Best Practices in the Design of a Direct Tax System

- Broad-based: drawing revenues from the broadest possible range of contributors to enable rates to be kept low
- Designed to provide sustainable, predictable revenue flows
- Fair and progressive: requiring contributions from taxpayers in proportion to their ability to pay
- Consistent: taxpayers with the same circumstances must be treated in the same way
- Aligned with government economic policy and the encouragement of long-term investment
- Designed to recognize the impact of global competition and the free mobility of capital, people and businesses
- Transparent: based on clear, well-understood principles, applied in a fully documented process
- Flexible: able to respond rapidly to changes in economic circumstances
- Simplicity: as simple as possible, to facilitate compliance
- Designed with the expectation of compliance, but with effective enforcement
- Provides for disputes to be handled in a cost-efficient, timely and respectful manner
- Compliant with Adam Smith's four tax principles of Adam Smith (see below)

Adam Smith
Four Canons of Taxation
(from *The Wealth of Nations*)

Adam Smith, the father of modem political economy, laid down four principles or canons of taxation in his famous book *The Wealth of Nations*. These principles are still considered to be the starting point of sound public finance. Adam Smith's celebrated canons of taxation are:

1. **Canon of equality or ability**: Canon of equality or ability is considered to be a very important canon of taxation. By equality we do not mean that people should pay equal amounts by way of taxes to the government. By equality is meant equality of sacrifice, that is, people should pay taxes in proportion to their incomes. This principle points to progressive taxation. It states that the rate or percentage of taxation should increase with the increase in income and decrease with the decrease in income. In the words of Adam Smith:

   "The subject of every state ought to contribute towards the support of the government as early as possible in proportion to their respective abilities that is in proportion to the revenue which they respectively enjoy under the protection of the State."

2. **Canon of certainty**: The canon of certainty implies that there should be certainty with regard to the amount the taxpayer is called upon to pay during the financial year. If the taxpayer is definite and certain about the amount of the tax and its time of payment, he can adjust his income to his expenditure.

   The state also benefits from this principle, because it will know roughly in advance the total amount it is going to obtain and the time when it will be at its disposal. If there is an element of arbitrariness in a tax, it will then encourage misuse of power and corruption. Adam Smith, in this connection, remarks:

   "The tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid all ought to be clear and plain to the contributor and to every other person."

3. **Canon of convenience**: By this canon, Adam Smith means that the tax should be levied at the time and the manner that is most convenient for the contributor to pay it. For instance, if the tax on agricultural land is collected in installments after the crop is harvested, it will be more convenient for farmers to pay it. Similarly, property tax, income tax, etc. should be realized at a time when the taxpayer is expected to receive income. The manner of payment of tax should also be convenient. In the words of Adam Smith:

   "Every tax ought to be levied at the time or in the manner in which it is most likely to be convenient for the contributor to pay it."

4. **Canon of economy**: The canon of economy implies that the expenses of collection of taxes should not be excessive. They should be kept as minimal as possible, consistent with administration efficiency. If the government appoints highly salaried staff and absorbs major portions of the yield, the tax will be considered uneconomical. Tax will also be regarded as uneconomical if it checks the growth of capital or causes it to migrate to other countries. In the words of Adam Smith:

   "Every tax is 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 into the public treasury of the state."