Unit — III

2. Principle / Justice theories of taxation.

Economists have propagated certain theories and formulated principles to make taxation just. The important theories on the principles of taxation are as follows :-

(1) Benefit principle of taxation: According to this principle, people must pay taxes in proportion to the benefits they receive from the government. People getting larger benefits must also pay larger taxes.

In principle the benefit theory appears to be quite logi. It justify the imposition of taxes because the tax payer get the benefit of public expenditure. It also measures benefit received by the individuals in the case of certain special taxes viz. petrol tax as on the users of roads, local property tax to finance police.

Benefit principle, inspite of its merits suffer from ~~cert~~ certa inconsistencies.

(i) Tax is a compulsory contribution and makes no promise for benefit to the tax payer.

(ii) It is unjust to realise tax in proportion to the benefit for the poor people.

Ability to pay principle of taxation: According to this principle, each individual should contribute to the state according to his relative ability. This principle requires the rich to pay more taxes than the poor because the capacity of the rich is greater than that of the poor.

The ability to pay has two approaches—

(i) Subjective approaches.

(ii) Objective approaches.

The objective approach is basically associated with the horizontal equitity concept that equal ~~treatment~~ imposition of tax burden distribution among people of equal ability to pay. The objective approach indicates the various basis of taxes like income, consumption, wealth etc.

The subjective approach is related with vertical equitity i.e, how people of different income or tax basis contribute differently. It is based on psychological reactions of tax payers and interpreted it in terms of sacrifice under the suggestion that a fair system of taxation is one where sacrifices of all tax payers are equal, i.e, the loss of welfare or utility of income is the same.

The principle of ability to pay appears to be quite sound. Firstly, it is justified on the ground of psychological effects of tax payments upon the individual tax payers. Each tax payer has the satisfaction that his contribution to the government is in accordance with his ability to pay.

Secondly, as income increases marginal utility of additional unit of income decreases and vice-versa. Hence the tax burden should be more on high income than in the low income groups.

(iii) Principle of equal sacrifice : According to this principle in order to distribute the tax burden equally, the tax system should be so framed as to ensure that tax payer share an equal sacrifice in the payment of taxes. All persons in a similar position should share tax burden equally.

The principle of equal sacrifice is interpreted in three different ways—

(a) Equal absolute sacrifice
(b) Equal proportional sacrifice
(c) Equal marginal sacrifice.

(a) Equal absolute sacrifice : It implies that total loss of utility or the total disutility created by the payment of taxes should be equal to all tax payers. In other words, tax payers in high income groups should pay more taxes than those in the lower income groups so that the absolute sacrifice for each individual is the same.

** (b) Equal proportional sacrifice : It implies that the loss of utility as a result of a tax should be proportional to the total income of the tax payers. Following this principles people with larger income will pay more tax than those with smaller income but the ratio of sacrifice to the income will be the same for all the persons of the society.

In brief —

$$\frac{\text{Sacrifice of tax-payer A}}{\text{Income of A}} = \frac{\text{Sacrifice of tax-payer B}}{\text{Income of B}} = \frac{\text{Sacrifice of tax-payer C}}{\text{Income of C}}$$

(c) Equal marginal sacrifice – for each indiv. the taxation dec his or her income to a value where the marginal utility of income is the same for everyone. Equal marginal sacrifice means the marginal utility of income sacrificed by all the tax payers should be the same. Thus Marginal Sacrifice of X = Marginal sacrifice of Y etc. This implies that since a person with high income has a low marginal utility of income and a person with a lower income has a high marginal utility of income, so the rich should pay much more than the poor. Since the marginal utility tends to diminish at a higher income level, equal marginal sacrifice calls for more progressive tax rates.

Effect
Effects of TAXATION on production

Unit 3 public finance

According to Dalton, the effects of taxation on production can be discussed in three ways—

(i) Ability to work, save & invest.

(ii) Willingness to work, save & invest.

(iii) Effects on the composition or pattern of production
(i.e effect on allocation of resources as between different industries & localities)

(i) Ability to work, save & invest: Tax reduces the disposible income of the people and they are forced to reduce their consumption standard as a result, the ability to work is greatly affected by the taxation of the poor section of the society. Since the rich may be compelled to reduce their expenditure on luxuries and comforts, this may not affect their ability to work. Therefore taxation on low income and on those articles which are consumed by them should be avoided for the sake of production.

Tax reduces the net income of tax payers which result reduction in the saving. The only taxes, which donot to some extent reduce individuals ability to save, are those which falls exclusively on people who are poor. It is thus obvious that heavy taxation on rich, though defensively on the grounds, substantially reduce their ability to save.

Ability to invest depends on savings. When savings are reduced by taxation, the ability to invest is automatically reduced.

(ii) Willingness to work, save and invest: The effects of taxation on people's willingness to work, save and invest is partly due to monetary burden of tax and partly due to the psychological state of a tax payer. So its effects can be visualised by examining—

ⓐ nature of taxation, i.e how an individual makes reaction to the taxation

ⓑ The psychological reaction of the tax payer.

ⓐ Nature of taxation – Some taxes have least or low bad effects at all on the desire to work and save while some taxes have distorting effects. For instance taxes on wind falls, such as a tax on abnormal profit in short period inheritance taxes special assessments etc. These incomes are unexpected and the taxation on this income will not affect the desire to work and save.

A reasonable commodity taxation, such as excise duties and sales taxes etc may not have any bad effect on the desire to work and save. The highly progressive income tax discourages most tax payers from working hard and saving more and same is true on wealth tax as well.

However taxes differ in nature and they also differ in their effects, has the on the desire to work and save, what is uncertain is that if proportional tax is found to reduce work effort, a progressive tax of equal yield will reduce even more and if proportional tax increase work effort, the increase will be less in the case of a progressive tax.

ⓑ Psychological reaction of the tax payer: It implies that how a tax payer is psychologically affected by the burden of taxation. When a tax is announced the tax payers immediately feel that it will reduce their income. This psychology of the tax payer may affect his desire to work or save more. This disincentive effect of a tax on the tax payer, willingness to work or save is called the announcement effect.

(iii) Composition of pattern of effects of taxation on diversion of resources:

The volume of production and national income of a country depends upon the ability to work and save and desire to work and save. But the pattern and composition of production depends upon the allocation of resources as between different industries and localities. Taxation may be used as an instrument of fiscal policy for the diversion of resources between industries and regions. Thus, taxation can affect not only the size and growth of production but also the pattern and composition of production

2. Effects of TAXATION on distribution

The effects of taxation on the distribution of income and wealth among the different sections of the society depends upon the following two factors :-

(i) Nature of taxation and tax rates
(ii) Kinds of taxes.

(i) Nature of taxation and tax rates: The nature of taxation implies how the burden of taxation is distributed among the different sections of the community i.e, whether the nature of taxation is progressive, proportional or regressive.

(a) Effects of regressive taxation on distribution: If regressive taxation is followed, the inequalities may increase in the distribution of income and wealth, as the burden of taxation will fall more heavily on the poor than on the rich.

(b) Effects of proportional taxation on distribution: Under proportional taxation, inequalities will continue ~~as~~ before, if the income remains the same. But however, if the income changes in unequal proportions, the inequality in income will increase.

(i) Effects of progressive taxation on distribution: Under progressive system of taxation the inequalities of income and wealth would be reduced, because a higher proportion of the income and wealth of the rich would be taken away by way of taxes. Hence a sharply progressive tax system tends to reduce inequalities in the distribution of income and wealth. The sharper the progression, the stronger is the tendency to reduce inequalities.

ii) Kinds of taxes.

(a) Indirect taxes and distribution: The burden of indirect taxes, like taxes on commodities which are widely consumed is generally regressive in nature. This is because poor people spent a larger proportion of their income on such groups than that of rich. Hence, the burden of indirect taxes falls more heavily upon the poors than the rich.

(b) Direct taxes and distribution: If taxation is to be used as an instrument for equitable distribution of income and wealth, all those taxes which fall heavily or exclusively upon the rich section of the society can have favourable distributional effect. Therefore, all those direct taxes, which are based on the principle of progression and ability to pay may have desirable distribution effect.

5. Effects of TAXATION on consumption.

Taxation can be used as an instrument for the purpose of regulation of consumption in the economy. The volume and the nature of the consumption can be regulated by imposing heavy taxes on the sale of some products. However the flow of product beyond national boundaries can be regulated by the imposition of export or import duties.

Box. 8.5 Proportional, Progressive and Regressive Taxes

Proportional Taxes: Taxes in which the rate of tax remains constant whatever the size of the tax base may be are called proportional taxes. For example if rate of tax is 10 percent. Then a person whose annual income is ₹ 40,000 will have to pay ₹ 4000 per year as tax. But if his income rises to ₹ 60,000 per annum. The same percentage of tax will be collected from him irrespective of size of his income. He will now pay ₹ 6,000 per year as tax.

Progressive Taxes: Taxes in which the rate of tax increases as the tax base increases are called progressive taxes. For example the government may fix tax rate at 10 percent for person earning between ₹ 50,000 to 1,00,000 per annum and a tax rate of 15 percent for persons earning between ₹ 1,00,000 and 2,00,000 per annum. In such a situation, the richer persons have to pay tax more than proportionately.

Regressive Taxes: When the rate of tax decreases as the tax base increases the taxes are called regressive taxes. The burden of such taxes fall more heavily on the poor than on the rich. Suppose, Government collects ₹ 10,000 per yea from a person as income tax. The rate of tax is 10 percent. Now suppose his annual income increases from ₹ 1,00,000 to ₹ 1,50,000 and he is now required to pay ₹ 12,000 as income tax. The average tax rate is now 8 percent. Thus the rate of tax has fallen with increase in income.