ABILITY TO PAY THEORY

- Most Generally Accepted Theory
- Each person should contribute to the state in proportion to his ability to pay
- Ideal ethical basis of taxation
- Two approaches:
  1. subjective approach
  2. objective approach

DEVELOPMENT OF THE ABILITY TO PAY

- Distribution of tax payment should be just
- Taxation according to faculty or ability
- It means first property and then income
- Argument for progressive taxation is based on faculty
- Traced back to an easy by Guicciardinii and a case for proportional taxation was made by Bodin.
A Different principle of taxation is needed, this new Principle is the principle of faculty or ability to pay is based on the logic that all should be treated equally.

**Justification to ability theory**

- Equality of sacrifice
- Diminishing marginal utility
- Faculty interpretation, Faculty is represented by the Income, wealth and property level of taxation should increase in higher proportion than the increase in income and property.

**How to measure ability to pay**

- Subjective approach: Sacrifice theory has been evolved to measure ability
- Objective approach: Turn measure the ability

Implementation of either principle requires a quantitative measure of ability to pay.
Measure would show the entire welfare which a person derive from all the options available to him for her including consumption, holding of wealth and the enjoyment of leisure. Value of the leisure can not be measured ability to pay has to measured with the help of observable measures.

**INDEX OF ABILITY TO PAY**

- **WHAT IS BEST INDEX TO USE IS IT INCOME, PROPERTY, WEALTH, CONSUMPTION, SIZE OF THE FAMILY ITC.**
- **Property:** Accumulated wealth and property was considered the index of ability to pay rather than income. But property is not primary test of ability, but it can be a supplementary index of ability due to following reasons:
  1. Important source of income but all property do not yield income
  2. Not continuous
  3. May Vary
  4. Property is taxed on its capital value
  5. Regarded supplementary shows.
     - Ownership of property give the owner additional capacity of paying tax.
     - Greater degree of paying tax ability
● **Income**: The second index ability to pay can be accepted as income. Gross income includes the elements of cost while net income is obtained after paying cost. Net income is a better index of measuring tax paying than gross income. Adam Smith was the first who accepted income as a measure of tax paying ability now it is Generally Accepted.

● **Size of the family**: It is also taken into account. A large size of the family with given income may have smaller tax paying ability than of small size. So size of family can be taken into account while determining the tax pain ability of an individual. But can not be taken as the primary measure of tax paying ability.

● **Consumption**: Consumption expenditure has been suggested as a measure of estimating tax paying ability of an individual. Taxation on property and income can be manipulated. Fisher and professor Kador advocated taxation on expenditure. But it has not attained any prominence. Income is the most widely used as measurement of tax paying ability.
Approach to measure ability to pay theor

1. **Subjective Approach**: Based on psychological or mental reaction of the taxpayer. Estimate the tax burden or sacrifices undergone by him. Each taxpayer should made equal sacrifice.

2. **Objective Approach**: Professor Seligman has used the term faculty to indicate ability in the objective. Also known as faculty theory of ability to pay. It takes various external factor including tax payer income, property etc to measure the tax liability of an individual.

   e.g.: for example it takes into account that not only the income as search but also how his income has earn and how this property is acquired.

**Index of ability in faculty theory**

- **Income**: Refers to an amount received by a family from any activity during certain period of time including the value of self owned durable consumer goods. But only net income is taken into account.

- **Property**: The amount of property and accumulated wealth is also considered because the level of living of people is influenced by the income and also by the accumulated wealth.
Consumption: consumption expenditure accounting to KALDOR Economics well being of the people depends upon the income spent.

Defects

According to Prof. Seligman: property index suffers from the limitation:

i. Property tax is regressive
ii. Lack of ability to reach personal property
iii. Lack of uniformity
iv. Incentive to dishonesty

Conclusion: Income is accepted as fair index of measurement. Because amount and source is also taken into account. Size of the family, regularity of the income and time period should also be taken, objective approach plays a supplementary role.

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