

The concept of equity in taxation



Taxation traces its origin to the ancient times as a major source of revenue needed for governance. Kingdoms, monarchies and even dynasties had an elaborate form of taxation imposed on their subjects to source funds that were used to run affairs of the government. These taxes were subjective and biased depending on those in power. Advancement in education led to important studies on the possible forms of taxation that reflected the aspirations and welfare of the people.

Owing to this therefore, Adam Smith, accredited as the “ Father of modern political Economy” carried out an extensive study in Public Finance seeking to give an in-depth analysis of taxation. Smith documented the findings in his book known as “ Wealth of Nations” in 1776. It is in this book that Smith scripted the four maxims of taxation which were later globally adopted as the Canons of Taxation which are summarized as Equity, Certainty, Convenience and Economy (Smith, 1776). Most economists and business scholars are of the opinion that equity plays the most important role in all these canons. Further advancements and changing world trends have led to addition of other taxation principles such as productivity, elasticity, simplicity and diversity by economists of the successive centuries. (Baumol)

A better insight in appreciating equity as a crucial canon of taxation begs the understanding of the fiscal policy as applied by the government from a specific perspective. Governments endeavour to manipulate their income and expenditure to attain their economic and social objectives. By so doing, they strike a delicate balance between the times of recession and times of high inflation. In times of inflation, the government raises taxes and cuts down expenditure (contractionary policy) whereas in times of recession, it

cuts down taxes and raises expenditure (expansionary policy). A justifiable taxation system is thus imperative in implementing the fiscal policy in order to have a satisfactory balance of payment, a high and stable employment level, a fair distribution of income and wealth, enhanced social security, a high rate of economic growth among other benefits. (Ahmed)

Administration of taxes can be categorized as progressive, proportional or regressive. Another analysis bases its classification on the shiftability of taxes under which taxes are either direct or indirect. Direct taxes are equitable, economical, certain and elastic. They are preferred by government to instill the sense of responsibility in citizens' contribution to governance. (Ahmed)

The canon of equity requires that every taxpayer contributes towards government support based on his ability to pay. Further the principle of fairness means that citizens pay taxes in proportions of their earnings. This is indeed a key concept in taxation that seeks to ensure fairness and equitability in administration of taxes. In upholding this concept, citizens are motivated to willingly contribute towards government operations in a manner that is satisfactory to them.(Baumol)

Equity or fairness is a concept that raises substantial debate on the manner in which taxes are handled. Many economists and business scholars have written extensively on this matter to help demystify this important issue. It can be categorically stated that two standards best capture the idea of equity in taxation; the benefit principle and ability to pay principle. (Cordes, 1999)

The principle of benefit arises from the need that greatest beneficiaries should make the greatest tax contribution. This is indeed the essence of fairness. It finds common application in near public goods whereby only those who pay and consume the goods are liable for such taxation.

Formidable examples include tourist paying their levies, students paying for their tuition, patients paying for their medical charges among many other instances. The people who do not directly benefit from such goods and services are thus exempted from the associated charges. Such manner of fairness is elaborately justifiable. (Cordes, 1999)

Despite the logical fairness identified in the principle of benefit, it suffers a setback in terms of efficiency. Inefficiency in provision of goods is based on the notion that there would be a decline in quantity demanded if direct beneficiaries pay a price equal to the derived value as it is for private goods. Further, implementation of this principle faces daunting challenges on public goods. Excluding non-payers and identifying the received benefits is complicated thus making it almost impossible to set the amount of tax. Again, it can be argued that some services provided such as infrastructural development and national defense may benefit everyone but not in equal proportions. A criterion for identifying the major beneficiaries in such scenarios may therefore be erratic.

Due to the inconsistencies in the benefit principle, the ability to pay principle forms a better alternative for equity in taxation. The principle suggests that the ability to pay should form basis of taxation to maintain fairness. This means that citizens who earn more should pay more taxes than their counterparts in lower income cadres. In spite of everyone sharing the

benefits, only those who can afford are taxed accordingly. The principle correctly addresses the concerns of efficiency since goods are provided to citizens at zero prices and tax payment is not pegged on the beneficiaries alone.

Ability to pay principle is further understood from two scenarios: people with the same ability paying same taxes (horizontal equity) and people with different abilities paying different taxes (vertical equity). Both scenarios lay emphasis on the fact that taxes should be paid in manner that is fair to all the involved parties. Depending on the way these scenarios are understood, horizontal and vertical equity can be seen as complimentary. However there is a thin line that distinguishes horizontal equity from vertical equity even when they have a similar basis. The point of divergence between these two forms of equity can clearly be seen when the benefit principle is incorporated with the ability to pay principle. Essentially despite people earning the same amount of income, the level of benefit from public goods and services may vary as the incomes increase. As dictated by vertical equity, the benefit tax incurred may either be proportionate, progressive or regressive depending on the proportion of variation in benefits in public goods to the increased income. However, horizontal equity maintains that people with same incomes should pay similar taxes.

Horizontal equity is simple and direct. For instance, if an accountant earns forty thousand sterling pounds and pays four thousand pounds in taxes, by horizontal equity, a sales executive is equally taxed four thousand sterling pounds for earning the same salary as the said accountant. This principle shields taxpayers from discrimination and upholds the tenet of equal worth.

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Horizontal equity is consistent with income tax and works well with implicit taxes. However horizontal equity may not be favourable for external cost. Commodities such as tobacco attract high taxes on smokers despite having the same income as non-smokers. It however remains a very approach on taxation even though it is not in tandem with horizontal equity. (Cordes, 1999)

Vertical equity on the other hand reflects the proportionality in tax payment. As seen earlier, there is a very thin line that separates this from horizontal equity. An assertion that people earning different taxes should proportionately pay different taxes can be interpreted to mean that people earning same income will automatically have to pay similar taxes. In considering vertical equity, all the factors that cause variation in income are taken into account. The essence of this form of taxation is to ensure that every person pays taxes that conform to proportional standards in terms of his earnings. An archivist earning 50, 000 pounds at the same time paying 5000 pounds in tax (10% of his income) means that a librarian earning 30, 000 pounds will pay 3000 pounds as tax. Such is the fairness associated with vertical equity.

In summary, the canon of equity remains the most important principle of taxation in advancing fairness in government's revenue collection from the people. This canon has a distinctive relationship with the other three canons. For instance, the canon of certainty demands that the quantity, manner and time of payment should be well defined so as there is a higher degree of certainty concerning tax payment and the budget in its entirety. On the other hand, the canon of convenience holds that taxes should be collected at <https://assignbuster.com/the-concept-of-equity-in-taxation/>

the most convenient time to the taxpayer probably at the end of the month for those who are on a monthly salary. Again the economy canon stipulates that taxes should be levied in an economy friendly manner that spurs a country's economic development.

Adam Smith's contribution on this subject remains quite outstanding as far as taxation is political and socio-economic gratification is concerned. It is worth mentioning that the modifications made on these canons reflect the changing trends in current economic environment.

Pre-budget Report 2009

One of the most notable aspects of the pre-budget report in 2009 was the concerted effort to uphold the concept of equity. The Chancellor of the Exchequer clearly understands the weight of this matter especially at a time when the environment is highly charged politically. As a matter of fact, the country was licking the wounds of a glaring global recession that had taken the world by storm. The Exchequer Chancellor therefore outlined efforts that would mitigate recession effects.

Chancellor Alistair Darling's pre-budget report in December 2009 aptly reflects the concept of equity in the taxation measures of the exchequer. Most of the tax waivers, deferrals, increases and decreases found basis in equitability on taxation. Both individuals and corporate groups were incorporated in the budget's scheme that emphasized fairness in administration of taxes.

A brief overview of the 2009 pre-budget report reveals how equitability in paying taxes took centre stage. The chancellor's decision to defer the one

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percent increase on corporate tax for small firms and extending the repayment time points at the firms limited ability to pay the prescribed taxes. Ability to pay principle forms a key basis on which the concept of equity is advanced. Therefore by taking such decisive measures, the Chancellor of the Exchequer can be viewed as acting in a manner that is relatively fair to the small firms. A point to note is that the tax was maintained at twenty one percent from the previous year's allocation.

(Report, 2009)

On matters of insurance, the chancellor announced a further rise of 0.5% effective from April 2010. In an apparent effort to uphold the principle of equity, the starting point was to be raised so as the scheme does not affect those who earn less than twenty thousand sterling pounds. An important equity aspect was the temporary increase of threshold for empty properties liable for business rates to fifteen thousand sterling pounds. This move alone exempted seventy percent of the country's empty properties in total.

Equity has also been reflected on fuel levies where the fuel benefit multiplier and the national insurance contributions (NICs) paid by employers in free private fuel production were based on eighteen thousand pounds effective from April 2010. Additionally, where fuel is provided for private travel in company vans, the amount was increased to five hundred and fifty pounds, a measure that was to take effect at the same time in the following year.

(Report, 2009)

Personal measures taken in the pre- budget report are perhaps the best reflection of equitability in taxation. Persons with a basic band rate of thirty

seven thousand four hundred pounds attract a tax rate of 20% whereas incomes higher than thirty seven thousand four hundred pounds attract a 40% tax. Incomes over one hundred and fifty pounds have an additional tax rate of 50%. Further, the chancellor chose to align the primary threshold and lower the profit limits with income tax personal allowance. A further increase of five hundred and seventy pounds was meant to compensate lowest earners (those earning twenty thousand pounds or less). (Report, 2009)

Other measures taken on matters such as pension relief, value added tax (VAT), bank payroll tax, climate change levy and capital gains tax were all in line the principle of equity as suggested by Adam Smith. In Conclusion, the concept of equity or fairness forms an integral part of a workable taxation scheme. It has to be considered to facilitate proper and acceptable taxation procedures.

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