Principles orTheories of Taxation

The economists have put forward many **theories or principles of taxation** at different times to guide the state as to how justice or equity in taxation can be achieved. The main theories or principles are as follows:

1. Benefit Principle:

2. Ability to Pay Principle:

1. Benefit Principle: The **benefit principle** is a concept in the theory of taxation from public finance. In its use for assessing the efficiency of taxes and appraising fiscal policy, the benefit approach was initially developed by two Swedish economists- **Johan Gustaf Knut Wicksell** (1851 –1926) and **Erik Lindahl** (1891 –1960).The principle bases taxes to pay for public-goods expenditures on a politically-revealed willingness to pay for benefits received

According to this Principle, the state should levy taxes on individuals according to the benefit conferred on them. The more benefits a person derives from the activities of the state, the more he should pay to the government. Hence, the benefit-received principle of taxation asserts that households and businesses should purchase the goods and services of government in basically the same manner in which other commodities are bought. One clear example is road tax. Thus, those who get the benefit of driving on the roads pay the tax for maintenance and construction of roads.

The main justifications or uses of Benefit Principle of Taxation are:

1. The principle recognizes that the purpose of taxation is to pay for government services by paying taxes in proportion to the benefits they receive from government spending.

2. Under the benefit principle, taxes are seen as serving a function similar to that of prices in private transactions. This may lead to an economically efficient solution as the allocation of resources through the public sector would respond directly to consumer wishes.

3. It also measures benefits received by the individuals in the case of certain special taxes such as petrol tax, betterment tax etc.

This principle has also been subjected to severe criticism on the following grounds:

1. The basic principle of the tax is that it is a compulsory contribution and there is no direct quid pro quo. Therefore, if the state maintains a certain connection between the benefits conferred and the benefits derived, this principle goes against the basic principle of Tax.

2. If we apply this principle in practice, then the poor will have to pay the heaviest taxes. This is because they benefit more from the services of the state. If we get more from the poor by way of taxes, it is against the principle of justice.

3. Though analytically interesting, the Benefit Principle seldom fails in practice when there are

“Free Riders” over pure public goods (like Street light) where benefit received cannot be measured.

So, it is clear from the above limitations that Benefit Principle is not possible to implement practically. Most people will enjoy the benefits of public expenditure but will be reluctant to pay taxes. To overcome this problem, an alternative principle has been suggested commonly known as “The ability to pay Principle”.

2. **Ability to Pay Principle:** The idea that people with the ability to pay more should pay a higher percentage of their income was espoused (to express support) by none other than Adam Smith. In the field of modern Public Finance, the Ability to pay theory presented by an English economist- Arthur Cecil Pigou (1877 –1959) is considered to be one of the Influential theories.

The ability-to-pay Principle of taxation maintains that taxes should be levied according to a taxpayer's ability to pay. Accordingly, the principle holds that those individuals, businesses, and corporations with greater ability to pay taxes—measured by income and wealth—should pay more. Hence, the idea underlying ability-to-pay taxation is that everyone should make an equal sacrifice in paying taxes. For instance, if the taxable capacity of a person A is greater than the person B, the former should be asked to pay more taxes than the latter.

The main justifications or uses of Benefit Principle of Taxation are:

1. **Pool more resources for government services:** With an ability-to-pay taxation system, individuals with more resources are able to provide more funding for services needed by all. Societies rely on government services, either directly or indirectly, such as police, scientific research, schools, and more.

2. **Government revenue scales with earnings:** Low-income earners most likely need a majority of their income, so an ability-to-pay taxation system allows them to keep a larger percentage of their income to help stimulate the economy.

This principle has also been subjected to severe criticism on the following grounds:

1. **Reduces incentive to increase income:** critics of the ability-to-pay taxation system argue that individuals will lose the incentive to earn more. In a sense, the critics argue that high incomes are penalized, even though the funds might have been accumulated through hard work and ingenuity.

2. **No government spending accountability:** When a government taxes its citizens, it makes decisions about how to best spend that money to benefit its citizens. However, government sometimes fails to maintain accountability in spending tax revenue. For example, all tax revenue that is collected from gasoline should be put towards roads, but it isn’t necessarily the case with ability-to-pay taxation as the government may use it for some other purposes.