Theories of Distribution of Tax Burden

Ability to Pay Theory of Taxation

Ability to Pay Theory of Taxation

- This approach considers the tax liability as a compulsory payment to the state without any quid pro quo. It does not assume any commercial or semi commercial relationship between the state and the citizens.
- The theory is based on principle of equity and justice and so is supported by socialist thinkers.
- The basic tenet of the ability to pay doctrine is that the burden of taxation should be shared by the members of the society on the principle of justice and equity. And these principles necessitate that the tax burden is apportioned according to their relative ability to pay.

Ability to Pay Theory of Taxation

- **Measurement of Ability to Pay**

    A. Objective Indices

    B. Subjective Indices

- An objective index may be measured on the basis of wealth, property, consumption expenditure or income etc. of the tax payers,
- A subjective index is based on some measure of sacrifice of utility by the tax payers.

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- **Objective indices of the ability to pay**

(i) Property:

- One of the indices, though an insufficient index.
- Has the demerit of adversely effect on will to work, save and invest and its consequent effect on the growth and capital accumulation in the economy.

(ii) Consumption:

- Choices of this index assume that people with greater consumption expenditure have more ability and derive smaller marginal utility from their expenditure.

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- The criteria suffers from the fact that people with more income may spend less and divert income towards saving and investment.
- Thus, increase inequality in distribution of income and wealth.

(iii) Income

- Income is one of the most accepted indices of ability to pay, though it is usually supplemented by other tax indices also. A citizen receiving a larger income is made to pay a larger state bill and vice-versa.

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(B) Subjective indices of ability to pay

- Subjective approach to ability to pay is based on the assumption that a tax payer sacrifice some utility by paying the tax.
- Based on equity principle
- Equity approach implies that the aggregate sacrifice of all the tax-payer should be minimum possible.

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- The term equal sacrifice may be interpreted in three alternative ways, viz.; equal absolute sacrifice, equal proportional sacrifice and equal marginal sacrifice. Problems arise to choose the right type of meaning of equity.
- **Three Interpretations of Ability to Pay**

(i) Equal absolute sacrifice

(ii) Equal Proportional sacrifice

(iii) Equal Marginal sacrifice

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(a) Equal Absolute Sacrifice

- This means that each tax- payer is made to sacrifice the same amount of utility so that the difference between the aggregate utility from income before tax and utility of income after tax is the same for each tax-payer.
- Symbolically, $U(Y)-U(Y-T) = U(T)$ should be the same for all,
- where U is the total utility; T is amount of tax; Y is the income before tax and Y-T is the income after tax. If this doctrine is applied, each members of the society will pay some tax at least. None will enjoy complete tax exemption.

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(b) Equal Proportional Sacrifice

- According to this approach, no one is exempt from sharing the tax burden.
- Each tax payer is supposed to sacrifice the same percentage of the total satisfaction which he would have derived from his income.
- Symbolically, it would mean that the tax liability of each individual is determined in a manner that for their income Y,

$$[U(Y)-U(Y-T)]/U(Y), \text{ or}$$

$$U(T)/U(Y)$$

is same for every one.

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(c) Equal marginal sacrifice

- According to this interpretation of equity, the tax burden should be apportioned is such a way that the marginal utility of post tax income (income left after tax) with any tax payer would be the same.
- Symbolically, for each tax payer U(Y-T) should be the same.