

The principles of how to design an effective tax system



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Adam Smith was one of a number of early thinkers who considered the principles of how to design an effective tax system, and in his book, *The Wealth of Nations*, published in 1776; he outlined four desirable characteristics of a tax system (Lymer and Oats, 2010/2011: p43-44):

“ The subjects of every state ought to contribute to the support of the Government, in proportion to their respective abilities; that is in proportion to the revenue which they respectively enjoy under the protection of the state.”

“ The tax which each individual is bound to pay ought to be certain, and not arbitrary.”

“ Every tax ought to be levied at the time, or in the manner, most convenient for the contributor to pay it.’

“ Every tax ought to be so contrived as both to take out, and keep out, of the pockets of the people, as little as possible over and above what it brings in to the public treasury of the state. A tax may either take out or keep out of the pockets of the people a great deal more than it brings into the public treasury, and in four ways: a) by the number of officers who levy it: b) by obstructing the industry of the people; c) by penalties incurred in attempting to evade the tax; d) by subjecting the people to the frequent visits and examinations of the tax-gatherers.”

Lymer and Oats (2010/2011) re-state these four characteristics as: equity, certainty, convenience and efficiency.

This essay will explain these four characteristics in detail and discuss whether the current income tax system of self-assessment achieves them in <https://assignbuster.com/the-principles-of-how-to-design-an-effective-tax-system/>

conclusion. Self-assessment is a system under which the taxpayer is responsible for working out his or her own tax liability and reporting it to the revenue authority each year. (Lymer and Oats, 2010/2011: p19)

Equity

All individual should be taxed fairly, and taxes should be charged according to people's taxable capacity. People will resent the government if a tax is not seen to be fair. Fairness is important because it helps to reduce tax avoidance.

There are two aspects to the fairness of a tax system: horizontal equity and vertical equity. A tax system is horizontal equity if taxpayers with equal taxable capacity on the same tax burden. A vertically equitable tax system is those with greater capacity to pay tax bear a higher tax burden. (Lymer and Oats, 2010/2011: p45)

There are two approaches to measure the equity: ability to pay and the benefit principle. Person's income level is one obvious factor in measuring ability to pay; another factor is person's stock. The benefit principle refers to those who benefit most from the services provided by a government should pay the most tax. (Lymer and Oats, 2010/2011: p46-49)

For examples of equity, in income tax, everyone is fair to have a personal allowance and then tax at different rate related to the income. Different amount of income will be taxed on different tax rate, such as rate between £0 to £37, 400 will be taxed at 20%; £37, 400 to £150, 000 will be taxed at 40%; what excess £150, 000 will be taxed at 50%. And different kind of income will tax on different rate too, such as the higher rate of savings

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income and dividends income are 40% and 32.5%. Otherwise, individuals who have a television are taxed on owning TV to contribute to the cost of the BBC by way of the licence fee.

Certainty

Taxes should not be random, taxpayers should know their tax liability and when and where to pay the tax.

A country's citizens need to be fully informed about who will have to pay the taxes in the tax system and when they will have to be paid (named the incidence of tax). Taxes where the incidence is clear are to be preferred over taxes where there is disagreement and uncertainty over the ultimate payer of the tax and when the tax must be paid. (Lymer and Oats, 2010/2011: p52)

Such as non-savings income tax, income between £37,400 to £150,000 must be taxed at 40%, individual can not change it to 20%.

Under the self-assessment system, it sets that those need to complete a self-assessment tax return (such as individuals have more complicated tax affairs, even they have already pay tax through PAYE. There are also certain circumstances need to complete a tax return – self-employed, a company director, a trustee and foreign income); when and where the tax payer must submit the self-assessment return (reach HMRC by midnight on 31 October as paper tax return or by midnight on 31 January online). (HMRC, 2011)

Convenience

Tax convenience relate to how individuals engage with the tax system and how people pay their taxes. Taxes should be easy for people to pay what they levy.

For instance, Pay As You Earn scheme and interest received are very convenience ways to have tax. Individuals will have tax deducted before they receive their salary and saving interest. Another example is VAT tax, people will have tax deducted at the time they buy something.

Self-assessment system provides a way easy for people to file their annual tax returns. It is online filing. This way makes a lot of advantages for both HMRC and taxpayers. Such as, the system will help to check if u put the figures in right place and then calculates the amount of tax due. The most important advantages is it helps to get the filing process faster, so the taxpayers can get any refunds as soon as possible.

Efficiency

The tax system should not affect the allocation of resources and its administration cost should be cheap. It should be avoided as much as possible that the taxes cost for the tax authority to administer. Cost to governments include administration costs, the cost of looking for delinquent taxpayers through audits, and the costs of considering quarrels with taxpayers over the way in which the tax laws operate. (Lymer and Oats, 2010/2011: p44)

Adam Smith divided efficiency into two parts: economic efficiency and administrative efficiency. (Lymer and Oats, 2010/2011: p54)

An economic efficient tax system is one that does not distort the economic and commercial decisions made by individuals. Lymer and Oats (2010/2011) said that Economic efficiency is sometimes referred to as fiscal neutrality, and the key idea is that taxes should, as far as possible, not interfere with the workings of the market. The more a tax cost to administer, the less of the money raised by the tax is available to the government for their expenditure plans. The administration cost should be as small as possible to achieve desirable economic efficiency. (Lymer and Oats, 2010/2011: p54-57)

VAT tax is a good example of efficiency. VAT tax receives directly when people buy something. When people buy something, they pay the tax immediately,

Under the self-assessment system, there is no need for the tax authority to produce assessment for taxpayers anymore. HMRC then can allocate more of its resources to following up cases that might be inaccurate, providing more advice and offer other services to help taxpayers rather than having to check every tax return that is filed to assess the tax liability. It reduces the administration cost to the government. However, it increases the cost to the taxpayer of complying with the system, but this will not interfere with the workings of the market. (Lymer and Oats, 2010/2011: p19)

Conclusion

As explain above, the current income tax system of self-assessment

achieves three Adam Smith's desirable characteristics obviously; they are '
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certainty', 'convenience' and 'efficiency'. For 'equity', self-assessment does threats each taxpayers fair, because anyone who delay to submit the self-assessment return, he or she will a penalty.