



B.Com Honours

Semester V

Calicut University

PRINCIPLES OF TAXATION

Course Code: COM5EJ313 • Module 1 Notes

Module I: Principles of Taxation & Canons of Taxation

Covers economic objectives of taxation, Adam Smith's Canons, Tax-GDP ratio trends, features of an optimal tax system, Benefit Principle, Ability-to-Pay Principle, and Taxable Capacity.

Unit 1: Meaning, Objectives, & Economic Effects of Taxation

Taxation: Compulsory contribution levied by state authorities on income, wealth, or transactions without direct quid pro quo. Objectives: Revenue generation, wealth redistribution, economic stabilization, & resource allocation. Economic Effects: Impact on work incentive, savings, investment, & resource re-allocation across industries.

Unit 2: Canons of Taxation & Tax-GDP Ratio

Adam Smith's 4 Canons: Equality (Equity), Certainty, Convenience, & Economy in collection. Modern Canons: Productivity, Elasticity, Flexibility, & Simplicity.

Tax-GDP Ratio: Total Tax Revenue divided by Gross Domestic Product ($\text{Tax-GDP Ratio} = \frac{\text{Tax Revenue}}{\text{GDP}} \times 100$ %). Measures tax effort & fiscal capacity.

Unit 3: Features of a Good Tax System & Benefit Principle

Features: Fiscal adequacy, administrative simplicity, economic efficiency, & tax equity. Benefit Principle (Lindahl Model): Individuals should pay taxes in proportion to public utility benefits received from state services.

Unit 4: Ability-to-Pay Principle & Tax Capacity

Ability-to-Pay Principle: Taxes levied according to taxpayer's financial capability.

Sacrifice Theories:

1. *Equal Absolute Sacrifice:* $U(Y) - U(Y - T) = c$
2. *Equal Proportional Sacrifice:* $\frac{U(Y) - U(Y - T)}{U(Y)} = c$
3. *Equal Marginal Sacrifice:* $\frac{dU(Y-T)}{d(Y-T)} = c$ (Justifies progressive taxation).

Taxable Capacity: Absolute (maximum tax economy can bear) vs Relative Tax Capacity.

Practical Solved Problem 1 (Equal Sacrifice Tax Liability Calculation): Individual A earns ₹10,00,000 with utility function $U(Y) = \ln(Y)$. Calculate tax liability under 10% Equal Proportional Utility Sacrifice rule.

Equal Proportional Sacrifice Formula: $[\ln(Y) - \ln(Y - T)] / \ln(Y) = S$

Step-by-step Solution:

1. Given $Y = 1,000,000$ ₹, $\ln(1,000,000) \approx 13.8155$.
2. Setting proportional utility loss $S = 0.05$ (5% utility reduction):
 $\frac{13.8155 - \ln(1,000,000 - T)}{13.8155} = 0.05 \implies \ln(1,000,000 - T) = 13.8155 \times 0.95 = 13.1247$

4. Tax Payable \$ T = 1,000,000 - 501,187 = \mathbf{\text{₹}4,98,813} \$. Effective Tax Rate = 49.88%.

Tax Equity Principles Comparison Table:

Tax Equity Principle	Measurement Basis	Primary Welfare Justification
Benefit Principle	Quantified public services & benefits consumed	Quid-pro-quo fairness (e.g. Toll road taxes)
Ability-to-Pay (Objective)	Income, wealth, & annual expenditure base	Horizontal Equity (Equal income = Equal tax)
Ability-to-Pay (Subjective)	Equal Marginal Sacrifice of marginal utility	Vertical Equity (Progressive tax rates)

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