Good tax system lessens tax avoidance and evasion economics essay

" The Centre for Policy Studies has labelled the treasury's new 50% tax rate as 'unfair, complex, inefficient and damaging'" telegraph. co. uk June 2009

" In view of the furore over the expenses of Members of Parliament, the question must be raised as to whether such a high rate is necessary."

Critically discuss with reference to the above quotations

The difference between tax avoidance and tax evasion and;

Assuming some taxation is necessary; critically discuss the principles of a good taxation system.

Tax avoidance has to be distinguished from tax evasion. Although in common parlance these words are often used interchangeably. In fact they tend to shade into each other at the margin but they can be clearly distinguished in principle.

Evasion is an illegal act. It involves giving false or misleading information, or suppressing relevant information, so as to reduce or eliminate tax that is legally due. It can take many forms, some of them well known. A trader or farmer may sell goods for cash over and above his declared sales, especially where there is no itemised record of them, just a purported total of cash received.

Services such as hairdressing and house decoration may be provided privately, the payer being unable to claim tax relief on the outlay and the recipient asking for payment in cash (quite possibly a reduced amount) so that there is no record of the transaction. An employee may acquire a second, part-time, or casual job which by itself is below the tax threshold and keep his job secret from the second employer.

Tax evasion of this nature is believed to be widespread and elimination of it is virtually impossible in a free society (and so even in a controlled society). Rather like trying to eliminate burglary, the cost of manpower required to check and supervise peoples activities would far outweigh the value of any benefits that might result, quite apart from their effect on the quality of the life of innocent and guilty alike.

Tax avoidance may shade tax evasion in the context of avoidance schemes which involve sequence of legal formalities that must be taken at the right times and in the right order. There may be a temptation to the ante-date crucial documents or to prepare records of formal meetings which should have taken place and did not.

This temptation is particularly strong if the avoidance possibility was not foreseen but becomes obvious with hindsight, and an attempt is then made to produce evidence of facts which did not actually happen at the alleged time.

By considering the kinds of activities that amount to tax avoidance and which are legal. Many of them amount to doing no more than taking advantage of opportunities presented by the tax laws themselves. An example of tax avoidance, a business may be run as a partnership or as a company. In so far as the taxation consequences influences the decision this is a form of tax avoidance, but not one which most people would regard as being morally wrong.

Similarly, a private investor will take tax efficiency into account in choosing from the range of investment opportunities. In both cases the tax factor is influencing the decision, but it will be observed that these decisions have legal and financial consequences quite apart from their effect on taxation liability or relief.

In economic terms, the higher the rates of tax, the more likely are people to try to escape paying some of their taxes. People who are subject to higher rates of income tax will be more tempted not to declare all their income. This tax evasion will be much easier for people not paying all their taxes through a pay-as-you-earn (PAYE) scheme.

This will include the self-employed and people doing causal work on top of their normal job. Furthermore, richer people can often reduce their tax liability-tax avoidance- by a careful use of various legal devices such as trusts and tax loopholes such as being allowed to offset business expenses against income.

" The Centre for Policy Studies has labelled the treasury's new 50% tax rate as 'unfair, complex, inefficient and damaging", based on this assumption the British tax has gone further in complexity, the system is becoming more like a cake: new layers are continuously added, and a very little of effort is done towards reforming.

This complexity is directed towards taxpayers who are finding more as an unfair, inefficient, and damaging to their incomes. Thus a simpler, well reformed tax system is required.

Adam Smith was one of a number of economists who considered the principles of how to design an effective tax system. In modern terms, the terms he described, are so called the canons of taxation and they can be stated as, equity, certainty, convenience, and efficiency.

Other writers have subsequently proposed further characteristics to add to this list. A common addition is flexibility. This suggests a tax system should be established in such a way as to be able to cope with changing economic circumstances over time without requiring substantive changes.

Starting with equity, tax changes have indicated a switching emphasis from vertical to horizontal equity. The systematic broadening of the tax base and simultaneous reduction in the rates of tax since 1984 has eroded the extent to which the tax system provides for vertical equity.

At the same time, taxing capital gains at the marginal rate of income tax since 1988 and the introduction of independent taxation in 1990 have improved fairness in the tax system but the emphasis has been on providing horizontal equity rather than vertical equity.

Horizontal equity: According to horizontal equity, people in the same circumstances should be taxed equally. In other words, taxes should be levied impartially. For example, people earning the same level of income and with the same personal circumstances should pay the same level of income.

Vertical equity: According to vertical equity, taxes should be fairly apportioned between rich and poor. What constitutes fairness here is highly controversial. No one like paying taxes and thus a rich person's concept of a fair tax is unlikely to be the same as a poor person's.

Equity between recipients of benefits: Under the benefits principle, it is argued that those who receive the most benefits from government expenditure ought to pay the most in taxes.

Now, many of the tax reforms instituted since the mid 1980s were aimed to making the tax system more neutral, to remove economic distortions and improve efficiency, for example: Reductions in reliefs, e. g. mortgage interest relief removing the bias in favour of home ownership; Bringing capital allowances more in line with economic depreciation making the tax system more neutral between different forms of capital investment; Reduction in the rates of corporate tax makes the corporate tax system more neutral between capital and income.

Philip Chapel suggested to achieve fiscal neutrality the tax system should apply the following principles:

Simplicity- the system should be simple for the taxpayer to understand reducing compliance costs.

Plainness: a single flat rate of tax should be applied.

Rate: the rate of tax should be set at a level that makes tax avoidance unprofitable.

Universality: the single flat rate should apply universally in the same way as VAT, and purls, privileges and allowances should be phased out.

Comprehensiveness: a proportion of tax should be levied on income as well as expenditure as an overall switch to expenditure is undesirable.

A flexibility tax is one which changes, or can be changes, easily in response to changes in the economic environment. A key aim of government is to reduce the fluctuations in economic activities caused by the economic cycle as this is often seem as good for an economy in the longer term.

A flexible tax, designed properly, can have a stabilising effect on the economy to assist with this goal. For example, it can cause money to be taken out of a growing to keep its growth at a manageable level, and reduce the amount of money that is taken out of the economy when it enters a recession to soften any downward spiral effect.

Whatever the requirements of taxation, when it comes to devising and administering particular taxes there are various principles that many argue should be observed:

Cheap to collect: Taxes cost money to collect. Those costs should be kept to a minimum relative to the revenue they yield.

Non distortionary: Taxes alter market signals: taxes on goods and services alter market prices; taxes on income alter wages. They should not do this in an undesirable direction.

Convenient to the taxpayer: Taxes should be certain and clearly understood by taxpayers so that they can calculate their tax liabilities. The method of payment should be straightforward.

Convenient to the government: Government use tax changes as an instrument for managing the economy. Tax rates should thus be simple and adjust. Also, the government will need to be able to calculate as accurately as possible the effects of tax changes, both on the total tax yield and on the distribution of the burden between taxpayers.

Minimal disincentives effects: Taxes may discourage people from working or harder, from saying, from investing or from taking intuitive. For example, a high rate if income tax may discourage people from seeking promotion or from doing overtime.

Of course, not all these requirements can be met at the same time. There is no perfect tax. The government thus has to seek a compromise when there is a conflict between any of the requirements. One of the most serious conflicts is between vertical equity and the need to keep disincentives to a minimum. The more steeply the rich are taxed; it's argued the most serious are the disincentive effects on them likely to be.