Impact of direct tax on consumer equilibrium

OBJECTIVE

This term paper is being done in order to check and determine the effect of various factors of the direct tax that have an impact on the consumer equilibrium. The main objective of this term paper is as under:

To determine what is direct tax and consumer equilibrium

Analysis of articles

Impact of direct tax and other factors on consumer equilibrium.

INTRODUCTION

In introduction , we will start with the basic like- what is direct tax and what is consumer equilibrium. We will discuss these two in a elaborated manner.

DIRECT TAX

CONSUMER EQUILIBRIUM

DIRECT TAX

The term direct tax generally means a tax paid directly to the government by the persons on whom it is imposed. In the general sense, a direct tax is one paid directly to the government by the persons. on whom it is imposed (often accompanied by a tax return filed by the taxpayer). Examples include some income taxes, some corporate taxes, and transfer taxes such as estate (inheritance) tax and gift tax. In this sense, a direct tax is contrasted with an indirect tax or “ collected” tax (such as sales tax or value added tax (VAT)); a “ collected” tax is one which is collected by intermediaries who turn over the proceeds to the government and file the related tax return. Some commentators have argued that “ a direct tax is one that cannot be shifted by the taxpayer to someone else, whereas an indirect tax can be.

The direct tax definition is not complete until we do not define or throw some light on indirect tax, thus-

INDIRECT TAX

A tax that is not assessed on and collected from those who are intended to bear it. Unlike a direct tax , it cannot take individual circumstances into account. Although levied on

Producers , the burden of an indirect tax may be ‘ shift’ to consumers.

Ex: value added tax, sales tax, payroll tax and excise duties

CONSUMER EQUILIBRIUM

When consumers make choices about the quantity of goods and services to consume, it is presumed that their objective is to maximize total utility. In maximizing total utility, the consumer faces a number of constraints, the most important of which are the consumer’s income and the prices of the goods and services that the consumer wishes to consume. The consumer’s effort to maximize total utility, subject to these constraints, is referred to as the consumer’s problem. The solution to the consumer’s problem, which entails decisions about how much the consumer will consume of a number of goods and services, is referred to as consumer equilibrium.

Determination of consumer equilibrium. Consider the simple case of a consumer who cares about consuming only two goods: good 1 and good 2. This consumer knows the prices of goods 1 and 2 and has a fixed income or budget that can be used to purchase quantities of goods 1 and 2. The consumer will purchase quantities of goods 1 and 2 so as to completely exhaust the budget for such purchases. The actual quantities purchased of each good are determined by the condition for consumer equilibrium, which is

This condition states that the marginal utility per dollar spent on good 1 must equal the marginal utility per dollar spent on good 2. If, for example, the marginal utility per dollar spent on good 1 were higher than the marginal utility per dollar spent on good 2, then it would make sense for the consumer to purchase more of good 1 rather than purchasing any more of good 2. After purchasing more and more of good 1, the marginal utility of good 1 will eventually fall due to the law of diminishing marginal utility, so that the marginal utility per dollar spent on good 1 will eventually equal that of good 2. Of course, the amount purchased of goods 1 and 2 cannot be limitless and will depend not only on the marginal utilities per dollar spent, but also on the consumer’s budget.

LITERATURE REVIEW

Hegde, Prakash and Barve, Nachiket, June 27, 2010, “ Impact of direct tax code on individual”, BUISNESS LINE says that Though most of the existing provisions of the income-tax law are finding place in the DTC, many provisions are new or modified that will affect the individuals significantly. The prominent ones are like DTC proposed significant reduction in individual income-tax by increasing tax slabs – 30 per cent tax rate at an income level of Rs 25 lakh (present – Rs 8 lakh). If proposed tax slabs and rates are implemented, then taxpayer’s take-home pay may see a substantial jump.

However, in view of relaxation or rollbacks of other tax proposals, one has to wait and watch whether Government still intends to offer the proposed tax slabs and rates. EEE preferred over EET, EET results in higher tax at retirement in contrast to ability to pay. Recognising the fact of absence of a well developed social security system and other challenges (technical / administrative) Government thought it fit to retain EEE and partial EET. One of the strange provisions in DTC, which had not caught public attention but can affect a common man travelling abroad, is furnishing an undertaking to the tax officer to the effect that he has made " satisfactory arrangement" for discharging his tax liability in India before he leaves India. The tax officer has to issue a no-objection certificate for his travel. If travel is made without a no-objection certificate from the tax office, the owner or charterer of the aircraft will be held responsible to pay the taxes due, if any. This process would have been more of a hurdle than a smooth ride.

Gillingham, Robert and Greenlees, John S, 4 August 1987, " The Impact of Direct Taxes on the Cost of Living" says in the article that, a cost-of-living index including direct taxes. They show its relationship to the traditional index and demonstrate how non consumption costs are properly treated. They then define a fixed-weight approximation, a tax and price index (TPI). Using federal, state, local, and social security tax rates for 1967- 85, the authors construct annual TPI series based on household data. They find that inclusion of direct taxes has sizable impacts on the estimated rate of inflation. Partitioning their household sample, they find that recognition of taxes significantly alters inflation rate differentials estimated using consumption prices alone.

Subramani, V. K, 29, August 2010, “ Expectation from code revision”, according to the author, There is a huge expectation that the revised Code would address the concerns of the taxpayers at large, by retaining the existing tax concessions and providing smooth transition, with minimal scope for confusion or litigation. There is Positives, negatives traits of the code. There are some positives in the first draft of the DTC, such as: (i) minimum rate of personal tax at 10 per cent for incomes up to Rs 10 lakh;(ii) deduction in respect of savings (similar to Section 80C) up to Rs 3 lakh;(iii) presumptive taxation of income for turnover up to Rs 100 lakh;(iv) short-term capital loss under the present law, called as ‘ terminal allowance’ in the DTC, eligible for deduction while computing business income; and(v) making reference to ‘ financial year’ instead of the currently used terms such as ‘ previous year’ and ‘ assessment year’. The negatives of the DTC, prima facie, include: (i) clubbing of spouse income with the income of spouse, whoever has higher income;(ii) restricting the exemption in respect of accumulated balance in provident fund account up to March 31, 2011;(iii) denying carry forward of business loss to any year, if the return is filed beyond the ‘ due date’ both in the year of incurring loss and any subsequent year in which it is carried forward with or without set off ;(iv) denying deduction in respect of medical treatment expenses (present Section 80 DDB) to HUF;(v) reduction in time limit for passing order of rectification to two years;(vi) advancing the date for filing the return of tax base and imposing penalty for failure to file tax base return before the ‘ due date’ as against the present time limit of March 31 of the assessment year; and(vii) giving precedence to the DTC in the event of conflict between DTAA and DTC.

Parthasarathy, Suresh, 20, June 2010, “ How the revised tax code impact us”, BUISNESS LINE, says that without social security the proposed EET (Exempt-Exempt-Taxed) structure was harsh on individuals, the revised code has proposed to bring some relief to long-term savings investment such as PF, PPF, New Pension Scheme, approved pure life insurance, annuity schemes and GPF. These will now be subject to the Exempt-Exempt-Exempt (EEE) method of taxation rather the EET model proposed last year. . The revised DTC proposes to follow the existing method of tax deduction on home loan at least for the interest paid. In case of the house being self-occupied, the individual will be eligible for deduction of interest on capital borrowed for acquisition or construction of the house, subject to a ceiling of Rs 1. 5 lakh, from the gross total income. This revised proposal is a change from the earlier stand of disallowing tax exemptions on the interest and principal paid on house property. The New Pension Scheme, was struggling to find patronage owing to uncertainties relating to its tax structure. In a attempt to make this scheme more attractive and to introduce some flexibility in making withdrawals in lump sum without being subject to taxation, the revised code proposes to extend the EEE method of taxation to the pension scheme administered by the Pension Fund Regulatory and Development Authority, apart from PF, GPF and recognised Provident Funds. Under the revised code, capital gains arising on account of transfer of equity shares or units of an equity oriented fund held for more than one year will be computed after allowing a deduction at a specific percentage of capital gains without any indexation.

Buch, Drupadh, 30 July 2010″How Revised Direct Taxes Code Will Impact Senior Citizens”, EZINE ARTICLES, according to the author of the article, it states that how direct tax has impact on senior citizen there has not made any changes in the Income Tax Rates and Income Tax Slabs that were proposed in the original draft. That means there is no change in the basic exemption limit for the Senior Citizens (resident individual of 65 years or above), which is 240, 000 per year. In the revised DTC, there is no change in the limit of deductions from taxable income for savings in specified investments. In the original draft, the limit has been proposed to be revised to 300, 000 from the present limit of 100, 000. However, it should not make much difference to the Senior Citizens, as the tax incentives for savings are basically meant for the youngsters. , the retirement benefits such as gratuity, commuted pension, voluntary retirement compensation and leave encashment will be exempt from tax subject to specified limits. Original Draft DTC had proposed a scheme of deferment of tax on retirement benefits, that is, the retirement benefits would not be taxed if it were invested in a Special Retirement Benefit Account, which would be subsequently taxed in the year of withdrawal. In the New DTC, be it in the original draft or in the revised discussion paper, there is nothing very much special for the senior citizens except the higher income tax slabs and the corresponding reduced tax rates. If the basic exemption limit of 240, 000 for senior citizens were revised substantially, it would have definitely been a great boon to the Senior Citizens.

Latest IRI Research Finds a New Consumer Equilibrium Emerging as Economy Continues to Transform –

It is no secret that the ongoing economic turmoil is dramatically affecting consumers' shopping and purchase behaviors. Consumers are eating out less, reducing the number of doctor visits and foregoing vacations to stretch their limited dollars. But, which consumer groups are driving these cost-saving strategies? The latest research from Information Resources (1) The data and information assets of an organization, department or unit. See data administration.

(2) Another name for the Information Systems (IS) or Information Technology (IT) department. See IT. , Inc. (IRI), Competing in a Transforming Economy 4. 0: The New Equilibrium leverages post-inaugural survey results to identify key consumer segments that are leading the change and helps retailers and manufacturers connect with their most important consumers.

Since the beginning of 2009, a new consumer equilibrium has emerged in which behaviors initially implemented to weather the storm have the potential to last well beyond an economic recovery. In this phase of our research, we went beyond studying the common spending, self-reliance and self-health strategies that are becoming common place in today's environment and examined how economic pressures have driven different types of consumers–by income level, household composition and even varying consumer mindsets–to change their strategies.

Gidwan, Sunil and Desai, Jignesh, October, 2010, " New Direct Tax Code: Impact on Banking sector", THE ANALYST. According to the author, The DTC is a good step taken by the Government of India to reduce litigations and simplify the tax provisions followed for nearly five decades. The banking sector plays a vital role in the economic development of any country. In India, the financial service sector is now acknowledged as the next growth engine. It is therefore crucial that fiscal policies recognize this role and through various measures support and strengthen the sector. Despite the representation made on behalf of the financial service sector after the first draft of the Direct Tax Code (DTC), the new DTC does not seem to address some of the issues faced by the banking sector. India has a better banking system in place, as compared to the other developing countries, but there are several issues that need to be addressed in order to ensure that these issues do not remain as hurdles in the sustained economic development of the country. . A number of stringent proposals were brought in the draft Direct Taxes Code, 2009. There were several areas of concern. Most of them, such as asset-based Minimum Alternate Tax (MAT) and treaty override, were addressed by the Finance Minister through the release of a Revised Discussion paper earlier in June this year

SOURCE OF DATA:

The source of data that I have used is SECONDARY SOURCE DATA.

Secondary data is elected in form of information which has already been collected by someone. Along with this some information on direct tax, their features are collected from internet.

For more information regarding research methodology , books from library have been referred.

ANALYSIS OF THE TOPIC

The direct tax and the consumer equilibrium has a direct relationship with each other. The direct tax code slabs affect the consumer in many ways and it's not just only direct tax that has an impact on the consumer equilibrium there are many other things that effect consumer equilibrium. When the direct tax which are implemented on the individual are low, i. e., the rate of tax that a consumer has to pay is minimum, it provides him the larger window to earn more money as less money will be deducted from his earnings. Due to this the budget line of the consumer will show the deviation, it will move towards right side

INDIFFERENCE CURVE

EQUILIBRIUM POINT

BUDGET LINE

QTY OF A

QTY OF B

Fig a: High direct tax Figb: Low direct tax

As we can see the above figure depicts if the direct tax that the individual has to pay are decreased than there will be the upwards shiftment of the budget line which will allow the consumer to buy more products by increasing his budgets. Indifference curve in the figure plays an important role , indifference curve should be tangential to the budget line because it’s the most optimum level at which the consumer could use his budget to get maximum satisfaction. The following conditions should be kept in mind for consumer equilibrium:

Consumer spends all the income in buying two commodities ; hence point of equilibrium will lie on budget line.

The point of equilibrium will always be on the highest possible indifference curve that consumer can reach.

Slope of indifference curve should be equal to the slope of budget line. In other words:

MUm/MUn = Pm/Pn

There are also some major factors that has effect on consumer equilibrium, which are as under:

Price effect

Income effect

Substitution effect

Price Effect:

Change in the price of the any of the goods he consumes will also lead to change the equilibrium point. Price effect shows the reaction of consumer to the change in the price of a commodity, other things remaining the same. It measures the change in amount (quantity) demanded of a commodity with change in it's price when price of the other commodity with which it is being combined remains the same.

When there is increase in the price of a commodity, obviously he consumes it less (and becomes worse off). And when the price of the commodity decreases or falls, he consumes the commodity more (and becomes better off). Remaining the consumption of a commodity in the combination same, it is clear that when the price of commodity (another in combination) increases, consumer shifts to the lower indifference curve, and when price falls, consumer goes to higher indifference curve.

When the price of a commodity in X-axis increases (remaining the price of commodity on Y axis same, consumer will certainly reduce the consumption of commodity in X – axis. Budget line shifts downward. After increase in the price of good in X – axis, his budget line moves down wards. He gets the new equilibrium point at which it is lower. This is in case of rise in price of a commodity. Price Consumption Curve may be upward sloping, downward sloping (or backward sloping). Nature of slope of PCC shows the types of goods and their cross elasticity of two goods. Slope PCC is dependent on the nature of goods whether they are inferior, superior, luxurious or whether the combination is complements or substitutes.

Income effect:

When there is change in income of consumer, there is change in equilibrium point due to change in quantity demanded; when there is change in income, there is shift in budget line. Generally income and quantity demanded relationship is positive. But it depends on the nature of goods whether it is inferior or normal. If good is griffin paradox or inferior, income demand relationship is negative. A line joining equilibrium points which are set due to change in income is income consumption curve.

When there is increase in income , quantity demanded of both commodities increases. PL is the original budget line or price line. When income of consumer decreases from PL to PL1, consumer consumes both the commodities less and Equilibrium E1 is set on new budget line P1L1 and in lower Indifference Curve IC1. But when there is increase in income of consumer, his budget line shifts upward to the right from the origin (P2L2). During increase in income, consumer consumes both the commodities more and equilibrium is set at point E2 on higher IC on budget line P2L2. Both commodities in X and Y axis are normal goods so ICC is sloping upward.

E2

E1

P2L2

PL

P1L1

PL1

Substitution Effect:

Substitution effect is also one of the responsible factor to cause change in consumers' equilibrium. Substitution effect is the result of consumers inherent tendency to substitute cheaper goods for the relatively expensive ones. Substitution effect means the change in the purchase of a commodity as a consequence of change in relative price alone, real income remaining the constant. When price of a good changes, the real income (or purchasing power) of the consumer is also changed. To keep real income of the consumer constant so that the effect due to change in relative price may be known, price change is compensated by simultaneous change in income.

For example when the price of good X falls, real of consumer increases. To find the substitution effect (i. e change in demand of X due to change in its relative price), we reduce the money income of consumer (to cancel the increase in real income due to fall in price of X). For further study of substitution, two slightly different theories have been developed. Theory developed by Hicks and Allen is called Hicks Substitution Effect and theory developed by E. Slutsky is known as Slutsky Substitution Effect

MERITS/DEMERITS OF DIRECT TAX

MERITS OF DIRECT TAXES

Direct taxes are the main income sources of government.

These taxes are easy to calculate on income and wealth of individuals and businesses.

Direct taxes finance government affairs to run smoothly.

These taxes help government to start and continue public welfare operations

DEMERITS OF DIRECT TAX

The implementation or direct tax is a tough job as people are resistant and show wrong assessment of their income and avoid tax payment.

Direct tax has the negative impact of individual income and decrease the amount of disposable income.

The collection is difficult as compare to indirect tax where consumer do not feel a direct burden of tax.

Cost of collection of direct tax is greater than indirect tax.

Change in the rate and pattern is also difficult for direct taxes as compare to indirect taxes