Subject: Public finance
Course code: ECON4009
Topic: Benefit Principal and Ability to Pay
M.A. Economics (2^{nd} Semester)

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The Benefit Principle

- The most important source of government revenue is tax.
- A tax is a compulsory payment made by individuals and companies to the government on the basis of certain well-established rules or criteria such as income earned, property owned, capital gains made or expenditure incurred (money spent) on domestic and imported articles.
- The principle recognises that the purpose of taxation is to pay for government services. If taxes are imposed according to the benefit principle, people pay taxes in proportion to the benefits they receive from government spending.

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- Therefore, those who derive the maximum benefits from government services such as roads, hospitals, public schools and colleges should pay the maximum tax.
- However, if the benefit principle of taxation is followed, the government will be required to estimate how much various individuals and groups benefit, and set taxes accordingly.

The Benefit Principle…

- According to the benefit principle of taxation those who reap the benefits from government services should pay the taxes.
- The benefit principle holds that people should be taxed in proportion to the benefits they receive from goods and services provided by the government.
- This principle is based on the feeling that one should pay for what one gets.
- One clear example is road tax. Receipts from road taxes typically are set aside for maintenance and construction of roads. Thus, those who drive on the roads pay the tax.

The Benefit Principle…

- The principle also leads to an economically efficient solution to the questions of how much government should provide and who should pay for it.
- However, using the benefit principle has several practical difficulties that render it impossible to apply it for many publicly supplied goods and services.
- When a good or service supplied by the government has the exclusive and rival characteristics of a private good, benefits can be computed rather easily and users can be charged accordingly.
- Examples include road tax, toll tax and transit fees.
- When a publicly provided service is non-rival and non-exclusive (a pure public good) the benefit principle is just a theoretical concept because the benefits cannot be measured.

Problems

- Let us suppose taxes are based on one's reported assessment of the benefits one receives from the good.
- In essence, taxation is voluntary. Some taxpayers might assert that they want little or none of the public good (like a road, or a public park or a bridge) in question.
- If most people want to enjoy the good or service free of cost (or, they attempt to 'free ride'), the public good may not be available at all.
- 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, viz., the ability to pay principle.

The Ability-to-Pay Principle

- If the objective of the government is to redistribute income, it should set taxes according to the ability-to-pay principle. However, it is difficult to measure ability. There are, in general, three measures of ability: income, expenditure and property.

  1. Income

- Income is said to be a better measure of ability than wealth. But here also some difficulties are encountered. All work do not involve the same sacrifice.
- A man earning Rs.500 through toil and trouble will not be a position to pay taxes as one earning the same amount without any effort (from paternal property) or gambling or through chance (lottery).
- One with the same level of income as another may have more dependents and more liability and thus lower ability to pay.
- Moreover, the marginal utility of money differs from man to man. It is higher to a man with lower income and vice versa.

2. Expenditure

- According to Prof. N. Kaldor, expenditure is the best possible measure of ability. He advocated an expenditure tax which was tried in India for sometime but withdrawn subsequently.
- A poor man may spend more if he has more dependants and if he has to look after his old parents.
- So, his expenditure may be higher than his colleague belonging to the same income bracket. But his expenditure does not reflect his true ability to pay.

3. Property

- Possession of wealth or property is a reflection of well- being, but to a limited degree. For example, if two persons have the same amount of wealth, they are not equally well-off. One may have some productive wealth like a building which yields a steady income.
- Another may have unproductive wealth (i.e., jewellery) of the same value. Naturally, their ability to pay taxes will differ greatly.
- Two basic indices (measures) of the ability to pay, viz., income and wealth provide a justification for progressive personal taxes.
- If taxes are imposed on the basis of the ability to pay principle, higher taxes will be paid by those with greater ability to pay, as measured by income and/or wealth.

Let us consider the three alternative income tax plans listed in Table 1

Table 1: Three Alternative Income Tax Plans

	Tax Payements (in rs.)			Average Tax Rate (%)		
Income (Rs.)	Plan 1	Plan 2	Plan 3	Plan 1	Plan 2	Plan 3
1,000	100	100	100	10	10	10
10,000	2,000	1,000	500	20	10	5
1,00,000	40,000	10,000	2,500	40	10	2.5

- Under all three plans, families with higher incomes pay higher income taxes. So, all these plans may be said to be operate on the ability to pay principle of taxation. Yet they have different distributive consequences.
- Plan 1 is a **progressive tax**: the average tax rate is higher for richer families. Plan 2 is a **proportional tax**; every family pays 10% of its income. Plan 3 is quite **regressive**: since tax payments rise more slowly than income, the tax rate for richer families is lower than that for poorer families.

- It appears that under plan 3 the principle of ‘fairness’ is violated. However, the modern system of progressive personal income tax seems to be based on the notion of vertical equity.
- Other things being equal, progressive taxes are seen as ‘good’ taxes in some ethical sense while regressive taxes are seen as -bad’. On these grounds, advocates of greater equality of income support progressive income taxes and oppose sales taxes.
- However, progressivity in taxation is not necessary for vertical equity. A proportional income tax system could well satisfy the equity principle

Thank You