the buyers will be greater than the tax when the commodity is being produced under decreasing cost conditions.
- 3. The incidence of tax on the buyers will be equal to the amount of the tax when the production of the commodity is subject to constant costs.