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| nowgong girls’ college |
| Public Finance - Principles of Taxation |
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| Here Benefit Theory and Ability to Pay Theory of Taxation has been explained for Sixth Semester Economics Major Students of Nowgong Girls’College |

**Benefit Principle of taxation:**

This principle suggests that the burden of taxes should be distributed among the tax payers in relation to the benefits enjoyed by them from government services or social goods. This means those who get more benefits from public goods should pay more taxes than others.

The benefit theory contains the value of services principle. It implies that every citizen should pay tax in proportion to the utility he derives from the public goods and services. Thus, those who receive more benefits or utility from social goods should pay more than others.

The main merit of this principle is that it assumes that the imposition of taxes is justified by the benefits involved in public goods. It also implies the voluntary exchange principle.

**This principle has the following drawbacks:**

1. It is very difficult to measure the benefits enjoyed by an individual from public services.

2. There are certain public goods which satisfy collective wants and are not subject to voluntary exchange principle.

3. It is not in conformity with the definition of tax. It makes tax similar to price. But, price has quid pro quo basis of exchange, a tax has no quid pro quo basis.

4. A blind application of this principle will cause great injustice. A poor person gets more benefit from low cost housing provision by the government. So, this principle will suggest to impose more tax on the poor because he derives more benefit from low-cost housing.

5. The principle is also not conducive to general welfare which requires redistribution of income in favour of the poorer sections through public welfare programmes and services for their benefit.

 **The Ability to Pay Principle of Taxation**

This principle of taxation was developed by J.S. MILL,SIDGEWICK, EDGEWORTH,AND PIGOU. According to this principle an individual should pay tax according to his ability to pay. In the words of J.S.MILL-the just distribution of tax shares prevails when all individual incur equal sacrifice while contributing to common good.

There are two approaches of the principle-

1. The subjective approach
2. The objective approach

According to the subjective approach , the equity principle is satisfied if all individuals make equal sacrifice while paying the tax. Here equal sacrifice refer to the sacrifice in terms of utility of income sacrificed by individuals in contributing to the common good.

ASSUMPTION

1. There is corelation of income and utility for which intr-personal comparisons of utility is possible
2. As income increases mu of income decreases.
3. Everyone’s utility function has the same character.
4. The taste and attitude of each tax payers are identical.

CONEN- STUART and EDGEWORTH put forwarded three concept of equal sacrifice :

(a) Equal Absolute Sacrifice

(b) Equal Proportional Sacrifice

(c) Equal Marginal Sacrifice.

(a) Equal Absolute Sacrifice:

This principle requires that the absolute amount of real burden due to payment of tax should be equal for every taxpayer.

The total loss of utility due to tax payment should be equal for all taxpayers. The rich may contribute more as taxes. One who has less income will pay less as taxes. But the sacrifice to both as a result of the tax should be equal.

(b) Equal Proportional Sacrifice:

This condition requires that the total loss of utility due to tax pay­ment should be equal for every taxpayer. Here the sacrifice should be proportional to income, rather than equal at all income levels.

The rationale of the proportional sacrifice doctrine was the argument that persons with greater incomes received much more benefit from soci­ety. Hence they should bear more tax sacrifice rather than the same amounts as persons with smaller incomes.

Thus for example, under the equal sacrifice doctrine, a person with Rs. 50000/- income would be taxed so as to bear the same real burden as a person with Rs. 25000/- income.

Under the proportionate doctrine, the former would be made to bear twice the sacrifice. That is the ratio of real burden will be the same for all. Thus the ratio: Loss of utility due to tax/ utility of pre-tax income should be equal for all taxpayers. For ex­ample, suppose there are two taxpayers G and H.

The income utility of ‘G’ and ‘H’ are measured at 200 units and 100 units respectively. If taxpayer ‘Gs’ loss of utility due to tax payment amounts to 20 units i.e. 10% of pre-tax income utility. Then to realize proportional sacrifice, taxpayer ‘H’ will have to pay 10 units, to equalize the loss of utility of pre-tax income with ‘G’ (i.e., 10%).

(c) Equal Marginal Sacrifice or Least Aggregate Sacrifice:

The third version was the minimum aggregate sacrifice or equimar­ginal sacrifice doctrine. This principle states that persons should be taxed in such a manner that the total sacrifice for society would be kept to the minimum possible extent. This in turn required that the adjustment of taxes ensure that the marginal sacrifice, i.e., the disutility arising from the payment of the last rupee of tax would be the same for all persons.

If this point were not attained, the shifting of tax burden from some persons to others would reduce the sacrifice of some persons more than it increased the sacrifice of others and thus lessen aggregate sacrifice. Suppose there are two taxpayers in a community – tax payer ‘G’ and H’. Let ‘U’ stands for total utility and ‘Y’ stands for income and T for tax amount. Then (Y-T) indicates income after tax.

Now we can express the three concepts of equal sacrifice principle in the following way:

(a) Equal absolute sacrifice principle can be expressed as:

U(Y)-U(Y-T)G =U(Y)-U(Y-T)H

(b) Equal Proportional Sacrifice Principle can be mathemati­cally stated as:





The left diagram pertains to low income taxpayer ‘L’ and the right diagram to high income taxpayer ‘H’. MuL and MuH are the respective marginal utility of income schedule. These schedules are identical and assumes to decline at a decreasing rate.

Taxpayer ‘L’s income before tax is OB and that of taxpayer ‘H’ is OBr The total utilities derived by tax payers ‘L’ and ‘H’ are OBDM and OB1D1M respectively. Now the figure explains the situation under which tax burden is to be allocated among the two taxpayers ‘L’ and ‘H’.

The question is if a given tax revenue T is to be collected from the two taxpayers how will it be allocated among the two taxpayers under the three rules of equal sacrifice principle: (a) Equal Absolute Sacri­fice, (b) Equal Proportional Sacrifice and (c) Equal Marginal Sacri­fice.

1. Graphical Explanation of Equal Absolute Sacrifice

Under this rule, taxpayer ‘L’ with income OB pays CB amount of tax, while taxpayer ‘H’ with income OB1, pays C1 B1 amount of tax. CB+ C1B1 constitute the total tax revenue T.

The loss of utility or sacri­fice suffered by ‘L’ equals CBDE and that of H equals C1B1D1E1. Hence under this principle, the total tax amount T will be distributed in such a way that CBDE = C1B1D1E1

1. **Graphical Explanation of Equal Proportional Sacrifice:**



If the total tax burden ‘T’ is distributed as per this rule, taxpayer ‘L’ will pay PB and taxpayer ‘H’ will pay P1B1 quantity, with (PB+ P1B1) again equals to T. The tax is divided between the two in such a way that the fraction of pre-taxed utility lost for tax payer ‘L’ (PBDK/ OBDM) is the same as that for taxpayer ‘H’. (P1B1D1K1/01B1D1M1).

3. Graphical Explanation for Equal Marginal Sacrifice:

Under this rule, taxpayer ‘L’ pays FB and taxpayer ‘H’ pays F1 B1 and (FB + F1 B1) corresponds to the total tax revenue ‘T’. Here the marginal sacrifice is the same for two taxpayers, since FG = F1G1. At the same time, two total sacrifice for both (FBDG + F1 B1D1G1) is minimized. After taxed incomes as per this rule are equalized at the point where OF = O1 F1.



Comparison of results for taxpayers ‘H’ and ‘L’ reveals that taxpayer ‘L’ does best under the equal marginal rule, followed by equal propor­tional and equal absolute sacrifice rules. Another fact is the tax­payer ‘H’ being rich, pays more than taxpayer ‘L’, whatever rule is chosen. This is an indication of the declining slope; of the marginal utility schedule. Moreover the tax formula will be progressive under equal marginal rule.

Limitations of the Subjective Approach:

The subjective approach to ability to pay theory has serious limita­tions. It is very difficult to equalize the marginal sacrifice of different taxpayers, because of a change in their attitude, taste, preference, temperament etc.

It is a highly changing phenomenon. Moreover sacrifice being a psychological phenomenon, is incapable of accu­rate measurement. Hence, subjective approach is an ideal approach which ignores the realities of practical life.

Moreover subjective ap­proach is not scientifically true. In this context Prof. Musgrave ob­served it remains to be seen whether a workable and reasonable measure of utility can be developed in time and whether thereby the subjective concept of ability to pay can be given an operational mean­ing.

Objective Approach to Ability to Pay:

Considering the practical difficulties associated with the subjective approach, some American economists developed an alternative ap­proach, based on objective factors consideration in the distribution of tax burden.

Prof. Seligman used the term ‘Faculty’ to indicate ability in the objective sense. Hence this theory is popularly known as ‘Faculty theory of Ability to Pay’. Taxes should be levied upon persons in proportion to their faculty or ability to pay and not in proportion to benefits received by them.

The basis of this approach is that people should help the state revenue in proportion to their power to help themselves. Persons who can earn large sums for themselves and so have ability to pay heavy taxes should be made subject to heavy taxation. Poorer classes who cannot earn much for themselves have comparatively less abil­ity to pay and so they should be taxed lightly.

Hence this approach considered faculty as a better criterion than benefit to impose taxes. Prof. Seligman expressed the view that money value of the taxable capacity of the taxpayer should be considered rather than his feel­ings and sufferings.

Index of Ability under Objective Approach:

The following index has been developed to measure the ability of a person to pay taxes:

(a) Property,

(b) Income,

(c) Consumption expen­diture, and

(d) Family circumstances.

In earlier societies, property was considered as the best index to measure the taxpaying capac­ity of a person. However, with the advent of the industrialized societ­ies, income began to be treated as the most objective criterion to measure the ability of a person. Recently, Kaldore and others sug­gest that, consumption expenditure should be taken as the real in­dex of a person financial status and to avoid tax evasion.

Mere in­come consideration will not hold good, since the size and composi­tion of family also exert influence upon the faculty of a person to pay taxes. Anyhow, objective approach gives a practical tool to analyses the distribution of tax burden in modern societies.