Tax and Its Characteristics

Tax: is a compulsory contribution from a person to the government to meet the expenses incurred in the common interest of all without reference to special benefits conferred.

Characteristics of Tax

1. It is a *compulsory contribution* from the people to the government hence anyone who refuses to pay tax is punished.
2. It is a payment of the people to the government to finance its functions for the *benefit of all* citizens.
3. It is *not paid for a specific service rendered* by the government to the person paying the tax. This means that the person can't ask the government to provide a service to him for the tax he has paid. And one cannot refuse to pay tax because he does not require the services of the government.

Public Revenue is the cash inflow of the government from various sources, which include: -

i). Taxes
ii). Fees levied on services provided by the government i.e. Motor Vehicle registration fees, Import licensing fees etc.
iii). Fines charged on law breakers
iv). State property fees i.e. Entrance fees for Game Reserves
v). Public debts i.e. Treasury
vi). Disposal of public investments i.e. Sale of government shareholding in parastatals
vii). Donor Aid i.e. IMF, World Bank
viii). Grants

Public expenditure on the other hand is the allocation of public revenue to the various functions of the government like recurrent expenditure which is day-to-day operations of the government i.e. salaries and wages of civil servants. Capital expenditure, which includes investment, projects of the government i.e. Building Schools, Roads and Hospitals

Functions of the Government

Governments world over are expected to carry out certain activities as part of their services to the public. These are divided into four major functions, namely: -

1. **Administration:** The government oversees the administration of the country by for instance in the Kenyan scenario, creation of provinces; Districts; Divisions; Locations and Sub-Location.
2. **Protection:** A good government must ensure the security of its people from external aggression and internal security must be provided. This is done through The Armed Forces and The Police.
3. **Social functions:** The government provides social facilities like Housing, Education and Health care among others

4. **Development functions:** It is the duty of the government to develop and maintain transport and communication network, agricultural systems and the economic infrastructure in general.

Why Governments Levy Taxes

Government(s) world over levy taxes not only limited to raising of revenue: -

1. **Raising Revenue: -** Every government requires funding to carry out its operations. A significant part of this funding is the revenue raised through taxation. Revenue is used to fund both recurrent and capital expenditure.
2. **Protectionist policy: -** The government uses taxes to protect local industries from competition brought by foreign industries. This involves taxation of similar goods imported into Kenya or the exemption of local products from taxation.
3. **Economic stability: -** The government uses taxes in times of inflation and deflation. This is mainly used to control expenditure patterns in the economy i.e. during inflation taxes rates are raised to suppress the purchasing power of money while in times of deflation tax rates are lowered to increase the purchasing power of people.
4. **Distribution of Wealth: -** A good tax system will tax the poor at lower rates than the rich and the money raised used to improve the living standards of the poor hence wealth balancing.
5. **Allocation of resources: -** Taxes are also used for optimal allocation of resources in order of priority. Revenue raised in taxes will be allocated to projects which are of fundamental importance to a society i.e. Beer and cigarettes are heavily taxed in terms of excise duty and the amount so raised used to fund social projects like Schools, health care etc.
6. **Employment Policy: -** The government can use money raised from taxes to put up projects to create jobs. This can be done by funding government institutions so as to employ people i.e. TSC. The government can also use the same to salvage government institutions, which are in financial difficulties to avoid job losses.

Types of taxation

1. **Income Taxes:** Income tax is a tax that governments impose on financial income generated by all entities within their jurisdiction. By law, businesses and individuals must file an income tax return every year to determine whether they owe any taxes or are eligible for a tax refund. Income tax is a key source of funds that the government uses to fund its activities and serve the public. They include among others: Corporation taxes for companies, PAYE for individuals, Capital gains tax, Advance tax, Presumptive tax, Fringe benefit tax, Withholding tax.

2. **Consumption Taxes: A** consumption tax, sometimes referred to as a "*spending tax*," is a tax levied on consumption spending on goods and services. The tax base of such a tax is the money spent on consumption. It closely resembles the income tax except that the tax base is spending, not income. The important difference is that the tax base is expenditure rather than income. They include among others: Value Added Tax, excise duty, Withholding tax
3. **Customs Duties: Customs** Duty is a tax imposed on imports & exports. The rates of customs duties are either specific or on ad valorem basis, that is, it is based on the value of goods traded.
4. **Other Taxes, Fees & Levies**

These include:

a) Entertainment tax
b) Petroleum Development Fund
c) Import Declaration & Fund (IDF)
d) Foreign Motor Vehicle Inspection Fee
e) Road Maintenance Levy
f) Road Transit Toll Levy
g) Aviation Revenue
h) Revenue Stamps
i) Kenya Bureau of Standards (KEBS) Levy

THE PRINCIPAL /CANONS OF AGOOD TAX SYSTEM

1. **Equality:** This principle of **equality** states that **"***the subjects of every state ought to contribute toward the support of the Government, as nearly as possible, in proportion to their abilities*". That is, a good tax system should be based on the ability to pay of the people. That is, all people should bear the public expenditure in proportion to their respective abilities. Tax burden should be more on the rich than on the poor. Since the rich people can pay more for public welfare, more tax should be collected from richer section and less tax from the poor. The ability to pay may be determined either based on income and wealth or based on consumption i.e. luxury or necessity. In simple terms, canon of equality implies that when ability to pay is taken into consideration, a good tax should distribute the burden of supporting government more or less equally among all those who benefit from government.

2. **Certainty: The** *tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, should be clear and plain to the contributor and every other person*". It means the time; amount and method of payment should all be clear and certain so that the taxpayer can adjust his income and expenditures accordingly. This principle removes all uncertainties in the payment of tax and ensures smooth functioning of the tax department.
3. **Convenience: Every** *tax ought to be levied at the time or in the way it is most likely to be convenient for the contributor to pay it*". That is, the tax should be levied and collected in such a way that is convenient to taxpayer. For example, it may be in installments, land revenue may be collected at the time of harvest etc. This principle reduces the tendency of tax evasion considerably.
4. **Economy:** *Every tax ought to be so contrived as both to take out and keep out of the pockets of the people as the little as possible over and above what it brings into the public treasury of the state*". This principle states that the minimum possible amount should be spent on tax collection and the maximum part of the collection should be brought to the Government treasury. This canon of '**Economy**' is naturally sub-divided into two parts '*Taxation should be inexpensive in collection*', and *Taxation should retard as little as possible the growth of wealth*'

5. **Productivity**: A Tax system should be productive enough i.e. it should ensure sufficient revenue to the Government and it should encourage productive activity by encouraging the people to work, save and invest.
6. **Elasticity:** The taxes should be flexible. It should be levied in such a way to increase or decrease the tax revenue depending upon the need. For example, during certain unforeseen situations like floods, war, famine, and drought etc. the Government needs more amount of revenue. If the tax system is elastic in nature, then the Government can raise adequate funds without any extra cost of collection.
7. **Diversity:** As Per this principle, there should be diversity in the tax system of the country. The burden of the tax should be distributed widely on the entire people of the country. The burden of the tax should be decentralized so that everyone should pay as per his ability. To achieve this, the Government should impose both direct and indirect taxes of various types. It should not depend upon one or two types of taxes alone.
8. **Simplicity**: This principle states that the tax system should be simple, easy and understandable to the common man. If the tax system is complex and vague, the taxpayer cannot estimate his tax liability and it will cause irregularities in the payments and leads to corruption.
9. **Expediency:** A tax should be levied after considering all favorable and unfavorable factors from different angles such as economic, political and social.
10. **Co-ordination:** In a federal set up like Ethiopia, Federal and State Governments levy taxes. So, there should be a proper co-ordination between different taxes imposed by various authorities. Otherwise, it will affect the people adversely.

Neutrality: This principle stresses that the tax system should not

<u>Single versus multiple tax systems</u>

Generally, there are two major types of tax systems. Single or unified tax system and Multiple tax system.

Single Tax System: means only one kind of tax. A single tax denotes the only tax exclusive tax on the one class of things. The single tax might be proportional progressive or regressive. It may be for a single fixed amount.

<u>Merits of Single Tax System</u>

i). The greatest merit of single tax is it ***simplicity***. Since there is, only one tax work of the government is simplified.
ii). Levy assessment and collection of revenue would become very ***easy***.
iii). Levy and collection of tax can be ***good*** if tax concerned is carefully selected.

<u>Demerits of a Single Tax System</u>

i). The greatest defect of the single tax system is that from the revenue point of view the tax ***yield may not be sufficient*** for the government.
ii). Yield of any single tax ***does not increase rapidly*** as the yield from multiple taxes system.
iii). Increase in the ***rate of tax*** alone cannot increase revenue.

Classification of taxes

Taxes can broadly be classified into three categories namely:

By effect

By tax rates

By tax bases

Classification by effect:

Incidence: *This refers to the person who bears the money burden of tax or payment*

Impact/Burden: *This is the person to* ***whom tax is imposed i.e. the person who has the responsibility of accounting for tax.*** Under effect taxes can be categorized as

- Direct taxes
- Indirect taxes

Direct Taxes

This refers to the type of taxes whereby ***both the incidence and the impact/ burden is on the same person.*** That is the person on whom the tax is imposed cannot transfer it to another person. He/she pays it himself/herself. They include Income tax; corporation tax; Capital gains tax; Inheritance tax etc.

Advantages of Direct Taxes

1. ***Equitable* -** Direct taxes are based on income hence people pay per ability.
2. ***Certainty* -** Usually the taxpayers knows how much to pay and at what time to pay since incomes is certain. The government also knows how much to collect and when to collect it.
3. ***Economical* -** The cost of collection is usually low since they are deducted and remitted to the government at source, which reduces the government's cost of collection and the taxpayers' cost of payment.
4. ***Elastic* -** It is possible for the government to vary the rates of tax from time to time to conform to the needs of the economy.
5. ***Simplicity* -** The tax system is such that it is easy to understand and make returns.
6. ***Civic Consciousness* -** They are the most understood taxes by the public since the public knows that they pay taxes to the government. They therefore take interest in knowing how the government uses the taxes, which promote accountability in government.

Disadvantages of Direct Taxes

1. ***Discourages Investment and Savings -*** Direct taxes consume what could have been saved and taxes on interest and Dividends are direct taxes and discourage savings and investments.
2. ***Low Coverage -*** Some people don't fall under these tax brackets and those who do not earn income do not pay taxes, yet they'll enjoy the benefits of projects funded with such taxes.
3. ***Discourages Production -*** Companies may reduce production to avoid paying high taxes especially when faced with financial problems.
4. ***Prone to Evasion -*** Taxpayers usually avoid direct taxes by making false statement to reduce their tax liability.
5. ***Inconvenient -*** Persons paying such taxes must undergo the process of registration with many formalities and tax payers must take their own time and resources to make tax returns to the government.

2) Indirect Taxes

These are taxes whose ***incidence and impact fall on different persons***. That is the person on whom tax is levied or imposed can recover the tax so paid from another person. They include, Value Added Tax; Import Duty, Export Duty etc.

Merits of Indirect Taxes

1. ***Wide coverage* -** Since they are based on expenditure they cover all classes of people since everyone must spend.
2. ***Elastic* -** The government can easily vary the tax rates from time to time as per the needs of the economy.
3. ***Economical* -** Those making returns are charged with the responsibility of paying the money to the government hence the governments cost of collection is minimal.
4. ***Diversity* -** These taxes can be levied on a wide variety of goods and services. This diversity increases the revenue collected by the government.
5. ***Less Evasion* -** The person charging the tax acts like an agent of the government he/she collects money from buyers hence such taxes are not a cost to him since the burden falls on the buyer. And because the taxes are included in the prices collect ability is high.
6. ***Economic Policy Tool* -** Indirect taxes can be used to promote exports and discourage imports by taxing imports and making exports tax free hence building the domestic market.
7. ***Social welfare* -** Indirect taxes are levied heavily on harmful commodities like Beer and Cigarettes, which reduce their consumption.

Demerits of Indirect Taxes

1. ***Uncertainty* -** Since they are based on expenditure government revenue is uncertain because it is not easy to tell how much people will spend in any period.
2. ***Regressive* -** The rich and the poor pay tax at equal rates in so doing the poor pay a bigger proportion of their wealth than the rich hence the burden is more on the poor than the rich.
3. ***Uneconomical* -** They can be uneconomical to collect especially for the customs duty. The government must employ officers at all points of entry into Kenya.
4. ***Inflation* -** Indirect taxes are included in the prices leading to high costs of production and high selling prices to consumers hence inflation.
5. ***Lack of Civic Consciousness* -** They are paid in commodity prices therefore the public is not usually aware that they are paying taxes They will not therefore be much concerned with allocation of such funds.

Classification by Rates of Tax

The rate of tax is the percentage of the tax base. Under rate, taxes can be classified as:

(a) Progressive Taxes

(b) Proportional Taxes
(c) Regressive Taxes
(d) Digressive Taxes

(a) Progressive Taxes

A tax is progressive when the ***marginal rate of tax rises with income***. A good example of a progressive tax in Kenya is the income tax on individuals.

Merits of Progressive Taxes

1. ***Equitable -*** High-income earners pay more than low-income earners
2. ***Productive -*** It yields more revenue, as the rate of tax is high on higher incomes.
3. ***Economical -*** Collection cost will not increase with the increase in tax payable.
4. ***Better Distribution of Wealth -*** High-income earners surrender more of their earnings than the low-income earners. This is then used to raise the living standards of the poor.

Demerits of Progressive Taxes

1. ***Discourages Savings -*** Since the rate of tax is high on high incomes this may reduce the funds available for savings and investment.
2. ***Arbitrary -*** Progressive taxes are based on scales hence complex to understand.
3. ***Assumption -*** It assumes that different people get equal utility from equal incomes.

(b) Proportional Taxes

A tax is proportional when the same rate of tax is applied to all taxpayers irrespective

of their income level, for example the corporation tax which currently stands at 30% for all firms.

Advantage of Proportional Tax Structure

niformly applicable

✓ It leaves the relative economic status of taxpayer unchanged

✓ It is simple in nature

✓ It is u

Disadvantages of Proportional Tax Structure

1. Inequitable distribution
2. ***Inadequate resources:*** means that the tax for the rich and poor are the same. Hence, the government cannot obtain from the richer sections of the society as much as they can give
3. ***Inelastic in nature:*** because the government cannot raise the rate whenever it wants to raise the revenue.

Regressive Taxes

A regressive tax is one where the rate of tax falls as income rises. Here, the poor are called upon to make a greater sacrifice than the rich.

Digressive Taxes

These are taxes that call upon the higher income earners to contribute less than their due contribution compared to the lower income earners

(a) The burden is relatively less since the tax is mildly progressive-the rate of progression is not sufficiently steep, or
(b) There is progression up to a certain point beyond which the rate become proportional.

CLASSIFICATION BY TAX BASE

The tax base is the object by which tax is calculated. Tax may be classified according to the tax base as follows:

(a) Income tax – The tax base is the income of an individual
(b) Corporation tax – The tax base is the profit of a body corporate /company
(c) Custom duty – the tax base is the value of imported goods
(d) Excise duty – The tax base is the value of locally manufactured goods

Tax shifting

Tax shifting is the transferring of some or all of a tax burden of an entity to another (for example, by a subsidiary to the parent firm, or by a producer or supplier to the consumer) Shifting of tax can take place in two directions forward and backward.

If tax is shifted, from seller to consumer, it is a case of **forwarding shifting. Backward shifting** takes place when consumers do not purchase commodities at increased prices. Sellers are then forced to cut down prices and bear burden of tax themselves.

Factors that determine tax shifting

1. **Elasticity of demand and supply**
   The more the elasticity, the lower the incidence on the sales. The higher the incidence on supply.
2. **Nature of markets**
   In an oligopolistic market (i.e. sellers and many buyers) tax shifting to buyers is high since few sellers can team up to determine the market price. In a situation where there are many buyers and sellers, a large portion of tax will be borne by sellers. For a monopolistic market, the entire tax burden falls on the shoulders of the buyer.
3. **Government policy on pricing**
   In the case of government price control, the supplier cannot increase prices hence cannot shift tax burden to buyers and vice versa.
4. **Geographical location**
   If taxes are imposed on certain regions, it is hard to shift them to consumers because consumers will move to regions with low taxes.
5. **Nature of tax (direct or indirect tax)**
   Direct tax e.g. PAYE cannot be shifted whatsoever while indirect taxes can be shifted through increase in prices.
6. **Rate of tax**
   If too high, shifting can occur backwards or forwards, if too low, it may be absorbed by the manufacturer.
7. **Time available for adjustment**
   The person who can adjust faster (buyer or seller) will be able to shift tax e.g. if the buyer cash shift to substitute goods, the seller will bear the tax burden.

Tax evasion and tax avoidance

Tax evasion is the illegal evasion of taxes by individuals, corporations, and trusts. Tax evasion often entails taxpayers deliberately misrepresenting the true state of their affairs to the tax authorities to reduce their tax liability and includes dishonest tax reporting, such as declaring less income, profits or gains than the amounts earned, or overstating deductions. Tax evasion means ***fraudulent action*** on the part of the taxpayer with a view to violate civil and criminal provisions of the tax laws. It can be defined as ***"tax evasion implies the activities involving an element of deceit, miss-representation of facts, falsification of accounts including down right fraud"***. Thus, Tax crime is a deliberate attempt to illegally obtain a tax benefit through violation of tax laws. Domestic tax crimes come in many forms which include: -

i). Nil/non-filing income tax returns,
ii). Failure to register as a tax entity,
iii). Failure to furnish tax returns,
iv). Failure to pay taxes,
v). Failure to keep records,
vi). Failure to remit withheld taxes,
vii). Dealing with excisable goods without a valid license,
viii). Fraudulent VAT refund claim,
ix). Under declaration of income, and
x). Falsification of books of accounts
xi). Use of fake security bonds to clear transit goods,
xii). Diversion/dumping of transit goods

Causes of Tax Evasion

The following are the important causes for Tax evasion:

a. Multiplicity of Tax Laws
b. Complicated Tax Laws
c. High Rates of Taxation
d. Inadequate Information as to Sources of Tax Revenue
e. Investment in Real Property
f. Ineffective Tax Enforcement
g. Deterioration of Moral Standards

<u>Remedies for Tax Evasion</u>

1. **Thorough Overhauling of Tax Laws** One of the main reasons for tax avoidance and tax evasion is loose drafting of tax laws which contain several loop-holes and weak points that enable the tax evaders to carry on the unlawful activities. Hence, it is necessary to re-draft the tax laws thoroughly without any loopholes and weak points.
2. **Reduction in Tax Rates** The prevalence of high rates is the first and foremost reason for this tax evasion. Hence, the rate of tax should be reduced to a reasonable level.
3. **Maintenance of Proper Accounts** Maintenance of proper accounts should be made compulsory for persons whose business and professional income exceeds a

prescribed limit. In the Income Tax law, a provision to this effect has been introduced recently.

Tightening of Tax Enforcement This may be said to be the crucial remedy if the penalties for violation of tax laws are strictly enforced, incidence of tax evasion

Taxable capacity

Taxable capacity is that maximum amount, which can be deducted from country's income consistent with the maintenance of that income for years to come. Taxable capacity is normally used into two senses, that is the absolute taxable capacity and the relative taxable capacity.

The absolute taxable capacity: - The absolute taxable capacity indicates the amount of money or the proportion of national income that can be taken away by the government from people in the form of taxes without producing unfavorable effects.

The relative taxable capacity: - The relative taxable capacity refers to the proportion in which two or more communities can contribute in the form of taxes to meet some common expenditure. In other words, relative taxable capacity of the community to contribute to some common expenditure in relations to the capacities of other communities

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Factors Affecting Taxable Capacity

Taxable capacity of a nation is determined by the following major factors: -

1. **Number of Inhabitants.** The bigger the amount, the larger is the taxable capacity of the society to add towards the operating cost of the management.
2. **Distribution of Wealth.** If capital is more uniformly disseminated, the taxable capacity will be equally abridged. But if there are big accretions of capital in the minority hands, the management can collect additional money by levying taxes on the rich.
3. **Method of Taxation.** A systematically created tax system with an intelligent collaboration of several **types** of **taxes,** direct as well as indirect, is certain to fetch in a better yield.
4. **Purpose of Taxation.** If the intention of taxation is to encourage interests of the public, they will be more eager to taxing themselves.
5. **Psychology of Taxpayers.** Much relies on the people's approach towards an administration. A well-liked government can stimulate the will of the public and train them for larger sacrifice.
6. **Stability of Income.** If the revenue of the residents is unstable, there will be not much capacity for additional taxation. It is only on stable incomes that long-term financial arrangements can be based.
7. **Inflation.** It reduces the buying capacity of the nation and it cripples countless individuals; it has an unpleasant result on taxable capacity.

Fiscal policies

Fiscal policy refers to use of government spending program and government revenue program to produce desirable effects and avoid undesirable effects on national income, production and employment.

Instruments of Fiscal Policy

The tools of fiscal policy are taxes, Public, expenditure, public debt and a nation's budget. They consist of changes in government revenues or rates of the tax structure so as to encourage or restrict private expenditures on consumption and investment.

Public expenditure During inflation, the government increases its expenditure and reduce taxes so that unemployment may be decreased and vice versa during deflation.

Public debt in times of inflation the government raises money through public debt (Treasury Bills and Treasury Bonds) this reduces money in supply and effectively reduces prices. While in times of deflation the government pays back the debts to increase money supply.

Public Revenue in times of inflation the government raises taxes to reduce disposables income of people, which effectively lowers the prices. In times of deflation the government reduces taxes to increase the disposable income.