Quadrant II – Transcript and Related Materials

Programme: Bachelor of Arts (Third year)

Subject: Economics Paper Code: ECC 108(Honours), ECD 108(General)

Paper Title: Public Finance-II

Unit: 2 (Taxation)

Module Name: Effect of taxation on production and distribution

Module No: 11

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Transcript: Effect of taxation on production and distribution

Effects of Taxation:

The most important objective of taxation is to raise required revenues to meet expenditures. Apart from raising revenue, taxes are considered as instruments of control and regulation with the aim of influencing the pattern of consumption, production and distribution. Taxes thus affect an economy in various ways, although the effects of taxes may not necessarily be good. There are same bad effects of taxes too.

According to Dalton taxation affects production and growth through three effects-

- Effects on the ability to work, save and invest
- Effects on the will to work, save and invest
- Effects on the allocation of resources

Effects on the will to Work, Save and Invest:

The effects of taxation on the willingness to work, save and invest are partly the result of money burden of tax and partly the result of psychological burden of tax.Taxes which are temporarily imposed to meet any emergency (e.g., Kargil Tax imposed for a year or so) or taxes imposed on windfall gain (e.g., lottery income) do not produce adverse effects on the desire to work, save and invest. But if taxes are expected to continue in future, it will reduce the willingness to work and save of the taxpayers.

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. They feel that it is not worth taking extra responsibility or putting in more hours because so much of their extra income would be taken away by the government in the form of taxes.

Effects on the Ability to Work Save:
Imposition of taxes results in the reduction of disposable income of the taxpayers. This will reduce their expenditure on necessaries which are required to be consumed for the sake of improving efficiency. As efficiency suffers ability to work declines. This ultimately adversely affects savings and investment. However, this happens in the case of poor persons. Taxation on rich persons has the least effect on the efficiency and ability to work. Not all taxes, however, have adverse effects on the ability to work. There are some harmful goods, such as cigarettes, whose consumption has to be reduced to increase ability to work. That is why high rate of taxes are often imposed on such harmful goods to curb their consumption.

Effects on the Allocation of Resources:
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.

Effects of Taxation on Income Distribution

Taxation has both favourable and unfavourable effects on the distribution of income and wealth. Taxes reduce or increase income inequality depends on the nature of taxes. Example progressive tax will reduce in equality because burden will on rich where as regressive tax will increase inequality .Taxes imposed heavily on luxuries and nonessential goods tend to have a favourable impact on income distribution. But taxes imposed on necessary articles may have regressive effect on income distribution. A progressive system of taxation has favourable effect on income distribution but it has disincentive effects on output.

Glossary of terms/words:

Willingness-the quality or state of being prepared to do something

Disincentive effect-something that discourages or deters

Disposable income-income remaining after deduction of taxes and social security charges, available to be spent or saved as one wishes.

Progressive tax-A progressive tax is based on the taxpayer's ability to pay. It imposes a lower tax rate on low-income earners than on those with a higher income.

Regressive tax-A regressive tax is a tax applied uniformly, taking a larger percentage of income from low-income earners than from high-income earners

Possible misconceptions/clarification

In the syllabus the module of “Sources of Revenue: Tax and Non-tax sources of revenue” is to be covered in brief