

Criteria for evaluating a tax system



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From government prospective, taxes are both a policy tool for economic management and a prime source of revenue. Taxes can be effective in discouraging certain activities that have negative consequences for the community as a whole.

A good business tax system will not distort business decision-making by, for example penalising certain kinds of economic investments. A poor tax system will encourage businesses to consider tax issues ahead of other criteria for investment.

Large number of state taxes increases the likelihood that the system as a whole will distort business decisions, without necessarily meeting government policy objectives.

Criteria for evaluating a tax system are as under:[1]

Simplicity: The tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner.

Certainty: The tax rules should clearly specify when that tax is to be paid, and how the amount to be paid is to be determined.

Equity: People should pay their taxes according to their taxable capacity or faculty as measured by some criteria, usually their revenue, that is, their income or their wealth or both.

Economic Growth and efficiency: That tax system should not impede or reduce the productive capacity of the economy.

Neutrality: The tax should not be discriminatory in any way, thus ensuring that a taxpayer will not alter his situation or be influenced in his actions by any tax effect.

Transparency: Taxpayers should know that a tax exists and how and when it is imposed on them and others.

Minimizing noncompliance: A tax should be structured to minimize noncompliance. Government should be able to judge the extent of tax evasion and the certainty with which the authorities can overcome it.

Cost-effective collection: The costs (i. e. administrative and compliance costs) to collect a tax should be kept to a minimum for both the government and taxpayers.

Impact on government revenue: The tax system should enable the government to predict the amount of revenue to be collected from year to year.

Payment convenience: A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.

Evaluation framework

A superior tax system would score well on simplicity and certainty, efficiency, competitive neutrality, equity, cost effectiveness, resilience/buoyancy and transparency.[2] Criteria should be ranked in following order:[3]

1) Simplicity and Certainty: For a tax system to work efficiently, it is important that taxpayer clearly understands his or her obligations and the amount of tax he or she has to pay and also when and where to pay his tax liability. For the Revenue Department it means clear understanding of the extent of its powers, lowered administration costs, less litigation and general higher compliance levels.

2) Efficiency: In an efficient tax system:

tax payers have limited scope to rearrange their affairs or re-configure transactions to materially alter the tax consequences;

same business decisions are made pre-tax or post-tax;

risk taking innovations are not discouraged;

economic restructuring is not hindered;

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the choice between private sector and public sector provision should not be distorted by tax considerations.

3) Competitive neutrality: A competitive neutrality ensures that:

people with same level of income (or wealth or both) bear the same share of tax burden;

there is no discrimination between business location, form, functions and transactions; and

tax does not create imbalance across competitors or industries.

4) Equity: People should pay their taxes according to their taxable capacity.

However, the ultimate impact of taxation on different groups is difficult to interpret without examining the economic incidence of taxes and the distributional aspect of government spending. Exclusion of a class of taxpayer from tax liability is inequitable. For instance, the principal place of residence exemption from income tax and land tax in Australia causes a bias against property used for rental and commercial purposes. Also, applying a standard levy regardless to capacity to pay may be considered to be regressive.

4) Cost effectiveness: Tax compliance and enforcement should be modest in relation to revenue raised so that revenue raised is not eaten up in administration costs. Compliance and administration costs can be kept low by: (i) simplifying tax legislation and calculations; (ii) harmonising interstate tax base and rates; (iii) good record keeping; (iv) education and informing taxpayers; and (v) providing ancillary and support services.

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5) Buoyancy: Government require revenue that is certain over time to enable their expenditure needs to be met. In a buoyant tax system: (i) the revenue yield from tax regime is sustainable and not subject to wide fluctuations; (ii) tax revenues are broadly based and strongly linked to growth in the economy; and (iii) the tax regime accommodates the effects of market redefinition, substitute transactions and/or products, and new ways of doing business. Secure revenue growth facilitates fiscal management, because government can better meet the costs of providing services.

6) Transparency: The principles and purpose behind the design of a tax should be clearly identified. It should be clear what is being taxed (tax base), who is liable (taxpayer) and how their liability is calculated.

I recommend alternative tax system replacing Tiny's current tax system using Zero-based approach.[4]This system is auditable, progressive and extremely simple. Further, it seems to provide the correct incentives for education, savings and investment and virtually eliminates the cheating incentive.

Key Features

A broad based “ Consumption Tax (that is, Goods and Services Tax) having a uniform rate of 45%” and a “ Wealth Tax having a flat 4% rate” would replace all of the following:

- a) Personal Income Tax;
- b) Company tax;
- c) All other taxes presently levied.

A large portion of federal receipts (for example, 45%) would be redistributed to state and local governments through a fair allocation process. The amount and design of this allocation could be based upon such considerations as population and taxpayer assets.

Corporations would not be taxed directly, but through their ultimate ownership by individuals. Cash dividends would be income used in the Consumption Tax calculation. Equity and debt market prices would be used in the net worth calculation for Wealth Tax; interests in non-public corporations would be valued by fair market value appraisals.

Financial accounting would be reformed so that all assets and liabilities will be shown at their fair market values in the end of the financial year. This applies also to balance sheets for individuals and governments. For businesses, a goodwill value would reconcile any difference to market.

Government allowances and benefits would be outside the tax system, for example, by paying subsidies. This would provide both simplicity and visibility to constituents.

Capital gains are automatically sheltered so long as the investment value remains in the person's portfolio. Also, the approach presented here automatically recognizes the effect of inflation.

Tax System Design Objectives

The proposed tax system fulfills the following criteria for evaluating tax system:

Simplicity and certainty: Consumption tax is far more simple and certain than personal income tax when both are compared as major revenue raisers.

[5] Personal income tax is far more complex and easy to avoid. It might not be clear to tax payers how much to pay and when to pay. A broad based Consumption Tax at a uniform rate is simple and it is easy to ascertain tax liability.

Efficiency: Savings in collection, reporting, records-keeping (outweighing minor tax burden inequities). A good recordkeeping will reduce administration costs. Income tax system is much more complicated than Consumption Taxes and more difficult to administer. Under Income Tax system, lot of time and money has to be spend by tax office to train staff.

Neutrality: A broad-based Consumption Tax is inherently neutral within its ambit. Were all savings made solely for the purposes of the saver's future consumption, it would be neutral between consumption and savings.[6] A broad based goods and services tax (GST) will be far more neutral than a specific tax, such as tax on alcohol or tobacco. In case of a specific tax, an individual can alter his or her liability just by changing spending patterns.

Equity: A broad-based GST serves horizontal equity by not discriminating savings and consumption. However it might not satisfy “ ability to pay principle” every time.[7]

Perceived Acceptance and Fairness: Consumption Tax has high level of acceptance and compliance and it is easy to detect any attempt of cheating as suppliers are required to registered. GST is collected on every sale of goods and services. A registered supplier can claim back input tax credits.

Although the tax authorities collect the GST at every point in the chain, they have to hand that collection over as a refund to next person down the chain. Therefore, the final collection of GST only occurs when the retailer hands over GST to the tax authorities. Hence, GST has the ability to remove the cascading problem.

Proper Investment Incentives: GST can be efficient way of collecting large and buoyant revenue for the government for education, savings, investment, and economic growth.[8]GST can be used to broaden the tax base and replace or reduce income tax.

Tax System Principles

Uniform and realistic accounting: Tax = Financial = Fair Market Value accounting bases would be identical. This provides administration and compliance economy and ensures meaningfulness.

Key requirement: Net Worth on balance sheets would represent net worth, valuing tangible and intangible assets and equities at market. Goodwill and human capital would be recognized by the entity's market valuation.

The proposed tax system will minimize income-shifting and tax-avoidance schemes.

Consumption Tax (GST)

A uniform flat rate (45%) which is multiplied by:

Consumption (Tax Base) = Income minus (costs of earnings, interest expenses, qualified donations, insurance premiums, savings).

There will be no exempt and zero-rated sales.

All the suppliers of goods and services will be compulsorily registered with the Tiny Inland Revenue (TIR). At least quarterly, Business Activity Statement (BAS) will have to be lodged with the TIR.

Administration costs will be low and it will be easy to collect GST for ITR because GST is one of the easiest taxes to collect and comply with, if it is with a single rate with none or few exemptions and zero rating. In Europe the administrative costs of collecting GST is less than 1% of the potential revenue yield of broad based GST.[9]

The Consumption Tax rate would have to be high, perhaps on the order of 45%, because former tax scheme is being replaced.

Income includes earned income, dividends, asset appreciation, gifts, inheritances, and insurance proceeds;

Asset appreciation does not cause or effect Consumption Tax;

Costs of earnings would include all expenses related to producing income. Expenses for education toward a trade or profession can be capitalized or expensed. However, capitalization of these expenses would be better;

Interest and insurance expense are deductible personally to maintain consistency with the traditional deductibility when reasonably incurred during the course of business;

Donations are deductible because of tradition, business allowance, and to encourage and partially match altruism;

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Savings is inter-period change in net worth.

Wealth Tax

Purpose of levying Wealth Tax: Tiny might not be able to raise much revenue from the Wealth Tax but it helps achieve equity and efficiency.[10]The objectives of wealth taxation can be concisely summarized by the words, equity, efficiency and revenue.”[11]

In terms of equity, wealth taxes are justified on the basis that to effectively treat persons with equal capabilities to pay equally, wealth must be taken into account.

From efficiency point of view, wealth tax discourages the investors in holding assets yielding low or zero returns and therefore incentives to seek out high yielding ones.[12]

Wealth Tax is based on a person’s net worth from balance sheet reporting.

This provides a progressive tax effect;

The flat Wealth Tax rate would perhaps be in 4% range. Annual Wealth Tax should be paid by lodging a Annual Wealth Tax return;

Alternatively, inflation indexing can be carried out to adjust asset values for net appreciation;

Under this proposed tax system, tax compliance can be verified by providing a net worth audit trial. Identifiable assets can be valued for easy and cost-effective auditing;

Administrative costs will be low because compliance and monitoring is easier due to just one tax. A centralized system of monitoring can be adopted.[13]

Alternatively, OECD has suggested that the value of particular classes of asset may be fixed by periodical official valuations which then remain in force for several years;[14]This will reduce the incentive to cheat.

Other Features and comments

A new requirement to report net worth can be expected to become a major issue due to the apparent diminished privacy. However, the TIR and credit reporting companies can easily know most of what there is to know about the finances of ordinary citizens;

All not-for-profit entities, such as, states, cities, universities, churches, sporting clubs, and homeowner associations should be tax-exempt. To qualify there must be no beneficial ownership of a profit making body or a small sub-group;

Partnerships would be treated as corporations so as to recognize any goodwill value for consumption tax and wealth tax purposes;

Ownership in closely-held businesses would have to recognize a control premium in interest valuations;

An important need is an effective TIR. With good management, the centralized tax agency can be much more efficient than having many different state and local taxing authorities;

Gifts received, inheritances, insurance proceeds, and the like should not be taxed if saved. Gifts when made should be taxed as consumption;

Welfare distributions should be labeled as such and should be clearly visible.

c) No one likes taxes, but they are necessary evil in any civilized society.

Whether it a developed economy or a developing economy, governments must have some resources in order to perform their essential services. A civilised society needs facilities, such as, roads, bridges, electricity, police, national defence system, legal system etc. No civilised society can function without these facilities. These have to provided for free. No private producer would do this, so the government must take over production and provide them free of charge. Taxation is necessary to provide the resources. It is the potential to inspire better governance through raising revenue that matters to civil society, and everyone has a role to play. To act as responsible citizens, every individual must pay the right amount of tax and be transparent about it.[15]Hence quote of Justice Holmes that “ Tax is what we pay for a civilised society” is correct.

Tax payers have to be educated to comply with their tax obligations. Each individual who is called upon to pay taxes derives some benefit from the goods and services provided by the government. While taxation is money raising exercise for public spending purpose, it is also used as an economic tool. There are broadly three category of expenditure function that necessitate a tax system:[16]

Provision of public goods like roads, electricity, public library, police, legal system, national defence system etc. For maximum welfare of society, these

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facilities need to be offered at a zero price. No private individual will provide them for free of charge. It is not feasible to exclude non-taxpayers from deriving the benefits.

Resources have to be allocated according to perceived needs, such as, social service, health etc. Also, resources might have to be redistributed to achieve a particular economic objective, such as, giving a tax holiday to foreign investors to encourage foreign investment.

In a free market system, there can be peaks and troughs, period of recession, unemployment, deflation or inflation etc. The government can use taxation to stabilise the economy.

Taxes are simply the preferred method for paying for these governmental functions, the other methods being the issuance of public debt and the issuance of money. Justice Holmes' quote establishes the propriety of taxation, but it tells us nothing about the form or levels of taxation, and, indeed, matters have changed significantly in both regards over the years since his pronouncement.

Taxes perform another important role besides funding government activities, that is, taxes also provide citizens with basic information regarding the total price for those activities. At present, government has become a dominant factor in our economy, absorbing significant resources for its purposes and redirecting many more resources through its regulatory policies and through a mixture of taxation and spending programs that remove resources from some areas to transfer those resources to other areas.[17]It is critical, therefore, that citizens have as much information as possible regarding

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these diverse programs and regarding their aggregate totals so they may decide for themselves whether the government's activities are appropriate. Taxes, and especially the paying of taxes, yield citizens a personal sense of the total price of those activities.

Governments on their part must be transparent about how they raise revenue and where they spend it, so that their decisions are open to scrutiny.