

# Principles of fairness in taxation

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**Is it true to say that some forms of taxation are fairer than others? How might the present taxation system in the UK be improved to make it fairer?**

Ideas about the fairness of systems of taxation will always be subjective.

Whilst wanting to enjoy the protection of the state and other benefits that taxation can provide, few citizens will be as keen to pay their taxes.

There is little argument against the principle that taxes should be paid – the more difficult question is what constitutes a fair tax system? Adam Smith was one of the first economists to try and address the issue. He devised four principles for a fair tax system: that citizens ought to make a financial contribution to the state according to their own income and ability to do so; that taxes should be certain rather than arbitrary; that the collection of taxes should be done at a time and in a manner that is convenient for the taxpayer and; that taxes should be kept as low as possible and involve as little time and expense to the taxpayer as is possible. In a more modern setting, Smith's principles can be summarised as equity, certainty, convenience and efficiency. <sup>[1]</sup>

Equity of taxes is perhaps the most important of the principles. The Poll tax protests of the early 90s show what public reaction can be like if a tax is widely believed to be unfair and the Council Tax in place today continues to court controversy. The tax forces people on low incomes to pay out up to thousands of pounds a year in tax, with rates often dictated by central government. It is also unfair as the levels of council tax can vary greatly according to the efficiency of their local council. People on the same income living in different areas of the country can have vastly different council tax

bills, with no great difference in the quality of their local services. Again, it appears to be the poorest that suffer – the poorest in the UJ pay four times as much as the rich as a proportion of income. <sup>[2]</sup> A contrary argument in respect of council tax however is that taxation should be agreed more at a local level when possible. 96% of taxes in the UK are levied centrally <sup>[3]</sup> More flexibility for local councils and the involvement of local people into taxation and spending decisions could help ensure that local needs are better met. Central Government cannot always make the correct local decisions and communities need to have the capacity to respond to local issues.

There is certainly evidence that the UK tax system as whole is unfair and weighted so that the poor have a proportionately larger tax burden than the rich. Looking at all taxes paid, the poorest 20% of the UK population pay 42% of their income in taxes as opposed to 34% paid by the richest 20%. <sup>[4]</sup>

The administration of a tax system should also be fair and efficient. Whilst self-assessment in the UK has helped improve this to some extent, a large part of the administrative tax burden in the UK is still with the taxpayer and this is unfair. Also, with a complex tax system, administration becomes even more expensive with small businesses in particular having to find funds for tax experts to conduct their tax affairs.

Fair taxation also entails that citizens have a good understanding of the taxes that they have to pay and that the legislation for taxation is clearly defined. Poorly written legislation will always be open to misinterpretation and accusations of unfairness. Some taxes in the UK, such as corporation tax

or VAT are often misinterpreted and this can again be seen as unfair on those who pay more simply because they do not have their own tax expert to make the most of the legislation for them. The confusion amongst UK taxpayers as to how and when they pay their taxes is clearly a weakness in the system.

A summary of the principle taxes collected in the UK is required in assessing the fairness of the UK's system. There are three types of tax base within the UK system; income which includes income tax and corporation tax; wealth capital which includes capital gains, inheritance tax and stamp duty and; expenditure which includes value added tax and excise duties. The income tax base that includes personal income tax and corporation tax is the tax that provides the most revenue. Total tax receipts for 2005/06 were an estimated £483 billion and income tax provided 28. 1% of this income. <sup>[5]</sup> There are however arguments that current levels of personal taxation are unfair. The Tax Reform Commission for example suggests that the basic rate of income tax should be set at 20%, that the personal allowance should be increased to £7185 and that the 10% rate should be abolished altogether, something that would see 2. 5 million of the lowest paid people stop paying income tax altogether. <sup>[6]</sup> Some personal allowances within the income tax system do already help in terms of equity – for example those over 65 have a personal allowance of £7090 before tax compared to a £4895 allowance for those under 65. What is clear however is that the current levels of personal taxation against the lowest paid in the UK seem inappropriately high and should be reconsidered.

National Insurance is a further example of this. Like income tax it is a direct tax on earnings yet different in that it is linked to certain social security benefits. In practice however there is little relation between National Insurance payments made and benefits received for many individual contributors. There are a number of failures in the UK's personal taxation in terms of fairness and it is the least well off that suffer. Including income tax, NI contributions and loss of tax credits, somebody working 30 hours a week on the minimum wage can pay a marginal tax rate of up to 70%, plus the likelihood of further penalties through the loss of means tested benefits. [7] The marginal tax rate is much noticeably lower for those with a higher income,.

There are certainly reforms that could improve and make fairer the current personal tax system. Reduced personal taxation, increased personal allowances and a reduction of the basic rate to 20% would help with this. The abolition of tax-free employee benefits and allowances would also simplify the system and a merging of income tax and National Insurance should be considered.

Capital gains tax is the primary tax collected within the wealth tax base. It is a tax levied on gains made from the disposal of assets by individuals. The timing of this tax allows planning by the taxpayer who can prevent the accruing of excess liabilities – in this respect the tax meets the requirements of certainty. It had generally been seen as one of the fairer taxes from when indexation allowance was introduced in 1965 yet this can be questioned in more recent years since the indexation allowance was abolished and taper

relief. Introduced. The timing of capital gains tax is also relatively fair in that it allows taxpayers to plan their returns to prevent excess liabilities being accrued.

Inheritance tax is the other principle capital tax. This is seen as an unfair tax by many of the middle classes who see it as an unjust tax on properties and savings that their parents have left for them. Inheritance tax brings in substantial funds for HM Treasury with an estimated yield of £3.3 billion <sup>[8]</sup>, yet a fairer system suggested by the Tax Reform Commission would be a shorter term capital gains tax on death excluding the family home – for many citizens liable for inheritance tax, the inclusion of property in this tax is seen as the most unfair aspect.

Finally, there is scope for making business taxes in the UK fairer and more appealing to investors. The current tax rate of 19% for small companies is fairly low in comparison to international standards, yet in other areas such as relief on capital expenditure, rules on inward investment and taxation of overseas profits, UK taxes are less attractive to overseas investment. Changes to aspects of business taxes would help small businesses in particular and seem fairer to those who pay them. The complexity of business tax is also seen as unfair by many small businesses. It increases the cost of running a business – the administrative burden of tax regulation on UK businesses currently runs at £5.1 billion, equating to 0.5% of GDP. <sup>[9]</sup>

The fairness of taxation systems is a contentious issue. Some systems of taxation will always appear fairer than others, yet this will largely depend on

who is paying them and the financial position of the individual. In the UK today, the burden on the lowest paid initially seems unfair, yet the richest in society will argue that a higher tax on their wealth is a disincentive to enterprise. The middle classes will see something like inheritance tax as unfair, whilst the poorest will see it as perfectly reasonable.

A lower overall tax burden for UK citizens is desirable and lower tax margins for the poorest would undoubtedly make the system fairer. More radical proposals such as the introduction of a much more simplified flat tax have been mooted, yet it is improbable that such a system could meet the demand for public expenditure in the UK today.

The basic principles of Adam Smith should still apply to the system of taxation in the UK today. Taxes should be fair, certain, convenient and efficient and whilst the UK system does not fully meet those criteria at present, tax reform should continue to work towards this standard.

## **References**

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Tax Reform Commission, Tax Matters – Reforming the Tax System, Institute for Fiscal Studies Publication 2006

<http://www.libdems.org.uk/community/issues/counciltax.html>

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### Footnotes

[1] p2 Ch 2, Lymer, Oats & Hancock, Taxation Policy and Practice, Accounting Education Ltd, Birmingham, 2003

[2] [www.libdems.org.uk](http://www.libdems.org.uk)

[3] (Stoker Gary, *Councils need more taxation freedoms*, p22 The Guardian July 3 2001).

[4] [www.libdems.org.uk](http://www.libdems.org.uk)

[5] p3 Adam & Browne, A Survey of the UK Tax System, Institute for Fiscal Studies Briefing Note, BN09, March 2006)

[6] p7 Tax Matters 2006

[7] p57 Tax Matters 2006

[8] p17 Adam and Browne 2006

[9] p21 Tax Matters 2006.