Direct Tax and Indirect Tax

Every form of government needs resources for the nation's development. It is by taxing its citizens the government generates revenue to meet its expense for nation's developmental activities.

In the literature of public finance, taxes have been classified in various ways and criteria. On the basis of how tax is paid, who bears the ultimate burden, the extent to which the burden can be shifted, taxes are most commonly classified into two types as:

1. Direct Tax: A direct tax is a tax which is paid directly by a taxpayer to the tax-imposing authority. It is also defined as the tax where the liability as well as the burden to pay it resides on the same individual taxpayer. Direct taxes are collected by the central government as well as state governments according to the type of tax levied. Major types of direct tax include:

a)Income Tax: Levied on and paid by the same person.
b)Corporate Tax: Paid by companies and corporations on their profits.
c)Wealth Tax: Levied on the value of property that a person holds.
d)Estate Duty: Paid by an individual in case of inheritance.
e) Gift Tax: An individual receiving the taxable gift pays tax to the government.

2. Indirect Tax: Indirect Tax is a tax levied by the tax-imposing authority on the production or consumption of goods and services or on transactions, whose burden can be shifted wholly or partly to another individual. Some types of indirect taxes are:

a) Excise Duty: Payable by the manufacturer who shifts the tax burden to retailers and wholesalers.
b) Sales Tax: Paid by a shopkeeper or retailer, who then shifts the tax burden to customers by charging sales tax on goods and services.
c) Custom Duty: Import duties levied on goods from outside the country, ultimately paid for by consumers and retailers.
d) Entertainment Tax: Liability is on the cinema owners, who transfer the burden to cinemagoers.
e) Service Tax: Charged on services rendered to consumers, such as food bill in a restaurant.

Difference between Direct Tax and Indirect Tax

The key differences of Direct Tax and Indirect Tax can be shown through the following table as below:

Context of differentiation	Direct Tax	Indirct Tax
Imposition	Imposed on income or profits	Imposed on goods and services
Taxpayer	Individuals, firms and companies	End-consumer of the goods and services
Applicability	Applicable to the taxpayer alone	Applicable to every stage of the production-distribution chain
Course of payment	Taxpayers pay it directly to the government.	Taxpayers pay it to the government through an intermediary.
Tax burden	The burden falls directly on the individual	The burden is shifted to the consumer by the manufacturer or service provider
Transferability	Cannot be transferred to anyone else	Can be transferred from one taxpayer to the other
Coverage	Confined to an entity or individual taxpayer	Wide coverage because all the members of the society are taxed
Administrative cost	Higher administrative costs and many exemptions	Lesser administrative costs because of stable, convenient collections
Tax evasion	Possible	Not possible
Allocative effects	Have good allocative effects since they put less burden on the collection	Allocative effects not as good as those of direct taxes
Inflation	Helps in reducing inflation	Might help in increasing inflation
Orientation	Discourage investments, lessen savings	Growth-oriented, encourage savings
Nature of tax	Progressive Tax -Reduces inequalities	Regressive Tax- Enhances inequalities
Most common Example	Income, Wealth, Corporate Tax	Goods and Services Tax (GST), **Excise Duty**

Advantages and Disadvantages of Direct Tax and Indirect Tax

The Key Advantages and Disadvantages of Direct Tax and Indirect Tax can be shown through the following table as below:

Table 4 : Direct vs. Indirect Taxation

	Advantages	Disadvantages
Direct Taxation	1. Relatively cheap and easy to collect.	1. Discourages hard work and enterprise.
	2. Equitable in that it falls on those who can afford to pay.	2. Increases the time and resources spent on tax avoidance.
	3. Gives the governement fairly direct control over people's spending.	3. The tax on company profits tends to reduce investment.
Indirect Taxation	1. Does not discourage effort.	1. Indirect taxes are regressive : as a proportion of income they fall more heavily on the poor.
	2. Can be used for specific social policies such as reducing smoking or gambling.	2. Can be difficult and costly to collect.
	3. People have a degree of choice in whether they will pay the tax.	3. The amount of revenue to be raised by excise duty or sales tax cannot easily be predicted.