Topic 5

Understanding tax

Learning outcomes

After studying this topic, you will be able to:

- define tax;
- describe the features and purposes of tax;
- describe different types of tax; and
- describe the impact of changes in tax.

Introduction

Paying tax is one of the main financial responsibilities that we have as UK citizens. Everyone pays some form of tax, whether in the form of income tax – which those of us who are in employment will pay – or as value added tax (VAT) – which we all will pay as part of the price of the things that we buy – or other taxes. As well as the tax that individuals pay, the government receives money from the tax that businesses pay (known as 'corporation tax').

By paying taxes, we contribute to the costs of running the country and the costs of supporting those people who need help. Although there are many different kinds of tax, some of which may be used to fund particular areas of government spending, tax generally is the government's main form of revenue (ie income), and the government sets out how it will spend that tax revenue in the form of the annual Budget. The non-payment of tax is a crime, and people or businesses that fail to pay their taxes can be fined or sent to prison.

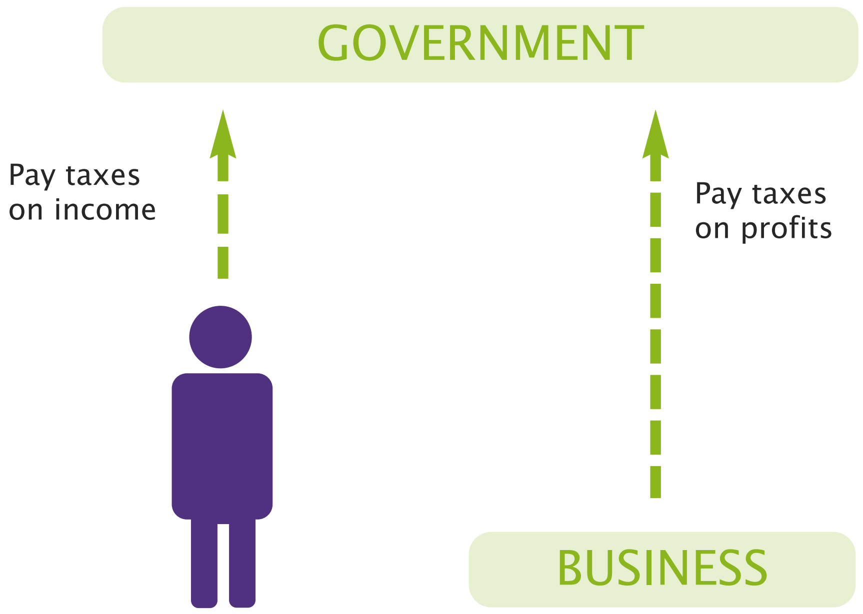
Changes in levels of tax have a huge impact on individuals and businesses, and on government spending. Sometimes, people have argued that levels of income tax have been such that, when tax has been deducted from their earnings, they have ended up earning less than they would be entitled to if they were claiming unemployment benefit payments. Some people have also been willing to earn only to a certain salary level, so that they will not be charged higher levels of income tax. Tax changes also affect how businesses decide to operate, which can affect levels of employment and therefore the amount of employees' contributions to the economy.

When the government needs higher revenue or to pay its debts, it may raise taxes. This can affect individuals, because they may no longer be able to afford to spend as much on the things that they want. While people will have less money, however, the government will have more – and if it spends the extra tax that it has raised to benefit the country, the result on the economy as a whole can be neutral.

5.1 What is tax?

Tax is a compulsory payment to the government made by individuals and organisations. For example, citizens pay income tax on their earnings and businesses pay corporation tax on their profits (see Figure 5.1).

Figure 5.1 Taxes paid by individuals and businesses



5.1.1 Different types of tax

Just as there are different types of income, there are different types and levels of tax. Most of the tax that we pay funds state expenditure and national systems such as education, the National Health Service (NHS) and defence. Tax is levied on all areas of life, including employment (income tax), housing (council tax), most goods and services (VAT), fuel (fuel duty), driving (road tax) and leisure (eg through a television licence). Paying these taxes is compulsory; anyone who refuses to do so can be fined, or even imprisoned.

The two main types of tax are as follows.

- **Direct tax** is the money that is taken directly from your income, such as income tax or National Insurance contributions (NICs). Everyone has a personal tax allowance, which is an amount of their income on which they do not have to pay tax.
- **Indirect tax** is the tax that people pay within the price of goods and services, rather than as a separate payment to the government.

In the UK, the main indirect tax is VAT, which is charged at 20%. This means that when you buy something, you will be charged an amount that is additional to the price – ie tax. Some things are exempt from VAT, meaning that they do not have any rate of tax attached to them. Examples of VAT-exempt items include children's clothing, insurance and financial services, gambling and lotteries, funeral costs, charitable events, healthcare, education, postage stamps, sport and cultural activities.

As we discussed in Topic 1, it is our responsibility as citizens to pay tax. As a result of this contribution, we also have certain rights, such as claiming State Pension when we retire.

Did you know?

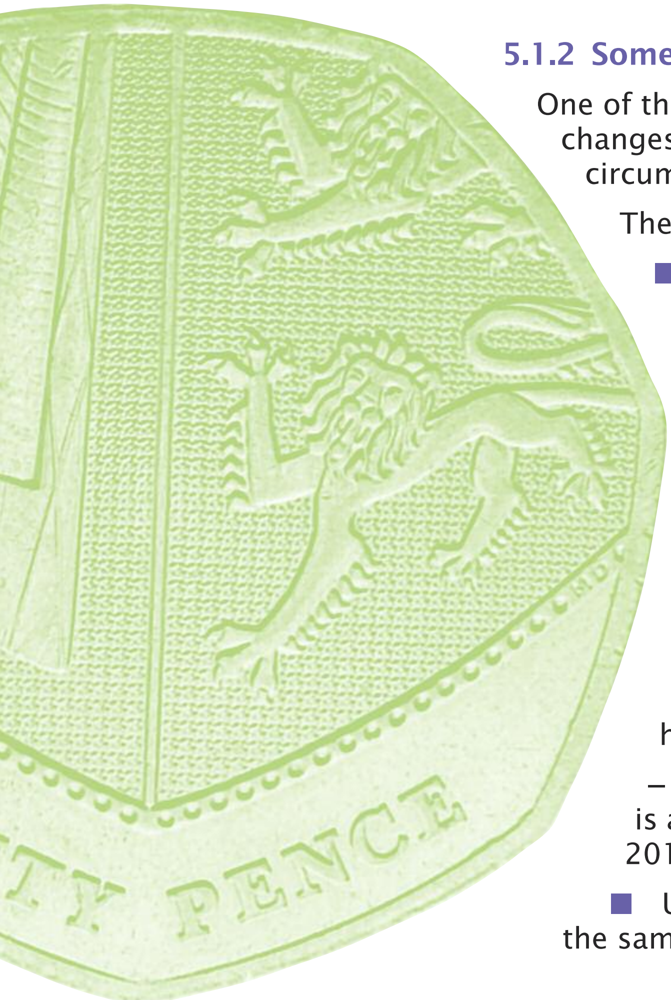
The oddities of VAT: Cakes and biscuits

Value added tax is a complicated form of taxation, and there are some strange distinctions about what should and should not have VAT applied to it.

The most famous case of this was that of McVitie's Jaffa Cakes in 1991. Under VAT rules, cakes are exempt, while biscuits are not. McVitie's argued at a VAT tribunal that Jaffa Cakes were, in fact, cakes and therefore should be exempt from VAT. It is rumoured that the company even produced a giant Jaffa Cake to prove the point! McVitie's won its case.

Some other strange distinctions of VAT are as follows.

- Cold takeaway food is exempt, while hot takeaway food is taxed at the standard rate (ie 20%).
- Nuts in their shell are exempt, but shelled nuts are taxed at the standard rate.
- Frozen foods are exempt, while ice cream and frozen yoghurt are taxed at the standard rate.



5.1.2 Some key features of tax

One of the key features of tax is that it fluctuates – ie it changes over time and depending on an individual's circumstances.

There are two main ways of taxing people.

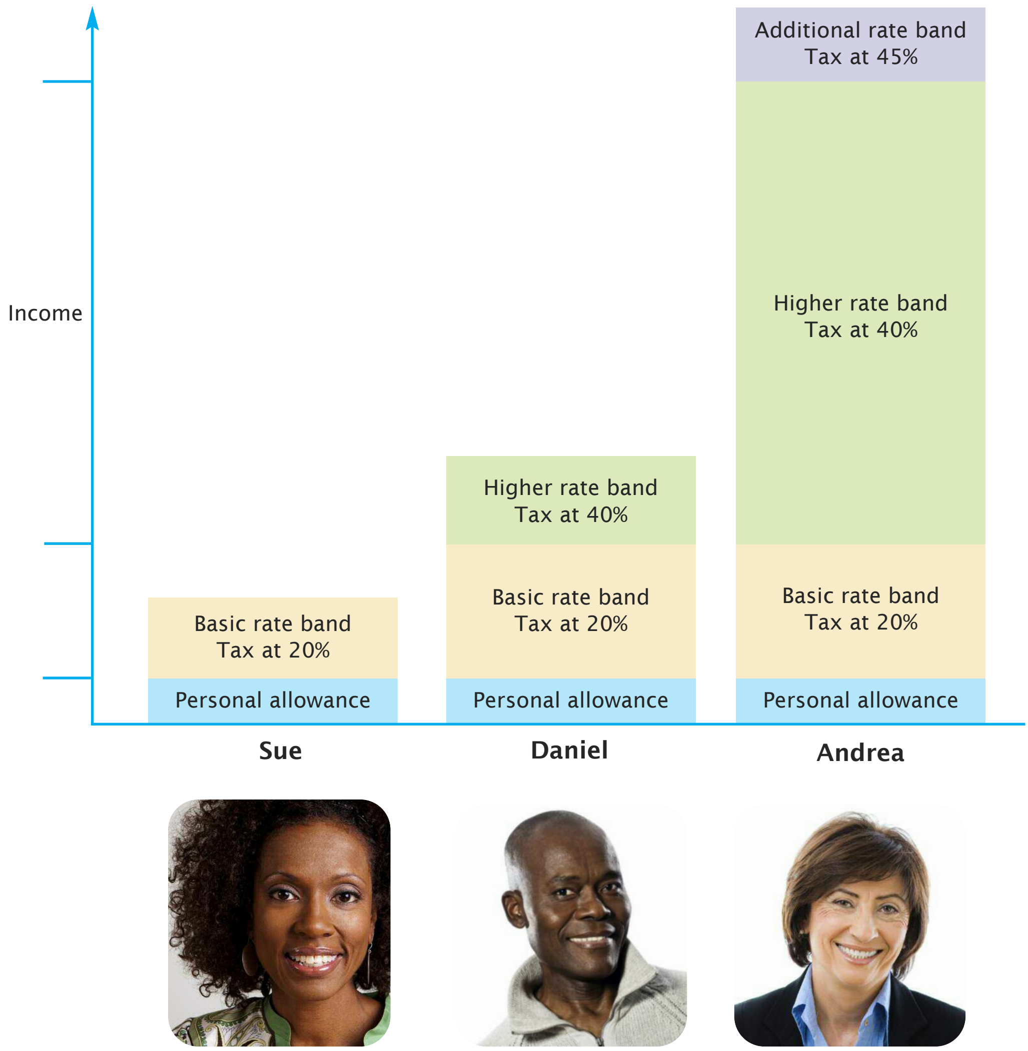
- Under **variable taxation** – such as income tax – the more you earn, the more tax you pay. Income tax is charged at different rates for different tax bands (see Figure 5.2).
  - All people have a personal tax allowance, on which they do not have to pay tax at all.
  - Earnings above the personal allowance that fall into the first tax band are taxed at the basic rate, which is 20%.
  - Any extra income that someone earns that is more than the basic tax band falls into the higher rate tax band and is taxed at 40%.
  - For people who earn very high salaries, there is an additional rate band taxed at 45% (GOV.UK, 2016a).
- Under **flat-rate taxation**, everyone is taxed at the same rate.

eg

Income and tax bands

- Sue Baker earns £30,000 a year, so all of her income falls within the basic rate tax band.
- Daniel earns £60,000 a year, so some of his income falls into the higher rate band.
- Daniel's boss, Andrea, earns £170,000, so some of her income falls into the additional rate band.

Figure 5.2 Income tax bands



The Chancellor of the Exchequer sets levels of taxation in the government's annual Budget. Leading up to an election, there will often be quite a lot of talk about tax levels, because of the significant impact that they have and the fact that the amount of tax revenue that a government raises determines its levels of public spending.

Did you know?

In the UK, if you watch live television or use BBC iPlayer, you have to pay the television licence – a yearly fee that is the same for every household. This is an example of flat-rate taxation and, because the licence is defined in law as a tax, it is a criminal offence not to pay it.

5.2 The purposes of tax

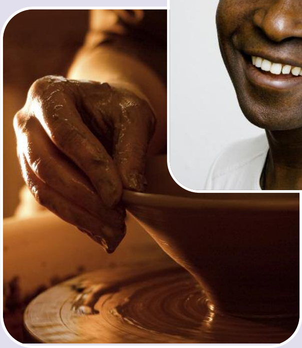
5.2.1 Funding public spending

Tax laws are extremely complex and the UK has a number of different kinds of taxes that contribute to the 'national purse' – ie how much the government can spend on the country.

The largest contribution is made through income tax and National Insurance. Both of these are taken from an employee's salary before it is paid and the deductions appear on the employee's payslip. This type of taxation is known as 'Pay as You Earn' (PAYE) and is discussed in more detail in Unit 2, including how it is calculated. The money raised as a result of income tax is used for general public spending in areas such as health care, education and defence, whereas National Insurance is used more specifically to fund state benefits. Taxes are raised in a range of other ways, some of which relate to specific areas.

Case study: How Richard Baker pays income tax

Richard is a self-employed potter. He pays his income tax and NICs to Her Majesty's Revenue & Customs (HMRC) himself, because he has no employer. He completes a 'self-assessment' tax return (a form) at the end of each tax year (5 April) and pays what he owes in two instalments throughout the year (by the end of January and of July).



In the past, Richard used to complete his tax return on paper. Now, he can choose to complete the form online instead, which he finds easier (GOV.UK, no date).

Value added tax is charged on goods and services, although, as noted in section 5.1.1, some goods (such as children's clothes) are exempt from VAT. Part of the reason for this is that these things are considered to be items that you have little or no choice but to buy, or because they are believed to be of benefit to the nation (so sport, health and cultural activities are VAT-exempt, for example). The purchase price of the item includes an amount of VAT, so that the buyer pays it to the seller. The business that sells the goods or services then pays the VAT on to the government. If you buy a new sofa, for example, part of the price that you pay is VAT. The company that sells you the sofa will then pass that VAT amount on to the government.

There are a number of other ways in which the government raises revenue for public spending. As well as income tax and NICs, individuals also pay council tax. The amount of council tax that you pay depends on the value and location of your home, and how many people are living in it. Councils set their own council tax rates within limits established by central government. This money part-funds the services that the local government provides (such as the police and fire services, roads and highways maintenance, recycling and rubbish collections, parks and libraries); central government tops it up with an additional amount.

Did you know?

Some early taxes

In the seventeenth century, taxes were introduced on:

- salt (1694);
- births, deaths and marriages (1695);
- bachelors (1695); and
- windows (1696) – ending in 1851 for health reasons, because people need air and light.

In the eighteenth century, taxes were introduced on:

- candles (1709);
- hats (1784);
- hair powder (1795); and
- income (1799).

Another indirect tax is stamp duty (also known as 'stamp duty land tax'), which is paid when buying property or land. Again, the rate charged varies depending on the value of the property being bought: higher rates of stamp duty will be charged on more expensive houses.

In addition to these general taxes, we pay some taxes that go to fund specific areas. Road tax (or 'vehicle excise duty') is spent, in part at least, on road infrastructure and repair projects. The money made from payments of the television licence, for example, is used to fund the BBC and to ensure that it can remain a non-commercial station – meaning that it does not need to raise money by showing adverts. These are compulsory taxes, like other forms of tax, and non-payment is a crime.

The government uses the money that it raises through taxes to fund public spending and to pay its own expenses, such as staff and debt payments. Funding public spending in areas such as education, healthcare, defence, transport, pensions and benefits is the main purpose of tax. It is how we pay for teachers to teach us, or nurses to treat us when we are ill. Figure 5.3 illustrates some of the different things on which the government spends tax money.

Figure 5.3 On what kinds of things does the government spend tax revenue?

5.2.2 Social justice

We have to pay tax because it is a compulsory part of being a citizen in a country. However, we also have a responsibility to contribute to the payment of the services that we use and to support those people in our society who are vulnerable or needy. Our taxes enable an element of social justice to be present in society – ie the idea that people should have equal opportunities and equal access to resources.

The purpose of tax in this instance would be to redistribute wealth in order to achieve a more egalitarian society. This means making sure that the gap between the richest and the poorest in society is not too great. Social justice is also built on the beliefs that those who are financially successful have a responsibility to help others who are not – ie that the richer should pay more tax to ensure that society is fair – and that we all have equal human rights, including the right to an adequate standard of living.

Inheritance tax (IHT) is an indirect tax that is charged on any money that you receive as a result of someone dying and transferring their wealth to you. The idea behind this kind of tax is, again, the social justice ideal of redistributing wealth to reduce inequalities of income: in theory, IHT stops the very wealthy from simply passing their money down through generations and concentrating wealth within only a limited number of families.

Did you know?

Tax rates in other countries

Although tax rates across countries are difficult to compare because of the complexity of tax laws and the number of different taxes, five of the ten countries with the highest tax rates are Scandinavian. These are also countries in which the government spends a lot of money on public transport systems, public healthcare and education – and in which high levels of well-being and happiness are reported.

Discuss

Taxes and social justice

- Would you be happy to pay higher taxes if the money were to be used to help poorer families?
- What do you think is a reasonable percentage of tax to charge people on very high incomes?

Capital gains tax (CGT) is another type of tax. 'Capital' means the value of assets such as houses, land, paintings and shares. You pay this tax on any gain (ie increase in value) that you make when selling such assets, exchanging them or giving them as gifts. It is only the gain that you make that is taxed, not the entire amount of money that you receive. The aim of CGT is to make sure that wealthy people cannot avoid paying income tax simply by buying expensive assets and so changing their income into capital. It does not apply to all assets that you sell: people who sell their main home do not pay CGT on the increase in value, for example, nor do they pay CGT should they sell their own car at a gain. There is also a tax-free personal allowance for CGT, just as there is for income tax (GOV.UK, 2016b).

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Marion pays CGT

Marion bought some shares for £5,000. She kept them for ten years and then decided to sell them – for £18,000. This means that she made a gain of £13,000.

Marion must pay CGT on the difference between this increase in value and her personal allowance. So, for example, if her personal allowance were £11,500, she would pay CGT on only £1,500 (£13,000 – £11,500).

Did you know?

Lottery winnings

Capital gains tax does not apply to lottery winnings.

5.2.3 Influencing people's behaviour

Although the main purpose of tax is to fund public spending, the government uses taxes in other ways as well. Excise duties, for example, are a way in which the government collects money and attempts to influence behaviour for the public good.

Excise duties are taxes that are placed on specific categories of goods. In the UK, there are high excise duties on alcohol, tobacco, sugary soft drinks and fuel. Part of the reason behind these taxes, additional to raising revenue for the government, is to control how much people buy and so to influence behaviour. High taxes on tobacco, for example, represent an attempt to reduce smoking, which not only is bad for the individual, but also costs the government a significant amount in terms of the healthcare costs of treating lung cancer and other smoking-related illnesses.

Discuss

Smoking is detrimental to your health, which is why the government puts taxes on cigarettes.

- Do you think it is okay for the government to try to change people's buying habits by putting taxes on some goods?
- If you were Chancellor of the Exchequer, what goods and services would you tax more highly to discourage people from buying them? On what goods and services would you reduce taxes to encourage people to buy them?

5.2.4 Encouraging corporate responsibility

As well as individual taxes, taxes are collected from businesses. (The financial role of businesses is discussed in more detail in CeFE Unit 3.) Companies pay corporation tax on their profits. This ensures that businesses also take on some responsibility for the success of the nation.

5.2.5 Encouraging saving

Saving is another key element of the tax system, for both the government and individuals.

- The government can use its saved revenue to stimulate the economy in the case of an economic downturn.
- By paying into a pension fund, individuals can secure themselves a future income.

5.3 Changes in tax

How much money a government can spend on public services depends on how much revenue it can raise. If the government wants to raise more money, then it will have to decide how it will do this – and the answer will usually be raising taxes. The government can raise direct or indirect taxes, or a combination of both. However, the decision that it takes will have particular effects on the economy of the country and on individuals. Changes in tax rates change the amount of tax income that the government receives. This change has an impact on the amount of money that the government can spend on services, and this has strong links with the economic climate within a country – an issue that was covered in Topic 2 and which will be discussed further in Unit 2.

If the government puts more money into particular public services, it may mean that citizens receive more. For example, if money were to be spent on providing free school meals for all children, people with children would have more time and money to do other things, which would have an impact on their lifestyle or their finances, or both.

However, an increase in income tax could have the following negative effects.

- People will have less money available to them, which could force them to make spending cuts in some areas.
- Work may become less attractive for people on low incomes, because they will have to work just as hard for less reward. It may stop people from working overtime or from pursuing promotions if they feel that they are going to be penalised with higher taxes that take away the reward of extra money for extra work.
- People may have less incentive to work and more incentive to stay on benefits, or start claiming them. It may be that higher taxes discourage people from working who already claim benefits, because the tax increases mean that a working wage will now be no higher than an income from benefits.
- If people have less money from income, they are likely to borrow more and spend less. This leads to the economy slowing down and potential recession, with less money moving around the economy (as was discussed in more detail in Topic 2).

While increases in tax mean lower net incomes, a decrease in tax or an increase in tax relief or personal allowances means more money in people's pockets. However, with less revenue for the government coming in from tax, citizens may receive fewer public services and financial support. This may also change their lifestyle or finances – for example the withdrawal of care for people who are housebound, a reduction in benefit incomes paid and changing the eligibility criteria for certain services so that only the most vulnerable people are prioritised.

Summary

Finally, we can recap what we have learned in this topic.

- There are various types of tax in the UK that are paid in different ways and collected by different levels of government: local, regional and national.
- Although it is usually thought that tax is collected in order for the government to raise revenue, there are many other reasons involving social justice ideals.
  - Tax enables the government to provide services and infrastructure that would not necessarily be provided by the private sector, but which may be considered essential to a nation's health and well-being, such as defence, universal education and universal healthcare.
  - Collecting tax also allows some of the wealth in a country to be redistributed to achieve a more egalitarian society.
  - The government helps people to buy everyday essentials by keeping the tax low, or by charging no tax at all, on such goods, for example by charging no VAT on fresh fruit and vegetables. It also uses tax to discourage people from buying items that are unhealthy, for example charging VAT on bars of chocolate and crisps (GOV.UK, 2014).
- Ultimately, the government sets particular levels of taxation through its annual Budget and other policies, and this has an impact on the financial decisions of individuals and organisations.

Thinking points

- Should we have to pay tax?
- What do you think would be the fairest method of taxing a population?
- If raising taxes leads to reduced spending in the economy and can put jobs at risk, should taxes ever be raised?

Key terms

Annual Budget – an outline, given by the Chancellor of the Exchequer, of planned government expenditure for the next financial year.

Capital gains tax – a tax on the increase in value of an asset, such as land or shares.

Corporation tax – a tax paid by businesses.

Direct tax – tax that is taken directly from income or wealth.

Excise duty – a tax levied on the manufacture or sale of specific goods, such as tobacco and alcohol.

Indirect tax – tax that is charged on spending, or on goods and services (eg VAT in the UK).

Inequality of income – a situation in which some people have much higher incomes than others.

Infrastructure – the physical and organisational structures and facilities that are needed for a society to run properly.

Inheritance tax – a tax levied on the value of property, or money, bequeathed after death or given as a gift.

Flat-rate tax – tax that is the same proportion at all levels of income.

Redistribution of income – a government policy aiming to reduce inequalities of income by increasing lower incomes and / or reducing higher incomes in some way.

Social justice – the ideal that people should have equal opportunities and equal access to resources.

Stamp duty (or stamp duty land tax) – a tax paid when buying property or land.

Value added tax (VAT) – a tax that is added to the price of goods and services.

Variable tax – tax that varies in level depending on income, ie a greater proportion of tax is taken from higher incomes and a lower proportion from lower incomes.

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