



**JUSTICE BASHEER AHMED SAYEED COLLEGE FOR WOMEN
(Autonomous) Afternoon Session, Chennai 18.
S.I.E.T.**

**Public Economics – I
(Unit - II)**

Topic - Theories of Taxation – Ability to Pay Theory

Department of Corporate Economics

II M.A. Corp. Economics - Semester III

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Meaning of Ability to Pay Theory



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- **The just and equitable theory of distribution is called as ability to pay theory.**
- **Ability to pay principle states that those who possess income or wealth should contribute to the state in proportion to his ability to pay.**
- **According to Mill “Equality in taxation means equality of sacrifice”. It implies that all people should incur equal sacrifice, only then taxation become just and equitable.**

Justification of Ability to Pay Theory



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- **The ability to pay principle has been justified on three grounds.**
- **It is justified on the basis of equality of sacrifice.**
- **It is justified on the basis of the law of diminishing marginal utility.**
- **It is based upon faulty interpretation.**

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1. Property – Property was considered to be the best measures of ability to pay. However, it cannot be the best measures of ability to pay because of the following reasons

- **Income from property is important source but the not the main source.**
- **It may not be continuous.**
- **It varies depending upon its nature, size and locations.**
- **The tax on property is based upon the capital value.**



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2. Income – Income is another important index of ability to pay.

Gross income is not suitable as its include cost. Therefore, net income is the best measures of ability to pay.

3. Size of the Family - Size of the Family is also an important factor affecting the ability to pay. Larger Size of the Family , the smaller is the tax paying capacity, but it cannot be a primary measures of ability to pay.

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4. Consumption – Consumption expenditure of an individual is also an index of ability to pay. Tax on income and property may be evaded by submitting false accounts. Prof. Kaldor says “ consumption rather than income should be the basis of taxation”.

➤ **In order to measure the ability to pay, two different approaches have been developed**

➤ **Subjective Approach**

➤ **Objective Approach**

Subjective Approach to Ability to Pay



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- **Subjective Approach** - The subjective approach is based upon the psychological reaction of tax payers. Each taxpayer should make equal sacrifice, if tax burden is to be equally distributed.
- It implies that similarly situated persons should be treated similarly so that horizontal equity can be achieved. On the other hand, people with dissimilar situations persons should be treated dissimilarly so that vertical equity can be achieved.
- The term equal sacrifice has been interpreted in three ways – equal absolute sacrifice, equal proportional sacrifice and equal marginal sacrifice.

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Equal Absolute Sacrifice	Equal Proportional Sacrifice	Equal Marginal Sacrifice/ Least Aggregate Sacrifice
<p>According to this principle, loss of utility should be equal to all tax payers.</p>	<p>According to this principle, loss of utility should be proportional to the total income of the tax payers.</p>	<p>According to this principle, total sacrifice made by all the tax payers should be the lowest.</p>
<p>It means the rich should pay higher taxes than the poor.</p>	<p>It means, higher income group should be taxed at a higher level than the lower income group.</p>	<p>It means, higher income group should be taxed at a higher level than the lower income group.</p>
<p>It leads to regressive taxation.</p>	<p>It leads to progressive taxation.</p>	<p>It leads to progressive taxation.</p>
<p>$[U(Y)-U(Y-T)]_A=[U(Y)-U(Y-T)]_B$</p>	<p>$\frac{U(Y)-U(Y-T)}{U(Y)}_A = \frac{U(Y)-U(Y-T)}{U(Y)}_B$</p>	<p>$\frac{dU(Y-T)}{d(Y-T)}_A = \frac{dU(Y-T)}{d(Y-T)}_B$</p>

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Where

➤ **Y = Income**

➤ **T = Tax**

➤ **U = Total Utility**

➤ **$U(Y)$ = Total Utility Before Tax**

➤ **$U(Y - T)$ = Total Utility After Tax**

➤ **The sub-scripts A and B are Individuals**

➤ **These three concepts can be represented diagrammatically. It is based on the following assumptions.**

Assumptions



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- **The marginal utility of income declines as income increases.**
- **The marginal utility of income schedule can be drawn to represent the utilities of all individuals in the economy.**
- **Income has no utility below subsistence level.**
- **The government has a given revenue requirement.**
- **Pre-tax incomes are given, they are not affected by the choice of distribution of tax burden.**
- **The following diagram shows the utility schedules of two individuals.**

Diagram of Utility Schedules of Two Individuals



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The following diagram shows the utility schedules of two individuals.

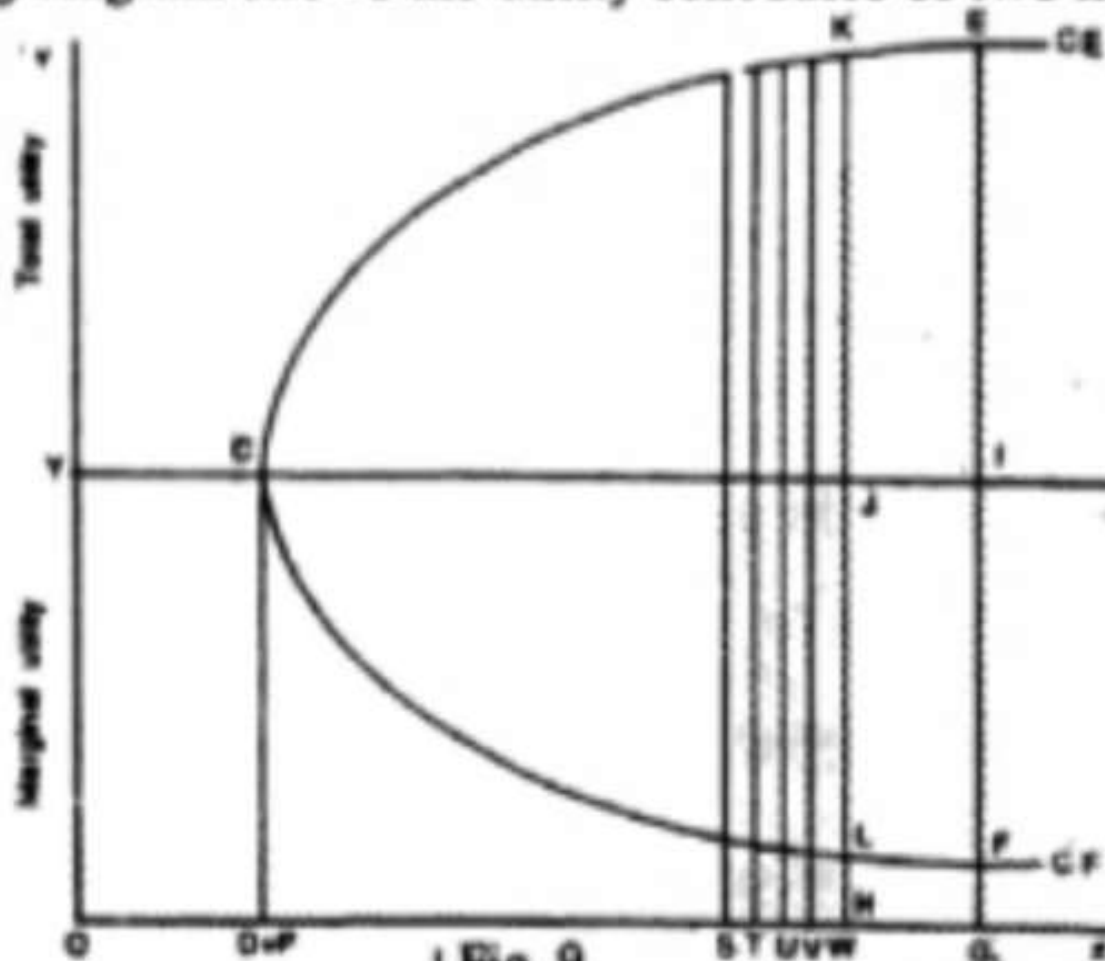


Fig. 9

Explanation of the Diagram



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- X-axis measures 'Income' and Y-axis measures 'Marginal utility' and 'Total utility'.
- 'CE' is the Total utility of income curve and 'CF' is the Marginal utility of income.
- 'OD' and 'YC' are amounts of income needed for subsistence.
- Taxpayer A has the income above the subsistence level equal to 'DG', and Taxpayer B has 'DH'.
- Total utility of A is 'IE' and Marginal utility is 'GF' and to Total utility of B is 'JK' and Marginal utility is 'HL'.
- Now an income tax equal to 'PG' is introduced.

Explanation of the Diagram



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- Under equal absolute sacrifice, A will pay '**WG**' and B will pay '**SH**'.
- Under equal proportional sacrifice, A will pay '**VG**' and B will pay '**TH**'.
- Under equal marginal sacrifice, A will pay '**VG**' and B will pay '**VH**' amounts of tax.

The Relative Tax Liability and the Relative Progressive of the Tax Structure Under the Different Sacrifice Principles are Summarized in the Following.



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Principles of Sacrifice	The liability of the		Relative Progressive of the Tax Structure
	Rich	Poor	
Equal Absolute Sacrifice	Least	Most	Least
Equal Proportional Sacrifice	Most	Less	More than (1) and less than (3)
Equal Marginal Sacrifice	Most	Least	Most

***The third column shows only the relative progressiveness of the tax structure under different sacrifice principles.**



Limitations to Subjective Approach

- Similarly situated persons may not involve same sacrifice, even if they pay same amount of tax, as they differ in their attitude, taste, preference. etc.
- Sacrifice is subjective, therefore, it cannot be measured and equated.
- It is impossible to measure the rate of decrease in marginal utility with increase in income.
- Utility depends on the individual income rather than the inherited wealth and property.
- Subjective approach is not true and it is not possible to base a good tax structure on it.

Objective Approach to Ability to Pay



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- **Due to limitations of subjective approach, American developed an alternative approach known as ‘faculty theory of ability to pay’.**
- **This approach has suggested three main criteria to measure ability to pay viz., income, property and consumption.**
- **Income - Income is considered to be the best index of ability to pay. Gross income is not suitable as its include cost. Therefore, net income should be taken into account along with source of income, nature of income and size of the family.**

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- **Property** – **The amount of inherited wealth and accumulated property is also considered to be the best measures of ability to pay.**
- **However, it cannot be the best measures of ability to pay, as all properties may not yield income.**
- **Consumption** - **Prof. Kaldor has advocated consumption expenditure to be the basis of ability to pay.**
- **Consumption expenditure is the true index of taxable capacity of an individual.**

Limitations to Objective Approach



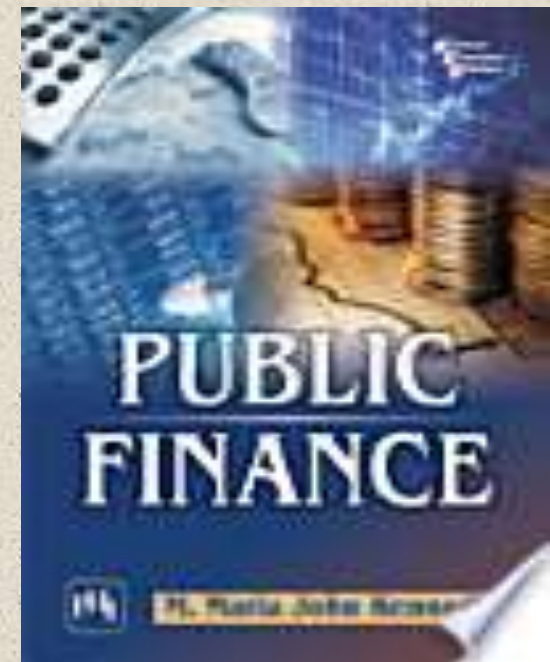
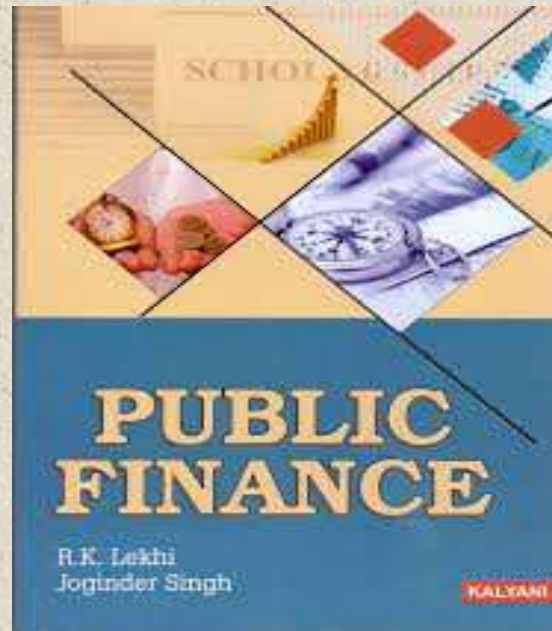
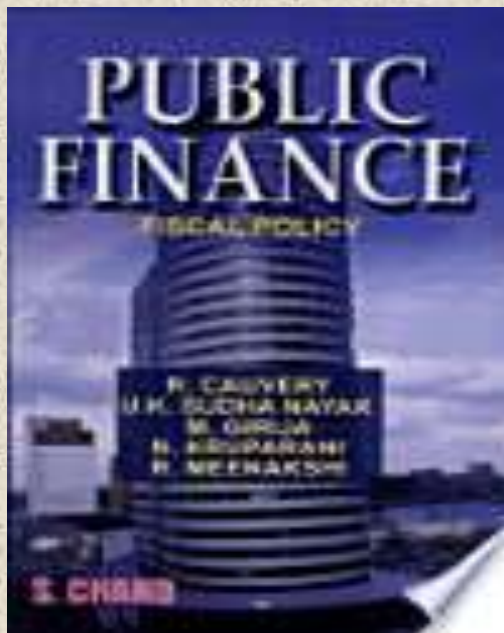
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- **A tax on property is regressive because it falls heavily on small property holder.**
- **There is also lack of uniformity in the assessment of tax.**
- **People may conceal their income and property in order to escape tax burden.**
- **Therefore, objective approach plays a supplementary role to subjective in achieving equity in the distribution of tax burden.**

Reference Books



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Thank You