



# DIRECT AND INDIRECT TAXES

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The Nation

# WHAT IS TAX

A tax is a compulsory financial charge or some other type of levy imposed upon a taxpayer by a governmental organization in order to fund various public expenditures. A failure to pay, along with evasion of or resistance to taxation, is punishable by law.

# Why are taxes levied?

The prime reason for levy of taxes is that they are the basic source of revenue to the government which can be utilised by the government for its expenses like defence, healthcare, education, different infrastructure facilities like roads, dams, highways etc.

# DIRECT AND INDIRECT TAXES

- The most fundamental classification of taxes is based on *who collects* the taxes from the tax payer.

- **Direct Taxes**

Direct are taxes that are directly paid to the government by the taxpayer. It is a tax applied on individuals and organizations directly by the government e.g. income tax, corporation tax, wealth tax etc.

- **Indirect Taxes**

Indirect taxes are applied on the manufacture or sale of goods and services. These are initially paid to the government by an intermediary, who then adds the amount of the tax paid to the value of the goods / services and passes on the total amount to the end user.

Examples of these are sales tax, service tax, excise duty etc.

# Direct Taxes

A direct tax is a tax that is paid by an individual or an organization to the imposing entity, or to be precise, Direct Tax is the one which is paid to the Government by taxpayers. Also, it is directly imposed by the Government and cannot be transferred for payment to some other entity.

# Direct tax (Advantages)

- ❖ **Equitable.** The burden of direct taxes cannot be shifted. Hence, equality of sacrifice can be attained through progression. Of course, the very low incomes can be exempted. This cannot be achieved by taxes on commodities which fall with equal force on the rich and the poor. The tax raises the price of the commodity and the price of a commodity is the same for every person, rich or poor.
- ❖ **Economical.** Their cost of collection is low. They are mostly collected "at the source". For instance, the income tax is deducted from an officer's pay every month. This saves expense. The employer acts as an honorary tax collector. This means great economy.

- ❖ **Certain.** In the case of a direct tax, the payers know how much is due from them and when. The authorities also know the amount of revenue they can expect. There is certainty on both sides. Certainty minimizes corruption on the part of the collecting officials.
- ❖ **Elastic.** If the State suddenly stands in need of more funds in an emergency, direct taxes can well serve the purpose. The yield from income tax or death duties can be easily increased by raising their rate. People cannot stop dying for fear of paying death duties.

- ❖ **Productive.** Another virtue of direct taxes is that they are very productive. As a community grows in numbers and prosperity, the return from direct taxes expands automatically. The direct taxes yield large revenue to the State.
- ❖ **A Means of Developing Civic Sense.** In the case of a direct tax, a person knows that he is paying a tax; he feels conscious of his rights. He claims the right to know how the Government uses his money and approves or criticizes it. Civic sense is thus developed. He behaves as a responsible citizen.

# Direct tax (Disadvantages)

- ❖ **Inconvenient.** The great disadvantage of a direct tax is that it pinches the payer. He 'squeaks' when a lump sum is taken out of his pocket. The direct taxes are thus very inconvenient to pay. Nobody can help feeling the pinch.
- ❖ **Evadable.** The assessee can submit a false return of income and thus evade the tax. That is why a direct tax is "a tax on honesty". There is a lot of evasion. Many of those who should be paying taxes go scot-free by concealing their incomes.

❖ **Arbitrary.** If taxes are progressive, the rate of progression has to be fixed arbitrarily; and if proportional, They fall more heavily on the poor. Thus, both are bad. The rate of taxes depends upon the whim of the Finance Minister. This is arbitrary.

# Indirect Taxes

An indirect tax is a tax collected by an intermediary from the person who bears the ultimate economic burden of the tax. It can be shifted by the taxpayer to someone else. An indirect tax may increase the price of a good so that consumers are actually paying the tax by paying more for the products.

# Indirect Tax: (Advantages)

- ❖ **The Poor Can Contribute:** They are the only means of reaching the poor. It is a sound principle that every, individual should pay something, however little, to the State. The poor are always exempted from paying direct taxes. They can be reached only through indirect taxation.
- ❖ **Convenient:** They are convenient to both the tax-prayer and the State. The tax-payers do not feel the burden much partly because an indirect tax is paid in small amounts and partly because it is paid only when making purchases. But the convenience is even greater due to the fact that the tax is “price-coated”.

- ❖ **Broad-based:** Indirect taxes can be spread over a wide range. Very heavy direct taxation at just one point may produce harmful effects on social and economic life. As indirect taxes can be spread widely, they are more beneficial and suitable.
- ❖ **Easy Collection:** Collection takes place automatically when goods are bought and sold. A dealer collects the tax when he charges a price. He is an honorary tax collector.

- ❖ **Non-evadable:** They cannot be evaded, as they are a part of the price. They can be evaded only when the taxed article is not consumed, and 'his may not always be possible'
- ❖ **Elastic:** They are very elastic in yield, imposed on necessities of life which have an inelastic demand. Indirect taxes on necessities yield a large revenue, because people must buy these things.

- ❖ **Equitable:** When imposed on luxury or goods consumed by the rich, they are equitable. In such cases, only the .Veil-to-do will pay the tax.
- ❖ **Check Harmful Consumption:** By being imposed on harmful products, they can check consumption of harmful commodities. That is why tobacco, wine and other intoxicants are taxed.

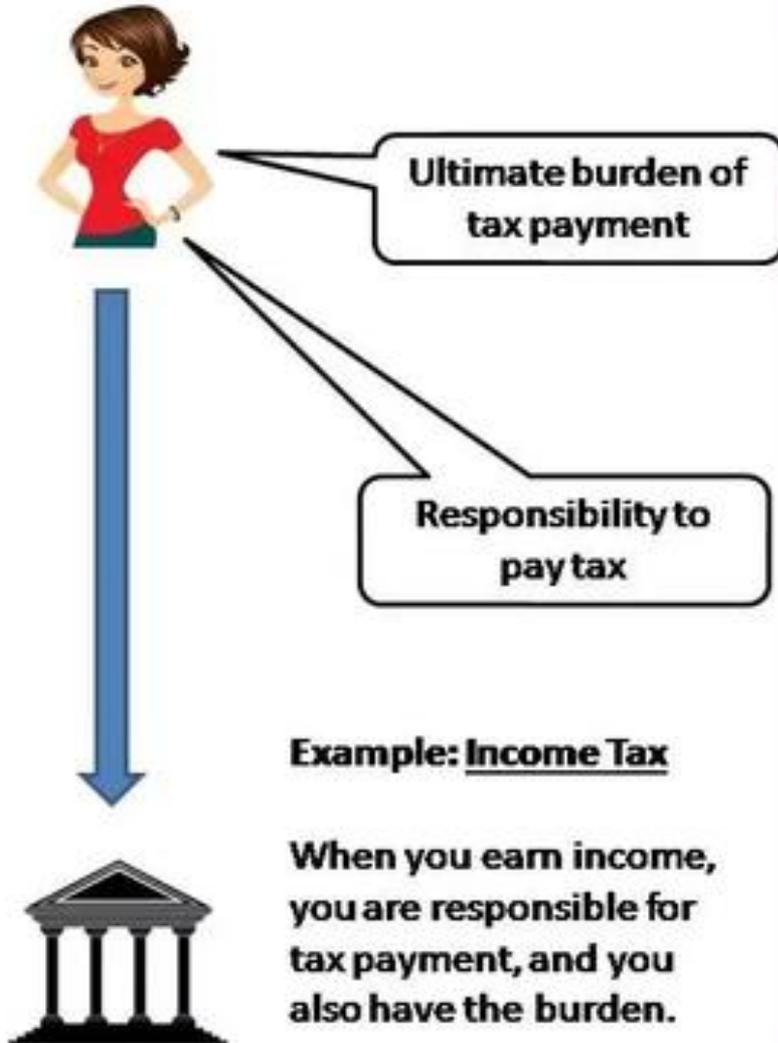
# Indirect Tax: (Disadvantages)

- ❖ **Regressive** Indirect taxes are not equitable. for instance, salt tax in India fell more heavily on the poor than on the rich, as it had to be paid at the same rate by all. Whether a rich man buys a commodity or a poor man, the price in the market is the same for all. The tax is wrapped in the price. Hence, rich and poor pay the same amount, which is obviously unfair. They are thus; regressive.
- ❖ **Harmful to Industries:** They discourage industries if raw materials are taxed. This will raise the cost of production and impair their competitive capacity.

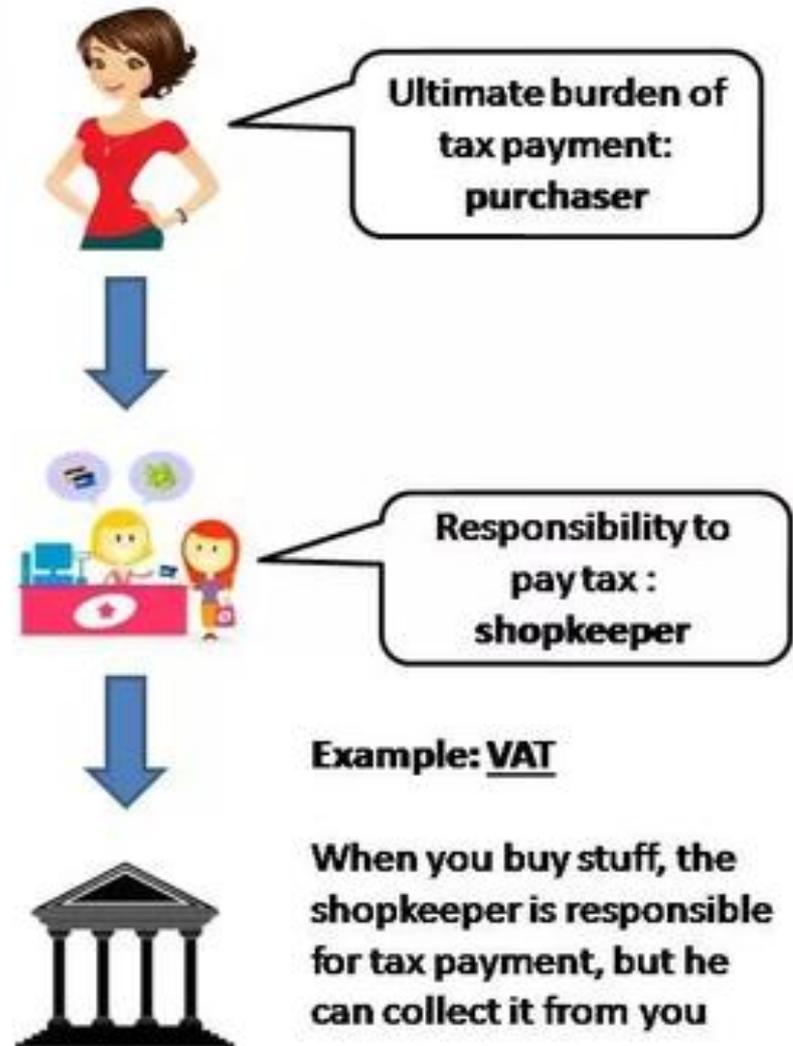
- ❖ **Raising Prices Unduly:** They cause the price of an article to rise by more than the tax. A fraction of the money unit cannot be calculated, so every middleman tends to charge more than the tax. This process is cumulative.
- ❖ **Uncertain:** Unless indirect taxes are imposed on necessities, we cannot be sure of the revenue yield. In the case of goods, with an elastic demand, the tax might not bring in much revenue. The tax will raise the price and contract the demand. When the thing is not purchased, the question of the tax payment does not arise.

- ❖ **Uneconomical:** The cost of collection is quite heavy. Every source of production has to be guarded. Large administrative staff is required to administer such taxes. This turns out to be a costly affair.
- ❖ **No Civic Consciousness:** These taxes do not develop civic consciousness, because many times the tax-payer does not even know that he is paying tax. The tax is concealed in the price.

# Direct Taxes



# Indirect Taxes



# Key differences between direct tax and indirect tax:

## Direct Tax

- ❖ Direct tax is paid directly by an individual to government.
- ❖ Direct Taxes are based on the ability, which means if you earn more, your tax will also be more.
- ❖ The purpose of Direct Tax is to distribute the revenue of a nation.
- ❖ Direct taxes cannot be passed to a different person.
- ❖ The individual upon which the tax is levied is responsible for full tax payment.

- ❖ It is considered as progressive tax because it is depended on ability of the taxpayer.
- ❖ Progressive in nature
- ❖ Impact on taxpayer only
- ❖ It helps in reducing inflation.
- ❖ Imposed and collected on Individuals, company, firms etc.
- ❖ Burden cannot be shifted.
- ❖ Income or wealth of payer is taxable.
- ❖ Examples: income tax, corporation tax, wealth tax etc.

## **Indirect Tax**

- ❖ Indirect tax is a tax that is collected by one person but actually born by another person.
- ❖ An indirect tax is taxed on goods or services, which increases the price of a good or services.
- ❖ The tax is actually paid by the end consumer with higher retail price.

- ❖ Indirect taxes are taxed equally upon all taxpayers irrespective of income.
- ❖ It is considered as regressive tax since all taxpayers whether rich or poor have to pay the same amount.
- ❖ Indirect tax increases inflation
- ❖ Imposed and collected from consumers.
- ❖ Burden can be shifted.
- ❖ Example: Purchase tax, Sales tax, Manufacturer tax and service tax.

# Conclusion

Both the direct and indirect tax have merits and demerits. Direct taxes they are equal because they are charged on person, according to their ability to pay. Indirect tax includes price of the product and services and it has paid by every section of the society.



