Tax Facts

A knowledge-based series by the Tax and Transfer Policy Institute

Principles of Tax System Design

Key principles

- Adequacy
- Resilience
- Simplicity
- Fairness
- Prosperity
- Consistency

Tax reform proposals are a standard element of election campaigning and budget proposals. But how should we think about these reforms? What is the tax system trying to achieve and how should it be designed?

This document briefly presents the key elements that should underpin tax system design and some ideas around each element.

Adequacy and Resilience

Governments engage in a range of activities including enforcing laws, providing and regulating the framework which allows social and economic activity to flourish, redistributing to those who are less well-off, correcting market failures and providing public goods. These activities bring well-being to citizens. The ideas of adequacy / resilience address the following questions:

- Does the tax system generate sufficient revenue to fund the activities of government that citizens want (public education, health care, disability insurance, etc.) now and in the future?
- Are tax revenue and government expenditure evolving in compatible ways?
- How is the tax system positioned relative to known, but uncertain trends? Including:
  – an ageing population;
  – increasing automation;
  – increasing casualisation of the workforce;
  – globalisation and increasing mobility of capital and labour.

Simplicity

A simple tax system has rules that are transparent and easy to understand. Simplicity brings a variety of benefits.

- Every day, citizens have to make difficult decisions in a complicated and unpredictable world.
- The tax system should not add unnecessarily to this complexity.
- A simple system is less costly. Less cost to taxpayers of administering their tax affairs and less cost to government of administering the system and verifying compliance. This means more resources to directly increase societal well-being.
- The more complex a tax system, the more likely that individuals will be able to use the tax system rules to achieve outcomes that were unintended and unexpected by policy-makers. This undermines fairness and adequacy.

Fairness

Fairness is subjective and complicated. What should matter? What should not? Should someone with a physical disability receive more money from the tax and transfer system? Should someone with a compulsive gambling problem receive more money from the tax and transfer system?

Nonetheless, there are several core principles that can be used to think about fairness.

- Horizontal Equity

People with equal ability to pay should pay equal tax. Things that have nothing to do with ability to pay (such as hair colour or personal relationship to the prime minister) should not affect how much tax is paid.

- Vertical Equity

Those who have a higher ability to pay should pay more. This principle may be based on the idea that those who are wealthier benefit more from government expenditure. Combined with redistribution, it may also be justified as government providing a missing insurance market.

- User-pays

Those who benefit most from a government service should pay the most for it. This is the idea behind road user charges that are based upon kilometres driven.

None of the above are uncontroversial and different people and groups will make different judgements on fairness. But the tax system should reflect societal views on fairness.

Prosperity

Economic growth has brought about major increases in life expectancy, health, education and societal well-being. The tax system should be designed to minimise negative impact on economic activity.

- Taxes discourage economic activity. For this reason, we tax things that we want less of; for instance, pollution, cigarettes.
- Theory and empirical evidence show that some taxes have larger negative impacts on economic activity than others. These negative impacts are called '**deadweight loss**'.
- Taxes should be designed to have the smallest possible deadweight losses. In general, indirect taxes (taxes on land, resources, consumption) have smaller deadweight losses than direct taxes (taxes on personal income or corporate profits).

Consistency

Policies should be 'horizontally' and 'vertically' consistent.

- Government policies need to work in concert with one another, not push in opposite directions.

For example, if one tax policy discourages savings and another policy is introduced to subsidise savings, even if the net result on savings is the same, the well-being to society is diminished by the deadweight losses from the two policies.

- Government policies need to be credible in the future.

This is particularly true for policies which affect long-term decision making such as those around education, savings and retirement.

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More information

Contact the director at robert.breunig@anu.edu.au | Contact us at tax.policy@anu.edu.au
https://taxpolicy.crawford.anu.edu.au/
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