

The characteristics of effective tax systems



Discuss what is meant by each of these characteristic, evaluate the importance of each and assess, making use of appropriate examples, the degree to which the current UK taxation system fulfils these characteristics.

According to Adam Smith and in the earlier year's majority of economist have thought and written about the effects and consequences for a good tax system. However, when doing so, they have regularly tried to approach and describe as what they regarded as desirable characteristics of tax system. Smith (1776, Book 5, Ch 2) therefore listed " four maxims with regards to tax in general". The first characteristics for tax is Equality which means that what people pays for tax should always be in proportion to what they earn (income) . The second tax characteristics has to do with Certainty meaning that tax liabilities should be clear and certain, rather than arbitrary. The third is convenience of Tax payment, that taxes should be collected at a time and in a manner that is convenient for the taxpayer; and the forth and the last characteristic is the economy in collection meaning that taxes should not be expensive to collect, and should not depress business (efficiency).

However, the second and third characteristic of tax have not been widely discussed by the economist but its ideas are incorporated in statements of taxpayer`s rights as opposed to the first and the last characteristic of tax that have absorbed the main interest on its explanation. The idea of equality, thus has been studied widely and still part of evaluation of any tax policy which according to smith's (tax payment in proportion to income) is not the only one that has received support. Musgrove (1959, Ch 4 and 5) provides a history of different views on what constitutes a fair distribution of the tax burden. According to Musgrove taxation proposals have been studied in

accordance to three criteria's. Therefore, within these criteria's there's a huge worry for tax to be fair (although fair means different things to different peoples), there's a worry to minimise administrative costs and the need to minimise disincentive effects. But according to Musgrove, this separations within three different criterion has brought difficulty because a particular policy proposal will typically satisfy one criterion but not another. For instance, in choosing between the poll tax (Community Charge) and a local income tax to finance local government expenditure, most people would regard the local income tax as fairer but it would have a greater disincentive effect on labour supply than the poll tax. In order to set a decision, it is important therefore to weigh the fairness advantage of the local income tax against its disadvantage of discouraging work and labour (not to mention taking account of the different administrative costs).

The approach of the optimal taxation is to use economic analysis to combine these criteria into one. Implicitly deriving the relative weights that should be applied to each criterion. This is done by using the concepts of individual (or household) utility and social welfare. Social welfare is seen as an indicator of the well-being of society and is taken to depend on the utilities of individuals. However, social welfare is not

necessarily seen as simply the sum of individual utilities; it can also depend on

how equally these utilities are distributed. It is typically assumed that social welfare decreases as inequality of utility increases. In this way, the concept of

social welfare reflects one idea of fairness in the tax system: that taxes are fair if

they decrease the level of inequality. Thus an attempt to maximise social welfare

will involve an attempt to achieve one interpretation of criteria of fairness or equity.

The second criteria according to Musgrove, reflects in social welfare because higher administrative costs will require a greater amount of gross tax revenue to be collected to finance government services, thus reducing individual utilities. The third and last criteria is incorporated because the discouragement of work will distort the economy and lower people's utility and hence social welfare. In this way, all three criteria are converted to aspects of social welfare and become commensurable, and so the policy that should be chosen is the one that gives the highest level of social welfare.

This is one of the main ideas behind optimal taxation, but it is typically not carried through completely. Economists have found it very difficult to model the

Relationship between tax rates and administrative costs. They have therefore

usually ignored administrative costs in their analysis and have concentrated on

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criteria (1) and (3). Effectively, they have been trying to determine the tax systems that will provide the best compromise between equality (or fairness) and

efficiency (or incentives). These same basic ideas have also been applied to the study of tax reform, where the aim is to identify whether specific (and typically small) tax changes will raise social welfare. There is clearly a close connection between the analysis of optimal taxation and tax reform: an optimal tax system is one in which there are no possible reforms that will increase welfare. Indeed most of the models

used in tax reform analysis reflect the approach described in this paper. The only

difference is that the aim is not to find the best tax system, but to find a better

one. A useful exposition of tax reform analysis is given in Ahmad and Stern (1991). The more modest aims of tax reform analysis lead to smaller informational

requirements: it is only necessary to know how economic agents will respond to

fairly small changes in taxes, rather than the large changes that might be

involved in a move to the optimal tax structure. This is clearly an advantage, and

it is worth noting that a country that follows a sequence of tax reforms that improve social welfare will eventually approach optimality. However, it is often

not a good idea for a country to repeatedly change taxes and,

there are a number of optimal tax results that are not very sensitive to

the precise specification of individual economic behaviour. These results give a

clear idea of some major characteristics of the desired final tax structure,

whether it is approached in a series of small steps or in one large change.

None the less, it would be foolish to suppose that any country could redesign a tax system and get everything right first time. A practical approach to tax policy should combine the insights of both optimal tax theory and tax reform analysis.

The basic idea of a Tax may be simply stated by first, it is a compulsory levy and secondly it is imposed by Government or in the case of council tax, by a local authority. Finally the money raised should be used either for benefit of people therefore for public purpose or if the purpose is not to raise money, it should aim to achieve social justice within the community. The meaning of tax may sound complex to define without however explaining its characteristics. Therefore, Tax has three important characteristics. It is a

compulsory levy imposed by an organ of government for public purposes.

The legal essence of this definition lies in the compulsion because Law requires that payment be made. On the other hand, the political essence lies in the public purposes for which the payment are made. Another way to define tax is by way of a list of levies that are beyond doubt, taxes. For instances, within this list of levies makes part the council tax, income tax, value added tax, social security contributions, corporation tax, the national business rate, capital gains tax, petroleum revenue tax, insurance premium tax. I also should include hidden taxes like, gas levy, national lottery levy, sugar levy, fossil fuel levy.

According to Adam Smith, the primary purpose of Taxation is to raise revenue for government expenditure. Thus, the government can raise revenue by borrowing or by “ printing money” or “ selling things” but in practise it is unavoidable that taxation should raise most of the government’s fiscal requirements. The government spends part of the money on services which private companies cannot provide, such as defence and law and order. It also pays for services that are on a universal basis such as security benefits, and education. However the attitude for taxation depends in some points on the views of taxpayers. For example, the government main duty is to share the revenue raised for public interest purpose and at this point would that be better off if the government provides a health service, new consumer protection laws or pensions ? On the other hand if raising money to pay for these things was the only reason behind taxes, government could, thus, have a much simpler legal system. However , if for instance government raises revenues for raising the rate of income tax

by 2% per cent, government could abolish the inheritance tax and capital gains tax and still make money, but would that be fair? Would it be efficient? Efficiency is therefore one of the characteristics of tax that according to Adam Smith the effectiveness of a tax system is partly a matter of success in enforcement and partly a matter of the total cost running it and complying with it.

Another purpose behind taxation is the redistribution of wealth and income. However it is generally agreed not universally that Income Tax should be progressive and that some government revenue should be spent on public welfare services. This why the Poll tax was unpopular because people thought it unfair that everyone should pay the same tax without differentiate from rich and poor or just because they lived in the same town.