

2020 TAX COMMISSION

TaxPayers' Alliance ♦ Institute of Directors

www.2020tax.org

Research Note 1

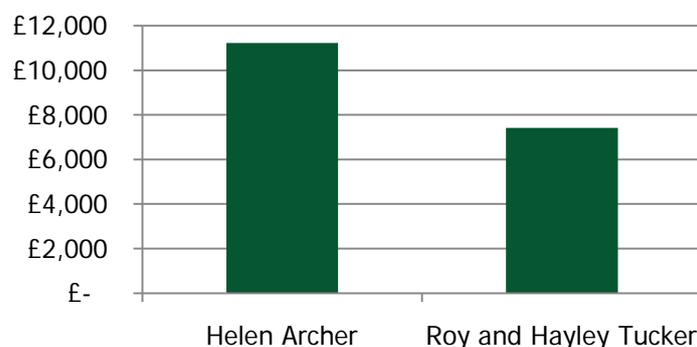
28 January 2011

“Fair” taxes

There is a widespread concern among the public and policymakers that fiscal policy should be fair. This has translated into analysis of how increases in tax and reductions in spending affect different parts of the income distribution, or how “progressive” they are. Distributional analysis of budgets, particularly when it doesn't take account of dynamic effects over time, is necessarily limited though, and tends to reward policies that entrench problems like benefit dependency. More detail on that problem is given later in this research note. If distributional analysis is not sufficient though, what alternative standard might capture fairness in a tax system?

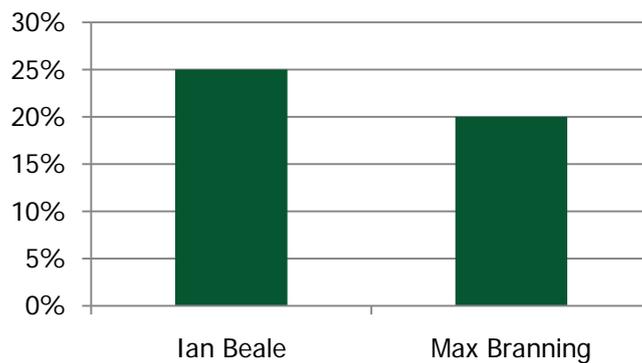
Many people would understand treating people “unfairly” to mean treating people in similar circumstances differently for no good reason. The Oxford English Dictionary definition of fair is “treating people equally without favouritism or discrimination”. On that definition, there are a number of ways in which even the clearly progressive income taxes can produce unfair results in practice. Here are some hypothetical examples under the current rates and allowances:¹

- Single earner families will pay more than two earner families, as they are forced into a higher tax bracket. If Roy and Hayley Tucker, characters in the Radio 4 programme *The Archers*, earn £25,000 a year each they will pay a total of £7,410 in income tax (£3,705 each). By contrast, if single mother Helen Archer earns £50,000 a year she will pay £9,930 in income tax. She would pay 34 per cent more in income tax despite having the same household income.

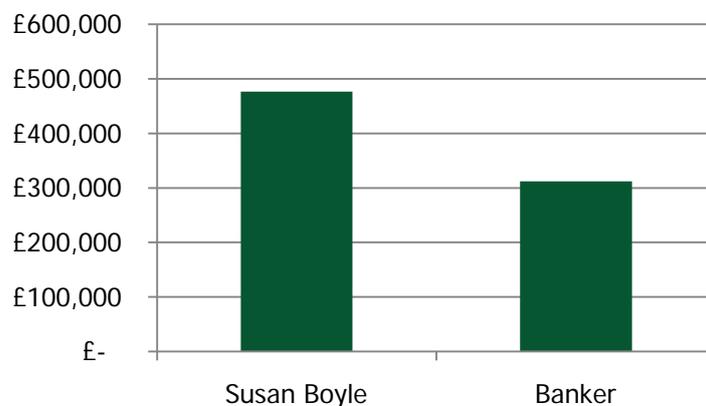


¹ All the examples given in this research note are for purposes of illustration only and are purely hypothetical, though the estimates given are an accurate estimate of the amount of income tax that would be due on the given earnings.

- The tax system will hit some people with higher costs, and therefore put more of a pressure on their discretionary income. If Ian Beale, a character in *EastEnders*, earns £30,000 a year but spends £10,000 a year on housing – around the average for a family of two adults with children² – he will pay £4,705 in income tax, nearly 25 per cent of his income minus housing costs. By contrast, if separated Max Branning earns the same amount of money but spends £5,500 a year on housing – around the average for a one person non-retired household – income tax will be less than 20 per cent of his income minus housing costs.



- Finally, people whose earnings vary from year to year will pay higher taxes than those with a stable income. For example, if a banker earned £100,000 a year for ten years, £1,000,000 in total, they would pay £299,300 in income tax. By contrast, if Susan Boyle struggled and earned nothing for nine years but then triumphed on *Britain's Got Talent*, had one big hit and earned £1,000,000 in a single year, she would pay £471,693 in income tax. She would pay well over 50 per cent more despite earning the same amount.



² Office for National Statistics, *Family Spending 2010*

The 2020 Tax Commission launched by the TPA and Institute of Directors is looking at these kinds of questions, assessing the economic and moral case for tax reform. It will look at to what extent the tax system can and should be made fairer, and how that objective is balanced against others like creating the conditions for greater economic growth and increasing employment.

To arrange broadcast interviews, please contact:

Emma Boon

Campaign Director, TaxPayers' Alliance

emma.boon@taxpayersalliance.com

07736 065 546

To discuss the research, please contact:

Matthew Sinclair

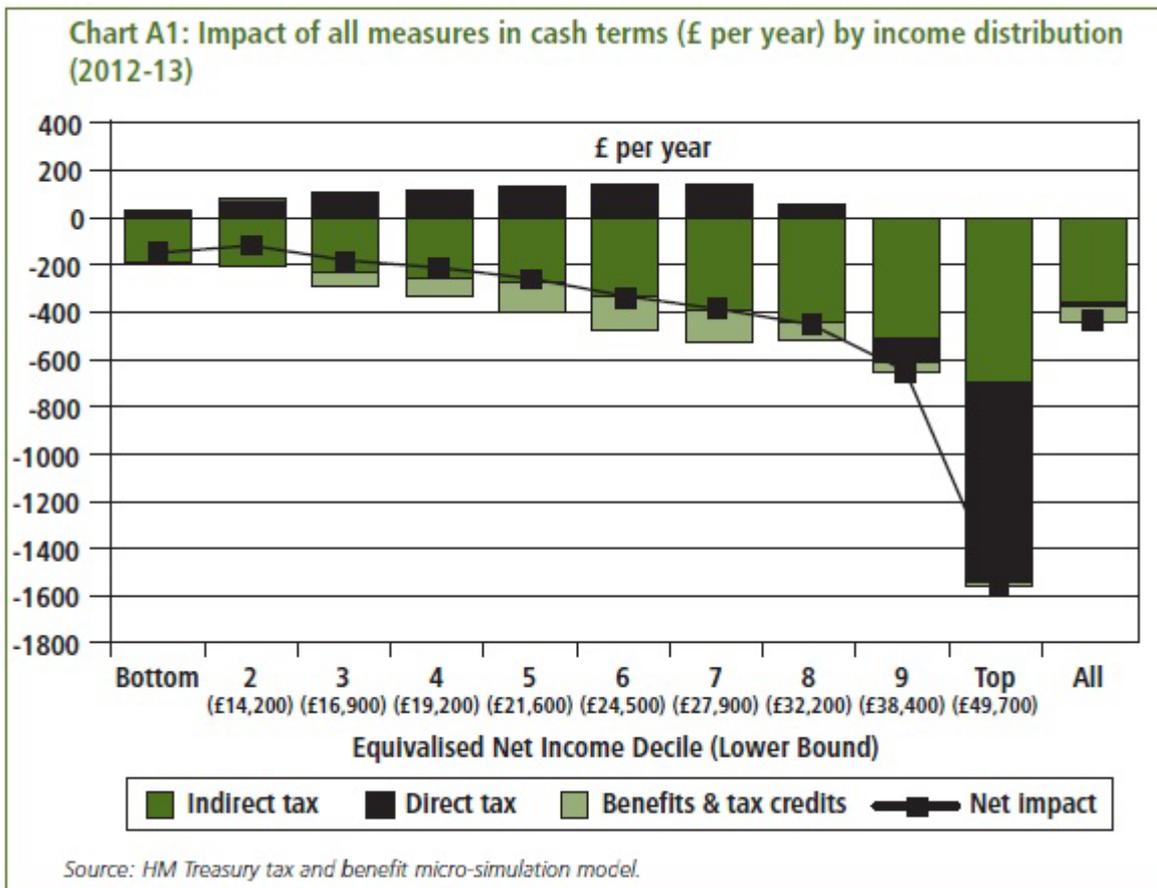
Director, TaxPayers' Alliance

matthew.sinclair@taxpayersalliance.com

07771 990 174

The weakness of distributional analysis

In many ways, all the attacks that the Government are enduring over whether their policies are “progressive” or “regressive” are the result of their own decisions to highlight that measure. They included a chart which purported to show the distributional impact of the measures in the Emergency Budget report.



As a result, it is understandable that a range of organisations – the IFS most prominently – are criticising them by arguing that the graph does not faithfully reflect the distributional impact of the Government’s proposals. But in reality, such a simplistic analysis of where the money is going obscures the real debate over how we can best improve the prospects of poor families.

Suppose you invented a policy, some kind of economic miracle, which doubled the incomes of the poorest ten per cent of families without the Government spending a pound. That would reduce benefit spending. It would also increase tax revenues from the poorest. The same method that the Government and the IFS are using in their reports would show the effects of that policy as horribly regressive, cutting spending on the poor and shifting the fiscal scales against them.

That is an extreme and artificial example. But it shows the big problem with an analysis which essentially assumes that the fortunes of those on low incomes add up to the amount of Government money spent on them.

That isn't just a problem in theory. In many British regions government spending is very high as a share of income. In their latest State of the Nation report the Centre for Economics and Business Research estimate that public spending is 63.9 per cent of GDP in the North East of England, 56.9 per cent in the North West and 54.9 per cent in Yorkshire and the Humber. By contrast, it is 41.3 per cent in the South East.³

2020 Tax Commission Chief Economist David B. Smith has set out a number of reasons why high public spending is likely to exacerbate the weakness of the private sector in regions like the North East.⁴ High spending – even if it is paid for in taxes somewhere else – encourages people to seek an income through political activism or state dependency instead of earning a living in the marketplace. For example, entrepreneurs enter politics instead of forming new businesses:

“There is also the interesting phenomenon that high government spending regions, such as Scotland, Wales and the North-East, seem to produce large numbers of political entrepreneurs, who live off and lobby for a large state, but few of the traditional wealth creating kind these days – compare and contrast the careers of James Watt and Gordon Brown, or George Stephenson and Alan Milburn, for example.”

In the same way, private sector companies will struggle to compete for good staff with public sector organisations, where pay is arranged by central bargaining and paid for in other regions. Improving that situation, and creating the conditions for a private sector recovery in the North of England, requires not more money but rebalancing their economy away from a dependence on subsidies from the South. That is essential to improving the prospects for Britain's less fortunate, but will appear regressive in a distributional analysis.

That doesn't mean assessing the distributional impact of fiscal policies is a bad idea in itself. Hiking VAT, for example, can hit the poor hardest and may, as a result, increase poverty and benefit dependency. But policies should ultimately be assessed on whether they improve the prospects of the poorest, and that will not be clear from assessing the distributional impact alone.

There are a range of reforms that could improve the prospects of the poor: reforming welfare so that it doesn't trap people on benefits; giving the parents of children at state

³ CEBR *The State of the Nation*, Forecasting Eye Special, 26 April 2010

⁴ Smith, D. B. Does Britain have Regional Justice, or Injustice, in its Government Spending and Taxation, *Britain and Overseas*, Economic Research Council, Spring 2007

schools the kind of consumer power those with the money to choose a private school have always had; building a dynamic economy that will produce new jobs and new opportunities. Whether or not the Government are implementing a set of policies that will help them is a complex question and cannot usefully be reduced to a single graph.