

EFFICIENCY AND FAIRNESS, IS IT POSSIBLE TO ACHIEVE? A REVIEW FROM TAXATION ASPECT

Tran Thi Thuy Linh¹, Dang Trung Kien²

¹ Lead author, Faculty of Banking and Finance, Thai Nguyen University of Economics and Business Administration, Thai Nguyen, Viet Nam.

² Corresponding author, Faculty of Business Administration, Thai Nguyen University of Economics and Business Administration, Thai Nguyen, Viet Nam.

ABSTRACT

Efficiency and fairness are expectations of every tax policy maker. In case of individual, a millionaire should not pay a “fair” flat amount as a low-income person, so the different payment rate by level of income (progressive income tax) may enhance the satisfaction of most taxpayer, which is helpful to political and social concern, but againsts the “fair” willing of some particular one. Meanwhile, the business sector, depend on their characteristics, some specific businesses or products have been taxed higher or lower, give them particular advantage or disadvantage in the market when comparing to other businesses. These issues sounds to be unequal for someone but fair to the others, it is just the matter of political and social purpose. Even there is conflict remains in real application, sometime we have to sacrifice one aspect to enhance the other. However, a balance between the two in the concern with tax objective is undeniable. To answer the question of equilibrium point, Horizontal and Vertical equity aspect can not be ignored for designing a sound tax system. Seeking horizontal perspective is important because taxpayer should enjoy the feeling of treated equally. Meanwhile, it is same necessary to achieve the vertical equity so taxation will not become a burden to taxpayers, especially those are in lower income group, the majority group of population in society

Keyword: Taxation, Efficiency, Fairness, Conflict.

1. INTRODUCTION

Taxation already has long history through human civilization, with the first form of tax records from six thousand years B.C. were founded (Carlson, 2004). Today, most of us basically understand tax is a compulsory contribution of citizen to enjoy the social services' beneficial, such as education, health care, sanitation, security, etc. In the other word, it is the payment of taxpayer (which may be individual or legal institution) to government to maintain their social amenities by funding various public expenditure (Charles and McLure, 2015). However, since tax is a compulsory, not a voluntary contribution, but a non-direct return in benefit to the taxpayer, these characteristics make tax often be considered as a significant expense in the liability of individual or bussiness, rasing a question of what is the benefit to pay tax, and how is its effectiveness. Thus, to secure a substantial tax revenues, the government or fiscal authorities need to “ensure that the tax system is seen to be efficient and fair”, said Institute for Fiscal Studies (Mirrlees, 2011)

2. TAX EFFICIENCY AND FAIRNESS

2.1 Tax efficiency

Tax is unavoiable and every country expect for an effective tax system. There are vary opinions how to design an effective tax system. According to one of world's first publication about the classical economics since seventeen century by Adam Smith, a tax system has to contain these four principles to be called good system, they are of:

Canon of Equity (Equality), Certainty, Convenience, and Economy (Smith, 1776). Today, it is still a fundamental study in promote national wealth and development.

In the first principle, equality characteristic were be noticed by Smith. According to canon of equality, the tax amount should be calculated based on each individual ability, as a proportion of their income and revenue. Which means a fix number of tax rate in percentage will be applied for every contributors.

Another important idea was spoken out in Smith's second description, the canon of certainty. The tax amount, due date, payment method must be clear to contributor or any other taxpayer. Smith declared that the short of certainty may encourages corruption in tax system. A real example can be observed from the Hungary's special taxes case during its state budget crisis (Deak, 2010) or the tax harassment happen because of the poor income tax policy in India (Marjit et al., 2000).

The third canon, principle of convenience declared not only the certainty, it is also important that the payment should be convenient to the taxpayer by the sum, the date and the payment manner of tax. As the matter of fact, mostly nobody may happy to spend money for a complicated system without clearly direction or guidance. Thus the more comfortable of tax system, the less upset and uncompliance of tax contributor. It is absolutely true, especially in case of modern life with rapidly technology improvement. Today, residents can easily check their tax via internet, filling the tax record online, pay the tax at convenience store or receive the advance notification about tax due date. A sound system should not run behind the social improvement. Law enforcement agency can utilize this principle to encourage better taxpayer's behavior, such as honest contributor may enjoy more convenience in tax service, while illegal one should be punished by more restriction. (Economic Daily, 2016).

The last characteristic for good tax system introduced by Smith is principle of economy. Tax, in its primary purpose, is the source of revenue for government, however to collect this contribution, they must suffer an amount as collection cost. It will be a waste for the national budget if the cost is too large, as of this spending contribute nothing to the economic growth. A stagnant administrative machinery with complicated tax regulation will employ larger collection cost. It is essential that government should avoid this problem and minimize the cost as far as possible by making the tax system simple and easy to access for citizens.

Until today, Smith's opinions still regared as fundamental concept of a good tax system. However, it was time since his study published, our society have been developed a lot and there are significant expand in economic theory and policy. Nowadays, tax is not only the funding collect for government's spending, it is also a method to reduce inequalities in the income distribution among people. Thus, it leads to the development and additional principle to the Smith's ideas. In general, to approach the efficient target, the modern tax system must satisfy some basic characteristics or principle as of: Simplicity, Neutrality, Stability (Mirrlees, 2011) and Flexibility (Fiscal Commission Working Group, 2013).

- *Neutrality*

The tax administrative must be neutral on decision by not favoring any specific individual or institution at other's expense. It is very important to avoid unexpected or negative effect, as of any tax change may cause the taxpayer's behavior changes and distortions (Tax by Design, 1978), which will followed by the complexity, raising the unwanted additional costs for both contributor and collector as well as encourage tax avoidance, such as transforming the struture of financial transactions activities with the aim to minimize the tax liability (Furman, 2008). It is clear that greater neutrality may enhance the simplicity and fairness of tax system. However, in some special case the lack of neutrality in the tax system may be appropriated to reflect the goals of policymakers as well as the value of society. For instance, the donations to charities are able to claim tax deductions while the health harmful products such as tobacco, alcohol are taxed higher. Sometimes, tax deviations is also a need to encourage the competitive of the market or the strength of the economics. Such as the reduction of personal income tax to zero percent (0%) to individual shareholder in Vietnam stock market during the period from 2011 to 2012, by that the market manager expected to attract more investment from citizen during economic recession. (Circular No. 134/2011/TT-BTC, 2011). So the level of neutrality of a tax system must be reviewed carefully by fiscal authorities. Any tax issue or reform decision should consider the effect relative to the whole untaxed markets, also the mutual impact and consequences of different taxes.

- *Simplicity*

Nearly everyone prefer simple rather than complicated, it is totally true in case of taxation. An effective tax system should be clear and easily understood in rules and obligations. The idea is close to Smith's principle of certainty. The more simple the tax structure is to understand, the less burden and uncertainty to both taxpayers and the exchequer. Or in other words, transparency is the key for a simple and effectively administering system (Holtzman, 2007). As people know clearly about their tax quantity and quality, they will reply in a higher voluntary compliance, which results the favourable of simple tax in case of less enforcement cost. While, a tax complexity waste resource by a sizable costs (Aghion et al., 2017) and create the opportunities for tax avoidance in ambiguous provisions

(Krause, 2000). It is clear for the benefit of an easily understood tax system, but it is difficult to have a truly simple one in reality, especially in case of political purpose, single taxes may be intended to support more than one policy matter (Zodrow and Mieszkowski 2002, ACCA, 2015). Nevertheless, the balance between simplification and complexity must base on the overall objectives of the tax system.

- *Stability.*

This characteristic should be viewed from both side of government and taxpayers. As the primary purpose of tax is revenue for government, the stability of the collection through taxation must be secure. In addition, it is in the same level of importance for tax regulation applies for taxpayers. In case of government, they expect to able to predict as precise as possible the collection, in order to plan any coming project. Meanwhile, from the taxpayers view, they desire for a stable tax with less burden from administrative machinery, to encourage the confident and efficient ongoing compliance of business and individual in the system. The stability level of financial and tax system particularly important for those investment in high value but long term of turnover project, such as oil and gas extraction, larger infrastructure etc, as investors need reassurance that tax rate and regulation will not change suddenly (ACCA, 2015), in order to create correct business decision making and secure their profit.

- *Flexibility*

In addition to above fundamentals, it also need to consider another essential characteristic, the flexibility objective (Fiscal Commission Working Group, 2013), an expand idea of Smith's convenience principle. Technology is improved rapidly today, it encourage other involving in global economic and social conditions. The administrative system as taxation should not be left behind, it should be sufficient flexible to catch up with the changes when human steps into the digital age. This is even more urgent for those are developing or less developed countries in cope with "more difficult environments with fewer resources" (Richard and Eric, 2008 and George, 2018). Making tax flexible to change may raise the concern about its stable if it is out of controlled, thus the fiscal authorities have to keep balance between flexibility and stability. We must ensure our system able to adapt with market change requirement without creating any unintended harmful shock to its predictability and certainty.

2.2 Tax fairness

Another important aspect of a sound tax system is Fairness or Equality. First of all, we must clear that the word "fair" (or "fairness") here should not identical to the meaning of equal tax rate (flat tax) as Smith's idea about taxes in proportion of income. In fact, taxing equally is unfair. As of being rich and being poor are not move in straight line, making their taxes can not be lineared. Today, most of the countries apply the progressive income tax, in which tax rate level should be levied on the amount of income, there more you earn the higher rate you be taxed. Of course, it is still not an easy to quantify how accurate the progressive income is, but the imbalance created by flat tax can be seen through some examples such:

- *There is a fact that the poor live more expensive than the rich.*

A classic example is about buying a pair of shoes. Mr. P, because of his limited budget, could only buy one pair of shoes at 20\$. Another person, Mr. R is rich so he can purchase one pair of shoes at 200\$ without any problem. Mr R's shoes are very expensive, it comes together with high quality, so he can use up for years without fail. While Mr P's shoes are fake, as the consequence they can be used for several months. Thus, in the long run, obviously Mr P have to spend more money for shoes than B.

"It's more expensive to be poor", a famous quote about an interesting phenomenon happens in economic. There is a raising of evidence about it in reality, especially for those countries with poor policy in removal of inequalities in income and wealth. For instance, the US, one of the world's most expensive healthcare, the majority of low-income people do not get the same health care services as the rich. When the poor's health is worse, their illnesses are not prevented early together with later treatment, it results in higher obesity. According to study of the National Bureau of Economics Research, the life expectancy increased significantly for the top income group (Alan et al., 2017). It means the rich takes more share from taxpayers by enjoy more beneficial of the healthcare system.

- *A person's basic spending needs may be fulfillment at a certain of wealth.*

For instance, whatever how much you may earn then spend for food, you can consume a limited number of calorine per day. An interesting with much discussed by a Nobel prize winner from Princeton University found that a peak of 75,000\$ income per year may be enough for a person's day to day satisfaction (Kahneman & Deaton, 2010), excess these number, money may not share major propotional to happiness. Of course, the people with high incomes will have higher needs, but those needs mostly belong to luxury aspect rather than essential for their survival. For the basic needs, there are no different between everyone.

- *The richer, the easier for people to consolidate his wealth.*

The richer will be more accessible with information, knowledge, influence and position to strengthen their wealth. They and their children may enjoy the better education and healthcare to be able to earn more money. The poorer

person, is more likely to be left behind with less chance to catch up the top. Low-income families somehow have to spend more than what they earn (Lerman, 2005). It may create unbalance if rich and poor pay in the same tax rate but someone on top will enjoy the larger share of social benefit.

Above opinions and examples may support to the idea of why the rich should be taxed higher rate, to create the “fairness” feeling for every taxpayers. In fact, even if taxes be complete removed, it cannot make the poorest wealthier, due to their limited income and tax involved (Bird, 1990). But the progressive income tax may able narrow the gap of inequality income (Brian, 2015).

3. EFFICIENT AND FAIR EQUILIBRIUM, IS IT POSSIBLE TO ACHIEVE?

A perfect market is hard to achieve if not want to say impossible, it only happens an effective equilibrium point of demand and supply. So it is for my opinion in case of tax system, there is no “perfect” efficient and fairness at the same time. But tax administrative may control them at an acceptable balance, where the tax purpose and objective still be fulfilled. In fact, there is raising question of conflict existence between efficient and fair about true equality among every taxpayers.

Previous explanation and samples already shown particular conflict among them. In case of individual, a millionaire should not pay a “fair” flat amount as a low-income person, so the different payment rate by level of income (progressive income tax) may enhance the satisfaction of most taxpayer, which is helpful to political and social concern, but againts the “fair” willing of some particular one. Meanwhile, the business sector, depend on their characteristics, some specific businesses or products have been taxed higher or lower, give them particular advantage or disadvantage in the market when comparing to other businesses. These issues sounds to be unequal for someone but fair to the others, it is just the matter of political and social purpose.

A coin has two faces, any policy always has its advance and drawback, but they all affect to the system by this way or that way. For example, the issue of financial measure, consumption taxes, be setted high to stimulate more saving, thus encourage the economic efficient. However, it may favor the rich because they are more able to save (Kilborn, 1988). In reverse, lower tax rate may also affect the system efficient. For instance, in case of China during the current trade conflict with USA, Chinese government presents an income tax cut plan. With the new tax reform (as of table belows), more people may access to the lower tax rate. The policy makers expect for a push to the domestic consumption, people with less concern about their tax liability will easier to open the wallet. More willing to spend may reduce the free cash in hand as saving of citizen, thus help to reduce the inequality (Wildaw, 2018). The legislator and law enforcement have to play the role of encourage policy’s advance and minimize its potential negative effect here, or in economics term, it should meet the Pareto improvement equilibrium, where the action results gain in net welfare without harm to someone else.

Table -1: China individual income tax reform - 2018

Bracket	Current IIT Law		IIT Reform Proposals	
	Monthly Taxable Income (RMB)	Tax Rate	Monthly Taxable Income (RMB)	Tax Rate
1	0 - 1,500	3%	0 - 3,000	3%
2	1,501 - 4,500	10%	3,001 - 12,000	10%
3	4,501 - 9,000	20%	12,001 - 25,000	20%
4	9,001 - 35,000	25%	25,001 - 35,000	25%
5	35,001 - 55,000	30%	35,001 - 55,000	30%
6	55,001 - 80,000	35%	55,001 - 80,000	35%
7	Over 80,000	45%	Over 80,000	45%

Source: <https://www.hrone.com/chinas-new-individual-income-iit-tax-reform-2018/>

To gauge the equality by fair share taxes in efficient system, two aspects of equity often be considered: Horizontal and Vertical equity.

On the one hand, the Horizontal argue that equally situated persons or businesses should be treated in the same way by the same amount of tax without any discrimination among them. There is a school of thought believe it is uncontroversial that a fair tax policy should be designed with horizontal equity aspect (Musgrave, 1990). It protects tax payers against the inequality by eliminating the arbitrary tax variations, which in the same scope of United States Clause about “the equal protection of the laws” (Cordes, 1999).

On the other hand, the Vertical aspect refers to the idea that better-off taxpayers should have higher taxes (Kaplow, 1989). The progressive tax (includes tax brackets) applied by most of countries today is the best evidence for vertical approach, in which people be taxed based on the bracket that their earning fall in, the higher tax bracket the higher contribution percentage. It is an essential policy to reduce the wealth gap between people.

We can clearly see how important of Horizontal and Vertical equity to an effective system. Horizontal violation may be viewed as serious loopholes for any taxation design (Elkins, 2006). Meanwhile, an unfair vertical tax condition may cause the individual behaviour changes (Castro, 2014). However, the equity principles sometimes is not always easy to achieve. As of in real tax base, there are tax exempt, deduction and other incentives. Any action breaks the amount be taxed may result different payment rate of similiar individual and the different required contribution may raise the conflict between each group of residents.

Back to China tax reform program for an example of Horizontal and Vertical equity in reality. The Chinese government tax reform program puts a big concern about fairness improvement among taxpayers during national growth slowdown period. In the 2011 reform project, they increased the level of personal income tax exemption from 2000RMB in 2010 to 3500 RMB in 2011 and simplified the tax system from 9 progressive tax rate brackets to 7 brackets for wage and salary. The vertical objective is presented through different tax brackets, where people have to pay different amount according to their income level. Meanwhile, an analysis revealed the Chinese tax reform actions reduced the average maginal tax rate and contributed to the horizontal equity performance (Li and Ma, 2017). Economy slowing is reflected by the less income of all economic sectors, signs potential stress may happen for payable concern, a potential cause for behavior changes to tax fulfillment responsibility. A flexible treatment by fiscal authorities in tax may calm down the market, making contributors more confident with an positive signal.

Table - 2: China individual income tax schedule for wage and salary

Source of income	Schedule
Wage	9-bracket progressive tax rate with monthly exemption of 800RMB: 94-05
	9-bracket progressive tax rate with monthly exemption of 1600RMB: 06-07
	9-bracket progressive tax rate with monthly exemption of 2000RMB: 08-11
	7-bracket progressive tax rate with monthly exemption of 3500RMB: 11-

Source: Li and Ma 2017

In addition, the measure of taxed income is also a debate by economists. With one school support for annual income while others prefer lifetime tax as yardstick (Cordes, 1999). Diagram 1 presents the example given in Cordes’ study to compare the two income measurements In addition, the measure of taxed income is also a debate by economists. With one school support for annual income while others prefer lifetime tax as yardstick (Cordes, 1999). Figure 1 presents the example given in Cordes’ study to compare the two income measurements.

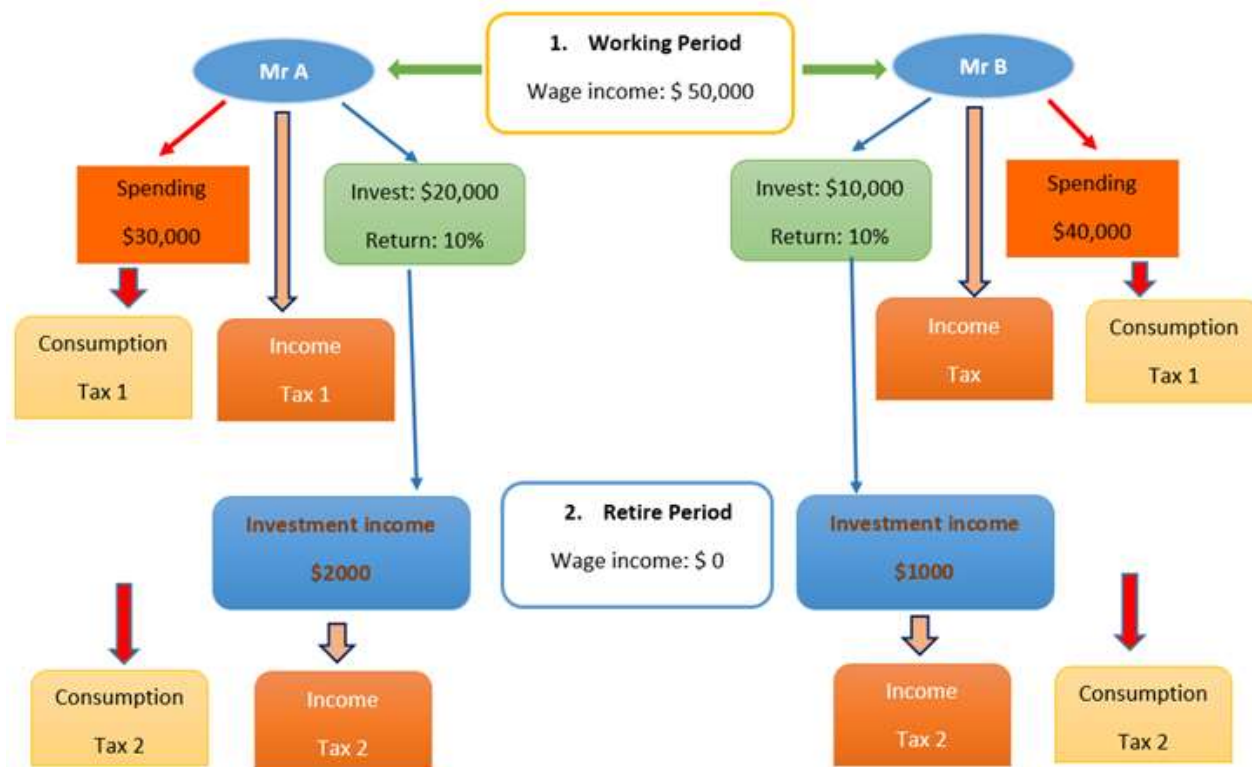


Fig- 1: Example of annual and life-time income measurement

Source: Based on study of Cordes, 1999

In this example, A and B sharing the same income during their working period and both planned to invest for future. According to annual income measurement, they pay the same amount of tax during the first period, but A have to pay more in retire period as of he invested more than B, making higher investment income, the case satisfies Horizontal standard. However, when consider their consumption tax, it can be seen that A is able to spend less than B, result in his lower consumption tax during working period. Thus, in total, even they have the same annual income, A would enjoy less in tax when comparing to B during their working time, making Horizontal equity tax bias. Thus, it leads to the second idea of lifetime income measured. In first period, A consumed less, but he will able to spend more during the second one, because of higher investment income. On the other words, the total consumption tax of A is not changed, he just shifted the consumption to later period, result the the Horizontal equity achieved in the lifetime perspective (Cordes, 1999). This example showing how necessary the policy designed by authorities

4. CONCLUSIONS

In conclusion, efficiency and fairness is expectations of every tax policy maker. Even there is conflict remains in real application, sometime we have to sacrifice one aspect to enhance the other. However, a balance between the two in the concern with tax objective is undeniable. To answer the question of equilibrium point, Horizontal and Vertical equity aspect can not be ignored for designing a sound tax system. Seeking horizontal perspective is important because taxpayer should enjoy the feeling of treated equally. Meanwhile, it is same necessary to achieve the vertical equity so taxation will not become a burden to taxpayers, especially those are in lower income group, the majority group of population in society

5. REFERENCES

- [1]. ACCA (2015). Foundations for a sound tax system: simplicity, certainty and stability. *The Association of Chartered Certified Accountants*.
- [2]. Aghion P., Akcigit U., Lequien, M. and Stantcheva, S (2017). Tax Simplicity and Heterogeneous Learning. *Banque de France Working Paper No. 665*.
- [3]. Alan J.A., Kerwin K.C., Courtney C.C., William G., Dana G., Ronald L., Charles M.L., Peter R.O., Louise M.S., Bryan T., David N.W., and Justin W. (2017). How the Growing Gap in Life Expectancy May Affect

- Retirement Benefits and Reforms. *The Geneva Papers on Risk and Insurance - Issues and Practice*, Palgrave Macmillan; *The Geneva Association*, 42(3), pp. 475-499.
- [4]. Bird, R., and Horton, S. (1990). Government Policy and the Poor in Developing Countries. *Canadian Public Policy*.
- [5]. Brian K. (2015). OECD Insights Income Inequality The Gap between Rich and Poor: The Gap between Rich and Poor, *OECD Publishing*.
- [6]. Carlson R.H. (2004). A Brief History of Property Tax. *IAAO Conference on Assessment Administration, Boston, Massachusetts*.
- [7]. Castro, M. F. (2014). Tax compliance under horizontal and vertical equity conditions: An experimental approach. *International Tax and Public Finance*, 21(4), pp 560-570.
- [8]. Circular No. 134/2011/TT-BTC. (2011). Guide for the performance of tax obligations. *Vietnam Ministry of Finance*.
- [9]. Cordes J.J., (1999). 'Horizontal Equity', *The Encyclopedia of Taxation and Tax Policy*, 1999 Urban Institute Press.
- [10]. Charles E., and McLure, Jr. (2015). Taxation. *Britannica*.
- [11]. Deak, D. (2010). *Hungary Introduces Special Taxes. European Taxation*, 50(12), pp. 545-549.
- [12]. Economic Daily. (2016). *Much Convenience in Tax Payment Available for Level-A Taxpayers*. State Administration of Taxation of The People's Republic of China.
- [13]. Elkins D. (2006). Horizontal Equity as a Principle of Tax Theory, *Yale Law & Policy Review*, 24, pp 43.
- [14]. Fiscal Commission Working Group (2013). Principles for a Modern and Efficient Tax System, *The Scottish Government*.
- [15]. Furman, J., (2008). The Concept of Neutrality in Tax Policy, *Testimony Before the U.S. Senate Committee on Finance Hearing on "Tax: Fundamentals in Advance of Reform"*.
- [16]. George M., (2018). Kenya: Impact of technology on tax administration, *Rödl & Partner*.
- [17]. Holtzman, Y., (2007). Challenges in achieving transparency, simplicity and administering of the United States tax code, *Journal of Management Development*, 26 (5), pp.418-427.
- [18]. Kaplow, L., (1989). Horizontal Equity: Measures in Search of a Principle. *National Tax Journal*, 42(2), pp 139-55.
- [19]. Kilborn P.T., (1988). Tax System: Efficiency vs. Fairness, *The New York Times*.
- [20]. Krause, K., (2000). Tax Complexity: Problem or Opportunity?. *Public Finance Review*, 28(5), pp. 395-414.
- [21]. Lerman, R.I. (2005). Are low-income households accumulating assets and avoiding unhealthy debt? A review of recent evidence, *The Urban Institute, Washington, DC*.
- [22]. Li R. and Ma G., (2017). Personal-Income-Tax Reforms and Effective-Tax Functions in China. *FinanzArchiv: Public Finance Analysis, Mohr Siebeck, Tübingen*, 73(3), pp 317-340.
- [23]. Marjit, S., Mukherjee, A. and Mukherjee, V. (2003). Harassment, corruption and tax policy, *European Journal of Political Economy*, 16(1), pp. 75-94.
- [24]. Mirrlees, J. (2011). Tax By Design: The Mirrlees Review. Institute for Fiscal Studies (IFS). *Oxford University Press*; 1st edition.
- [25]. Musgrave, R., (1990). Horizontal Equity Once More. *National Tax Journal*, 43 (2), pp 113-23.
- [26]. Richard M.B. and Eric M.Z., (2008). Technology and Taxation in Developing Countries: From Hand to Mouse, *National Tax Journal*, 61(4), pp. 791-821.
- [27]. Smith, A., (1976). The wealth of nations. *New York, N.Y., Bantam Classic*.
- [28]. Wildaw G., (2018). China plans income tax cut to boost consumption and reduce inequality, *Financial Times, Shanghai*.
- [29]. Zodrow, G.R. and Mieszkowski P., (2002). United States Tax Reform in the 21st Century. *Cambridge Books, Cambridge University Press*, pp. 212-213.