

 THE EQUALITY TRUST



# UNFAIR AND UNCLEAR

THE EFFECTS AND PERCEPTION OF THE UK TAX SYSTEM

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June 2014

# CONTENTS

Executive Summary	4
Introduction	6
Methodology	8
Key Findings	10
Public Perceptions of the Tax Distribution	11
Public Attitudes Towards the Tax Distribution	12
The Reality: The UK's Current Tax Distribution	14
How Has the Tax Distribution Changed?	15
Individual Taxes	16
Indirect Taxes	21
The UK Tax System - Key Questions	23
Policy Recommendations	26
Conclusion	27

# EXECUTIVE SUMMARY

Tax has long been an important area of public and political debate in the UK. Who pays what, who avoids tax, and whether tax is 'fair' are questions that are regularly tackled in our press and in Parliament. But much of this debate is based upon a reductive and misleading account of tax. For example income tax is often used to describe overall tax, despite only accounting for just over a quarter of the total tax take, less than the combined tax take of VAT and National Insurance Contributions. In addition, people's understanding of their own tax is often considered only in terms of their marginal tax rate.

Given these muddled waters, it is unclear how much the public really knows about what they and others are taxed. This report aims to not only clear these waters by determining people's understanding of tax, but also discover what they believe people should be taxed, and how this compares to the UK's current tax system.

Public polling conducted in partnership with Ipsos MORI reveals that:

1. Public perception of how the UK's tax system affects households in different income groups contrasts sharply with the reality
2. The public believe the UK's tax system is more progressive than it is, with nearly seven in ten people (68%) believing that households in the highest 10% income group pay more of their income in tax than those in the lowest 10%. In reality, the top 10% pay a smaller proportion of their income in tax than the bottom 10%
3. Public support for a more progressive<sup>1</sup> tax system is high. Over eight in ten (82%) believe that households in the highest 10% income group should pay a greater proportion of their income in tax than those in the bottom 10%. An even greater majority (96%) would like the tax system to be more progressive than it currently is.

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<sup>1</sup> Defined as the lowest 10% household income group paying a lower proportion of their income in tax than the average household, who in turn pay a lower proportion than households in the highest 10% income group.

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Our analysis of the proportion of gross household income that households at each decile pay in all taxes shows that:

- 1. The current tax distribution in the UK is regressive.**
- 2. A household in the bottom 10% pays 43% of its income in tax, while the average household and a household in the top 10% both pay 35% – 8 percentage points less than the bottom 10%.**
- 3. The higher percentage paid by the poor (bottom 10%) is attributable to a number of taxes.** While income tax and national insurance are broadly progressive, the bottom 10% of households pay roughly 23% of their gross household income in indirect taxes on consumption and more than four times as much of their income in council tax as the top 10%.

These findings show that the current tax system is not fit for purpose. For the system to better acknowledge the preferences of the electorate, policy must aim for a tax system that is progressive.

In view of our findings in this report, we make the following recommendations:

- **Parties seeking to form the government from 2015 should commit to the principle that any changes in tax policy are progressive**
- **Council tax should be transformed into a progressive property tax by re-evaluating properties and creating new bands with higher rates for high value properties**
- **Government should look to reduce VAT when it has a budget surplus**
- **The upper limit of National Insurance should be raised to ensure that the tax is progressive across all deciles.**

# INTRODUCTION

In recent months the UK's economy has appeared to pick up. But although cautious optimism may have returned, another question is now being asked – who is benefitting from the recovery?

For many people real wages continue to stagnate, or even fall, but at the top a small number of the 'super-wealthy' have seen their incomes and wealth soar. Over the past year alone, the richest 100 people in the UK have seen their wealth increase by a staggering £40.1 billion to a total of £297.133 billion. This is equivalent to over £100 billion more than the wealth of the poorest 30% of the UK population. Such inequality is of growing concern to the British public<sup>2</sup>, and as others have proven, spiralling inequalities of income and wealth divide communities, damage health and place the economy in jeopardy<sup>3</sup>.

Tax is an important tool in reducing the worst excesses of rising inequality. When used well, tax and transfers can reduce the income disparity significantly, for instance by 38% in Finland and 31% in Germany<sup>4</sup>. In the UK however, when all taxes are considered, our system is in fact regressive. Households in the lowest 10% income group are taxed proportionally more than those in the highest 10% income group.

Unsurprisingly, there is considerable public, political and academic debate about the fairness of the tax system in the UK, particularly in relation to economic inequality. But the extent to which this debate is based on reality is questionable. For example, discussions on the tax distribution frequently concentrate on income tax only, despite this constituting only about 27% of the overall tax take.

This report seeks to illuminate the current levels of confusion in the tax debate and dispel some of this misunderstanding by setting out the actual tax distribution. In doing so, it aims to provide the basis for a more honest debate about the UK's tax system, as well as explore possibilities for the development of a tax system that better acknowledges public preferences.

The first section explores the UK public's understanding of the amount of tax paid by people across the income distribution and investigates what the public perceive to be a fair distribution. This is followed by an analysis of the tax system in its current form and assessment of the extent to which tax is fairly distributed across the income spectrum. The final section

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2 Economist/Ipsos MORI March 2014 Issues Index March 2014

3 <http://www.equalitytrust.org.uk/about-inequality>

4 Therborn G, 2013, The Killing Fields of Inequality, Polity Press

discusses the findings and asks whether the current tax system is an accurate reflection of public perceptions and preferences.

# METHODOLOGY

Research was conducted online by The Equality Trust in partnership with Ipsos MORI among a total of 1,036 adults aged 16-75 in the United Kingdom from 11th – 14th April 2014 via its Online iOmnibus Survey. The survey data were weighted by age, gender, region, social grade and working status to the known profile of the UK population aged 16-75.

It was ensured that all respondents had the same working definition of “household income” and “all types of taxes” by requiring them to read the following before beginning the survey:

“The next few questions are about households across the United Kingdom – that is across England, Scotland, Wales and Northern Ireland.

The questions are about “household income” – that is total household income from all sources, before tax and other deductions. The next few questions ask about all of the different taxes individuals in a household may pay. By tax we mean all of the following types of tax:

- Income tax
- Tax on interest earned by savings/rental income/other income
- Capital gains tax
- Council tax
- Car/vehicle/road tax
- Inheritance tax
- Stamp duty
- Tax added to the cost of some goods, services, and transactions (i.e. VAT):
- National insurance
- Tax duty on fuel, beer, cider, wine, spirits, tobacco
- Betting & Gaming Duties
- Air Passenger Duty
- Insurance Premium Tax
- Landfill Tax
- Climate Change Levy
- Aggregates tax

If you are unsure of the answer to one or more of the questions please provide your best “guesstimate”.

It is important to note that at no point were respondents made aware of the actual figures for the percentage of income paid in all types of taxes by the household income groups.

To calculate the level of tax paid by each group we used the ONS Effects of Tax and Benefits on Household Income, 2013 data. The data available from the ONS runs from 1977 to 2011. We looked at the difference between gross income and post-tax income measuring the percentage of gross income removed through direct tax and indirect taxation. The ONS data addresses taxes on incomes and not those on capital, as there is not a valid way of estimating these taxes. We are focusing on households in the lowest 10%, Mean and highest 10% income groups, as these are available in the ONS dataset and are the easiest to communicate to the public.

# KEY FINDINGS

- 1. Public perception of how the UK's tax system affects households in different income groups contrasts sharply with the reality**
- 2. The public believe the UK's tax system is more progressive than it is, with nearly seven in ten people (68%) believing that households in the highest 10% income group pay more of their income in tax than households in the lowest 10% income group.** In reality, households in the highest 10% income group pay a smaller proportion of their income in tax than households in the lowest 10% income group
- 3. Public support for a more progressive<sup>5</sup> tax system is high.** Over four fifths of the population (82%) think that households in the highest 10% income group should pay a greater proportion of their income in tax than households in the lowest 10% income group. And 96% would like the tax system to be more progressive than it currently is.

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<sup>5</sup> Defined as the lowest 10% household income group paying a lower proportion than the average household, who in turn pay a lower proportion than households in the highest 10% income group.

# PUBLIC PERCEPTIONS OF THE TAX DISTRIBUTION

Just under seven in ten (68%) people believe that households in the highest 10% income group pay more of their income in tax than households in the lowest 10% income group. And 41% think that the tax system is progressive across the board – that is that households in the lowest 10% income group pay a lower proportion of their income in tax than those on an average income, who in turn pay a lower proportion than households in the highest 10% income group.

On average, the public think that households in the lowest 10% income group pay almost a quarter (24%) of their total household income in all taxes, the average household pays 30% and a household in the top 10% pays 36%.

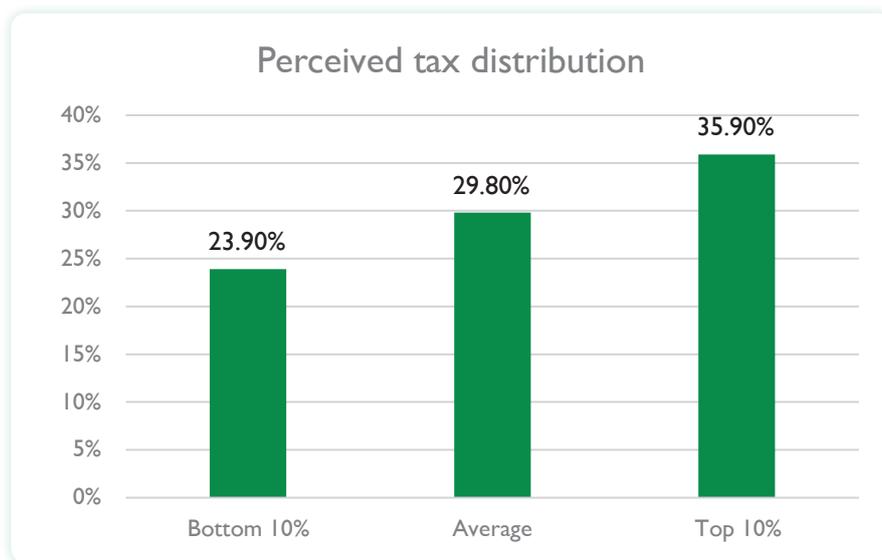


Figure 1: Public perceptions of the tax distribution.

# PUBLIC ATTITUDES TOWARDS THE TAX DISTRIBUTION

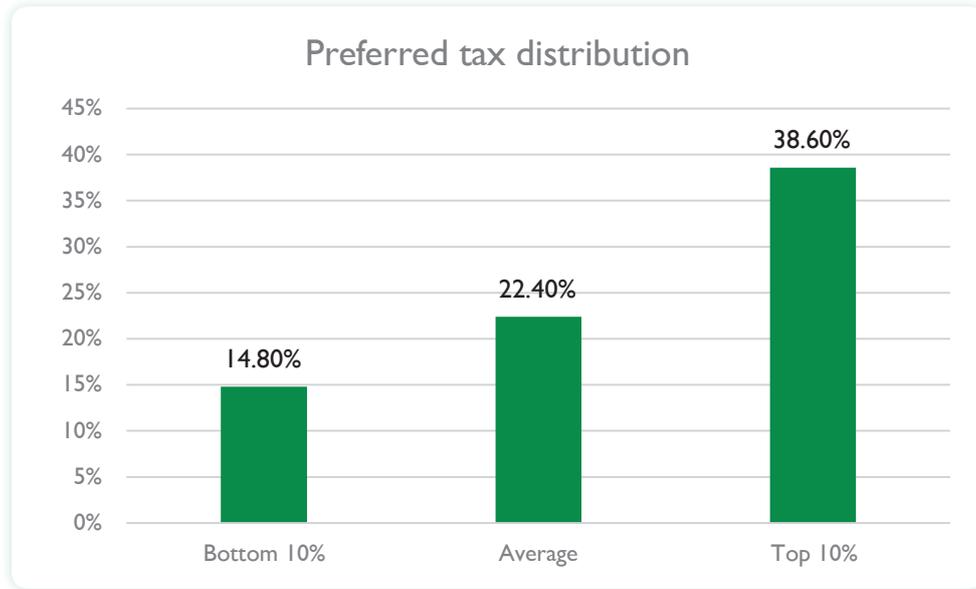
People think that the tax system should be considerably more progressive than they perceive it to be.

Over four fifths of the population (82%) think that households in the highest 10% income group should pay a greater proportion of their income in tax than households in the lowest 10% income group. Six in ten people (59%) believe that the tax system should be progressive across the board, with households in the lowest 10% income group paying a smaller proportion of their income in tax than those on an average income, who in turn should pay less than households in the highest 10% income group.

When people's preferences are measured against the actual tax distribution, rather than their perception of what it is, 96% think that the gap in tax paid between households in the highest 10% income group and households in the lowest 10% income group should be more progressive than it currently is.

On average, people think that:

- Households in the highest 10% income group should pay 39% of their income in tax – 3 percentage points more than they believe they currently do pay
- The average household should pay 22% – 8 percentage points less than they think currently do
- Households in the lowest 10% income group should pay only 15% of their total income in tax – 9 percentage points less than they are currently thought to do.

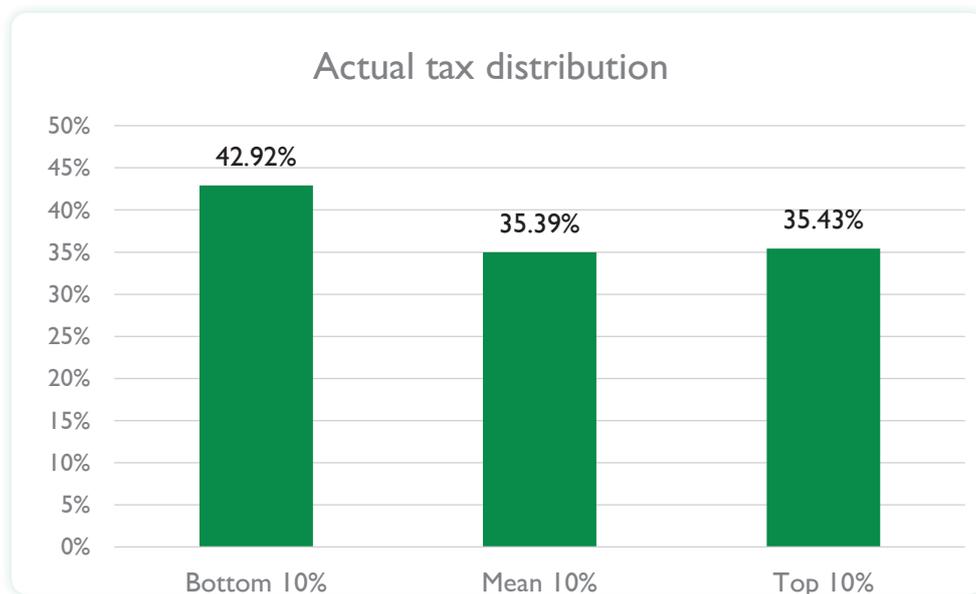


**Figure 2:** Public preference for the tax distribution.

There is a surprising consensus on preferred tax distribution, with supporters of all parties and people from all income groups on average favouring a more progressive tax system than they think currently exists. Nevertheless, within these categories, there are significant differences when it comes to what percentage of income they think particular households in different income groups should pay in all taxes.

# THE REALITY: THE UK'S CURRENT TAX DISTRIBUTION

The UK's tax distribution is not only less progressive than the public's perceived and preferred distribution, it is actually regressive when comparing the richest and poorest 10%. A household in the lowest 10% income group pays 43% of its income in tax, while average households and those in the highest 10% income group both pay just 35% – 8 percentage points less than those in the lowest 10%.



**Figure 3:** 2011/12 proportion of gross household income taken in tax for 'all households' at 1st, Mean and 9th decile.

**Source:** ONS Effects of Tax and Benefits on Household Income, 2013

# HOW HAS THE TAX DISTRIBUTION CHANGED?

The tax distribution has changed substantially since 1977. It changed dramatically from 1977-1978 from a very regressive system to a moderately progressive one. This was mainly due to the bottom 10% of households. The proportion of total income paid in all taxes by this group fell from 45% in 1977 to 36% in 1978. This did not persist however, with the amount of tax paid by the bottom 10% fluctuating between 37% and 40% throughout the early 1980s, while the proportion paid by the middle and the top 10% remained fairly stable.

Since 1986, the bottom 10% of households have paid a greater proportion of their income in tax than the middle and the top 10%. The tax system was at its most regressive in 2001, when the bottom 10% of households paid 55% of their total income in all taxes, while the middle paid 36% and the top 10% paid 34%. From 1977 to 2009, the top 10% of households paid a lower proportion of their income in tax than, not only the bottom 10%, but also the average household. The proportion paid by the middle and the top converged (34%) in 2009.



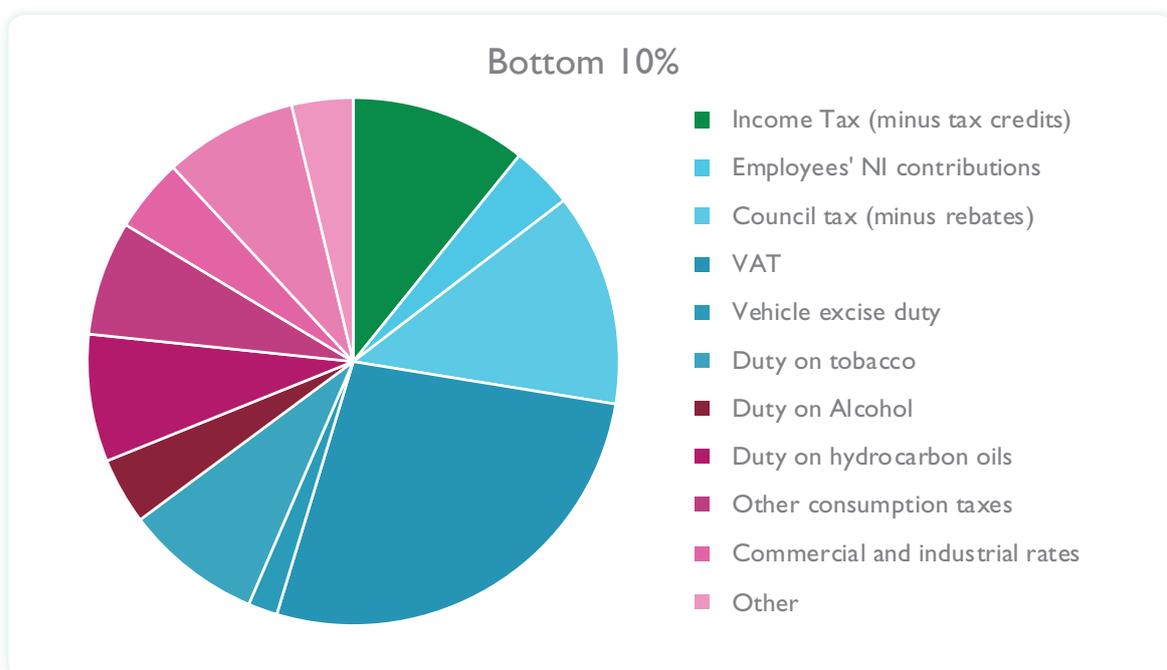
**Figure 4:** 1977-2011 proportion of gross household income taken in tax for 'all households' at 1st, Mean and 9th decile.

**Source:** ONS Effects of Tax and Benefits on Household Income, 2013

# INDIVIDUAL TAXES

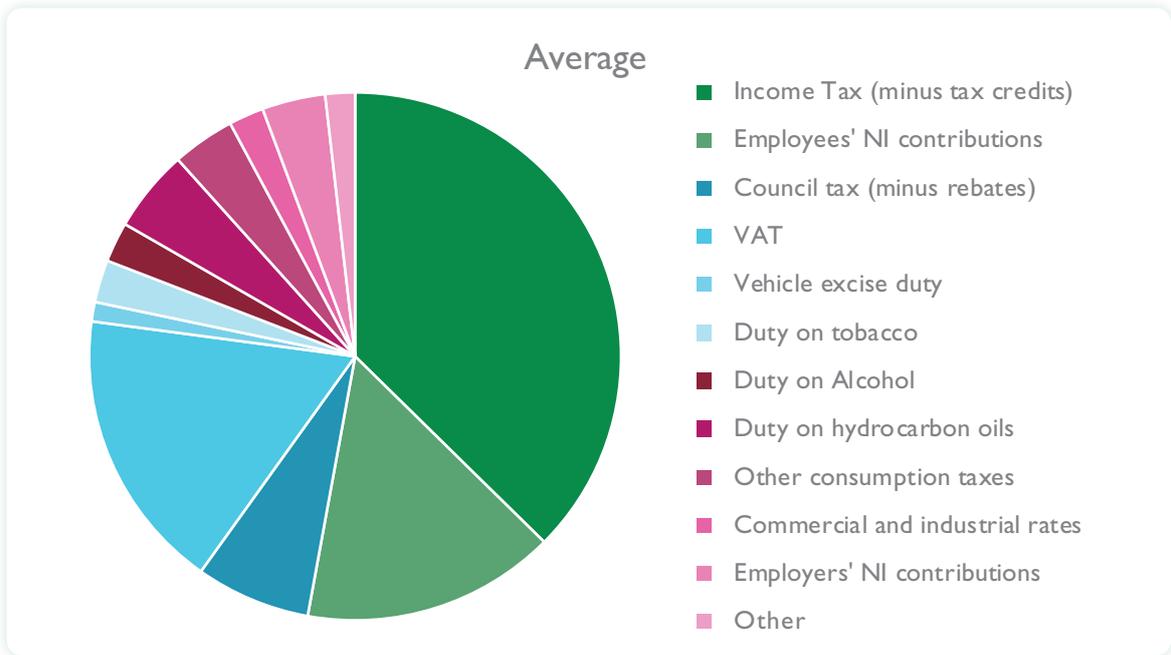
Direct and indirect taxes play a different role for different parts of the income distribution, as can be seen in the following section. The largest tax that affects households in the bottom 10% is VAT. Income tax constitutes only a small portion of the tax that they pay. However, income tax plays a much larger role for the average household and an even greater role for households in the top 10%.

Closer scrutiny of specific taxes, set out below, illustrates how and why the UK tax system is regressive:



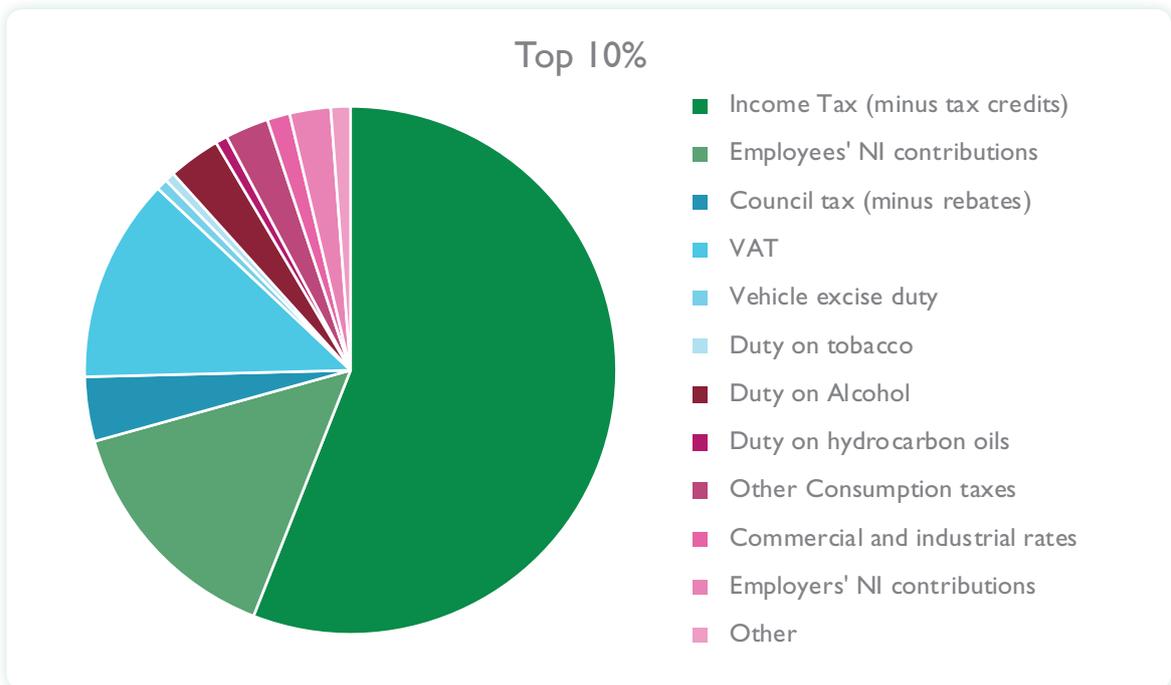
**Figure 5:** 2011/12 proportion of tax paid by households in the bottom 10% of the income distribution split into different taxes.

**Source:** ONS Effects of Tax and Benefits on Household Income, 2013



**Figure 6:** 2011/12 proportion of tax paid by mean household split into different taxes.

**Source:** ONS Effects of Tax and Benefits on Household Income, 2013

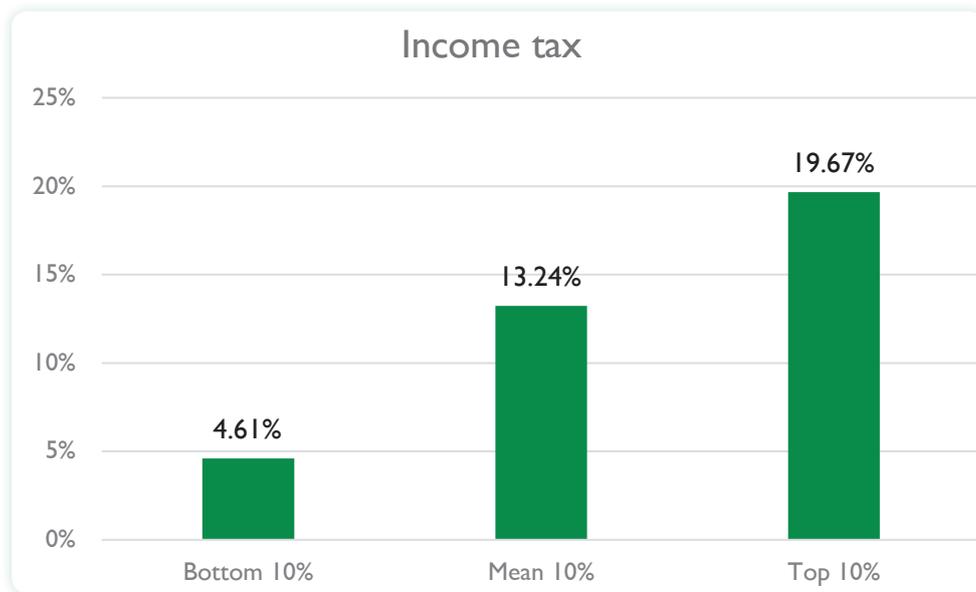


**Figure 7:** 2011/12 proportion of tax paid by households in the highest 10% income group split into different taxes.

**Source:** ONS Effects of Tax and Benefits on Household Income, 2013

## INCOME TAX

Income tax is, by design, progressive for all households: the larger your income, the higher the proportion of that income that will be taxed. Households in the top 10% of households pay 20% of their total income in income tax, while the average household pays 13% and those in the bottom 10% pay just 5%. This is attributable to income tax's graduated nature and the tax-free personal allowance.

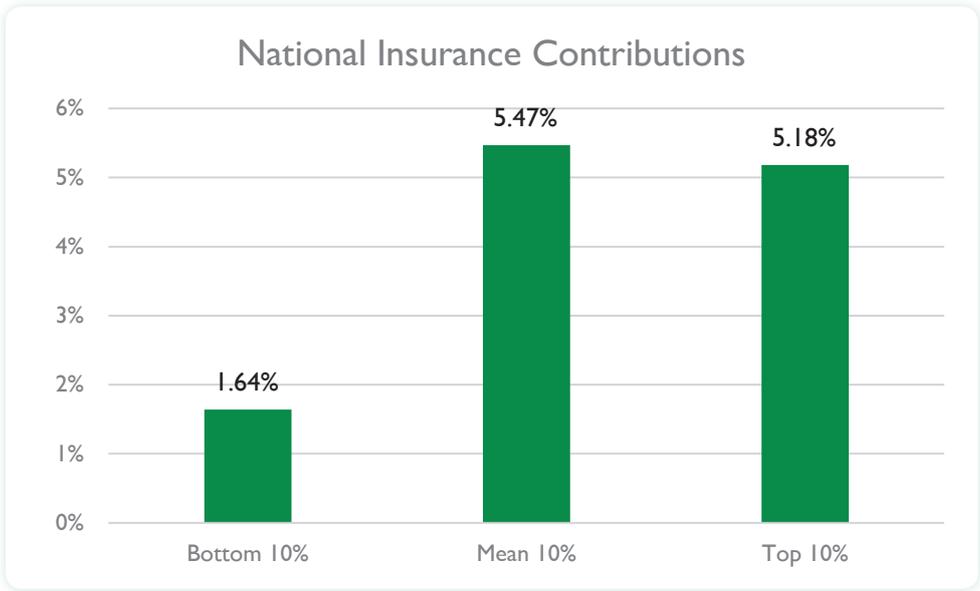


**Figure 8:** 2011/12 proportion of gross household income taken in net income tax (i.e. including tax credits) for 'all households' at 1st, Mean and 9th decile.

**Source:** ONS Effects of Tax and Benefits on Household Income, 2013

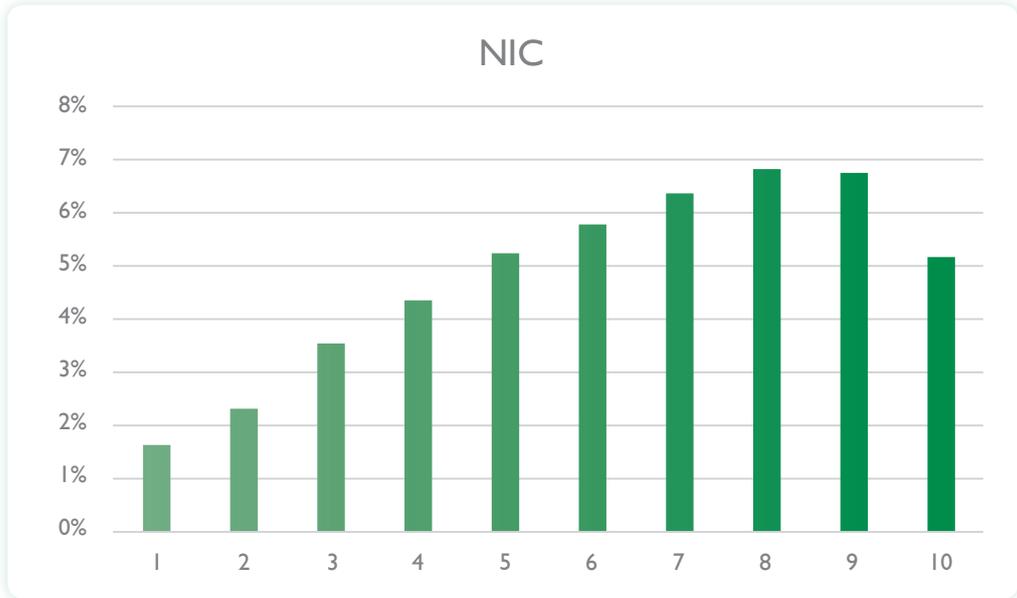
## NATIONAL INSURANCE CONTRIBUTIONS

Employee National Insurance Contributions (a tax based on a person's wage) are progressive until the 8th decile and then fall back for the 9th and 10th deciles. This is due to the upper limit on Employee National Insurance Contributions where National Insurance decreases from 12% to 2% on incomes over £805 per week. Employee National Insurance Contributions as a proportion of total household income are slightly higher for the average household at 5.47% than households in the top 10% (5.18%). Employee National Insurance Contributions are comparatively low for the bottom 10% of households (1.65%).



**Figure 9:** 2011/12 proportion of gross household income taken in Employee National Insurance Contributions for 'all households' at 1st, Mean and 9th decile.

**Source:** ONS Effects of Tax and Benefits on Household Income, 2013



**Figure 10:** 2011/12 proportion of gross household income taken in Employee National Insurance Contributions for 'all households'.

**Source:** ONS Effects of Tax and Benefits on Household Income, 2013

## COUNCIL TAX

Council tax (based on the value of a property) is regressive, affecting the bottom 10% substantially more than the top 10%. This persists even after council tax benefit and account rate rebates have been taken into account. Households in the bottom 10% pay over twice as much of their income in council tax as the average household and more than four times as much of their income as the top 10%.



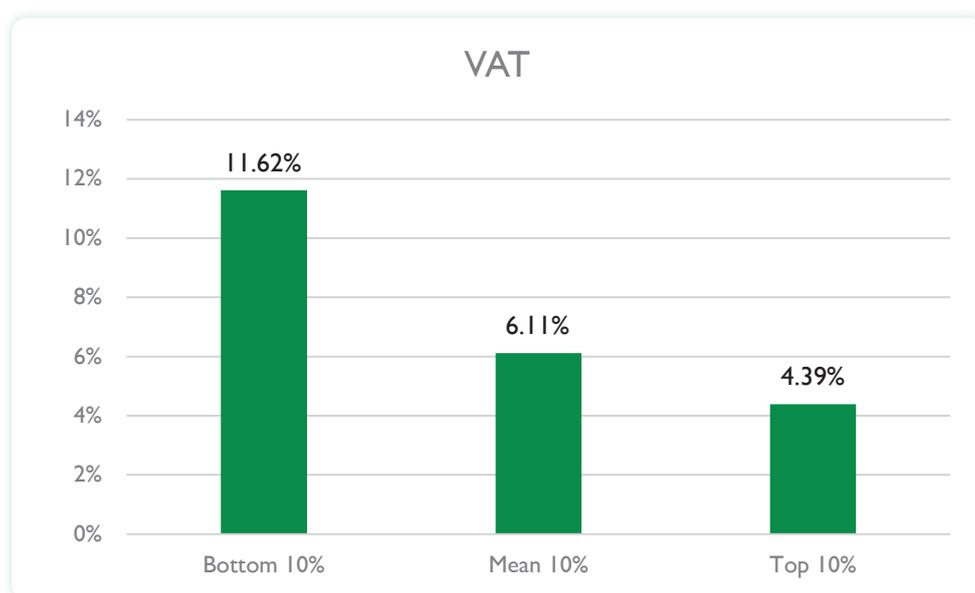
**Figure 11:** 2011/12 proportion of gross household income taken in Council Tax for all household types (after taking into account rate rebates and council tax benefit) at 1st, Mean and 9th decile.

**Source:** ONS Effects of Tax and Benefits on Household Income, 2013

# INDIRECT TAXES

## VALUE ADDED TAX

Value Added Tax (VAT) (a tax on most items sold in the UK) is slightly less regressive than Council Tax, but occupies a larger proportion of household incomes. The bottom 10% of households pay 11.62% of their total income in VAT, almost double the proportion of the average household (6.11%) and close to three times the proportion paid by the top 10% of households (4.39%).

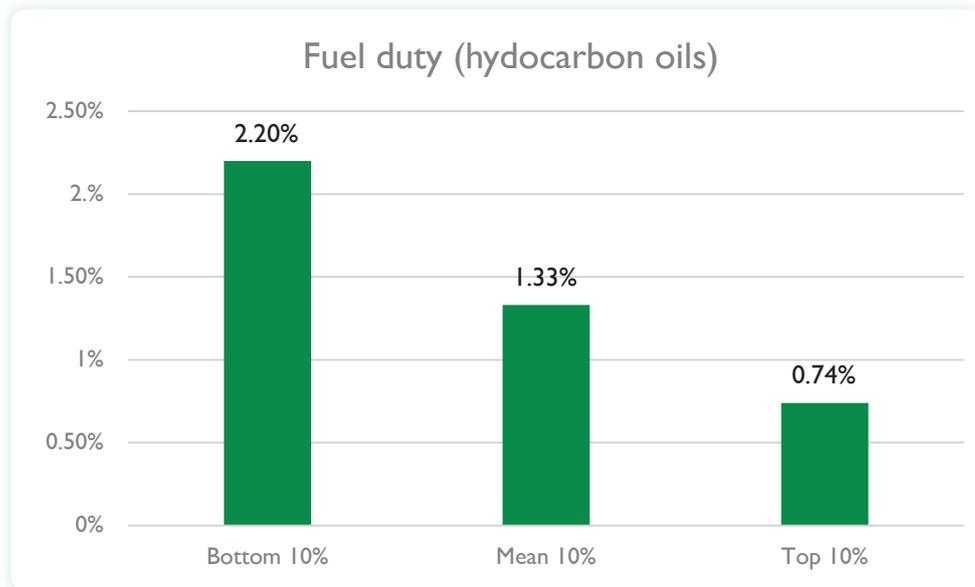


**Figure 12:** 2011/12 proportion of gross household income taken in Value Added Tax for all household types at 1st, Mean and 9th decile.

**Source:** ONS Effects of Tax and Benefits on Household Income, 2013

## FUEL DUTY

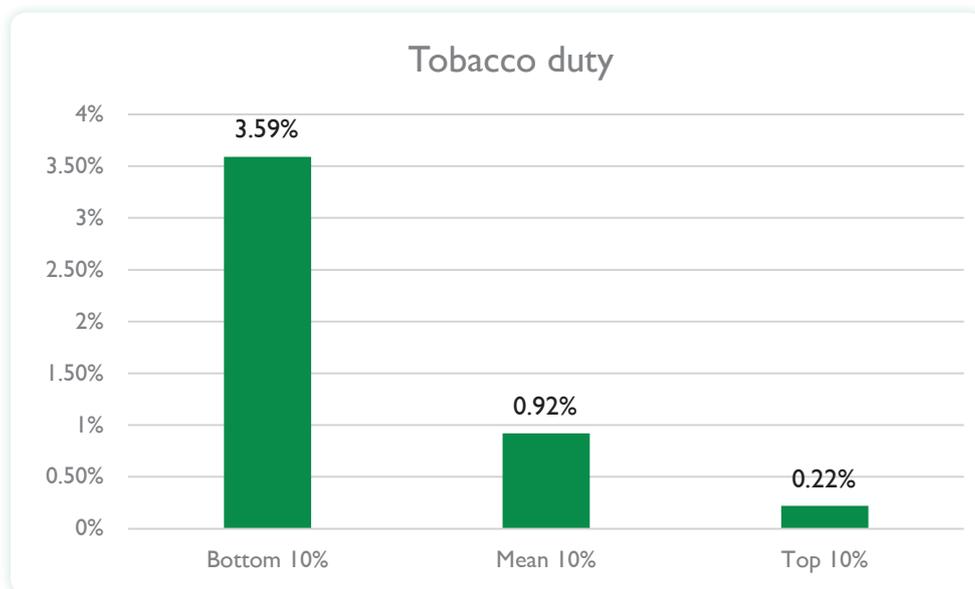
Fuel duty is slightly less regressive than VAT; however, like council tax, it occupies a substantially larger proportion of the poorest 10%'s total income than either the average household or the top 10%.



**Figure 13:** 2011/12 proportion of gross household income taken in duty on hydrocarbon oils for all household types at 1st, Mean and 9th decile.  
**Source:** ONS Effects of Tax and Benefits on Household Income, 2013

## TOBACCO DUTY

Tobacco duty is a very regressive tax. The poorest 10% of households pay 4% of their total income in duty on tobacco. This is almost twice the amount paid by the richest 10% of households in absolute terms, and sixteen times greater as a proportion of their household income.



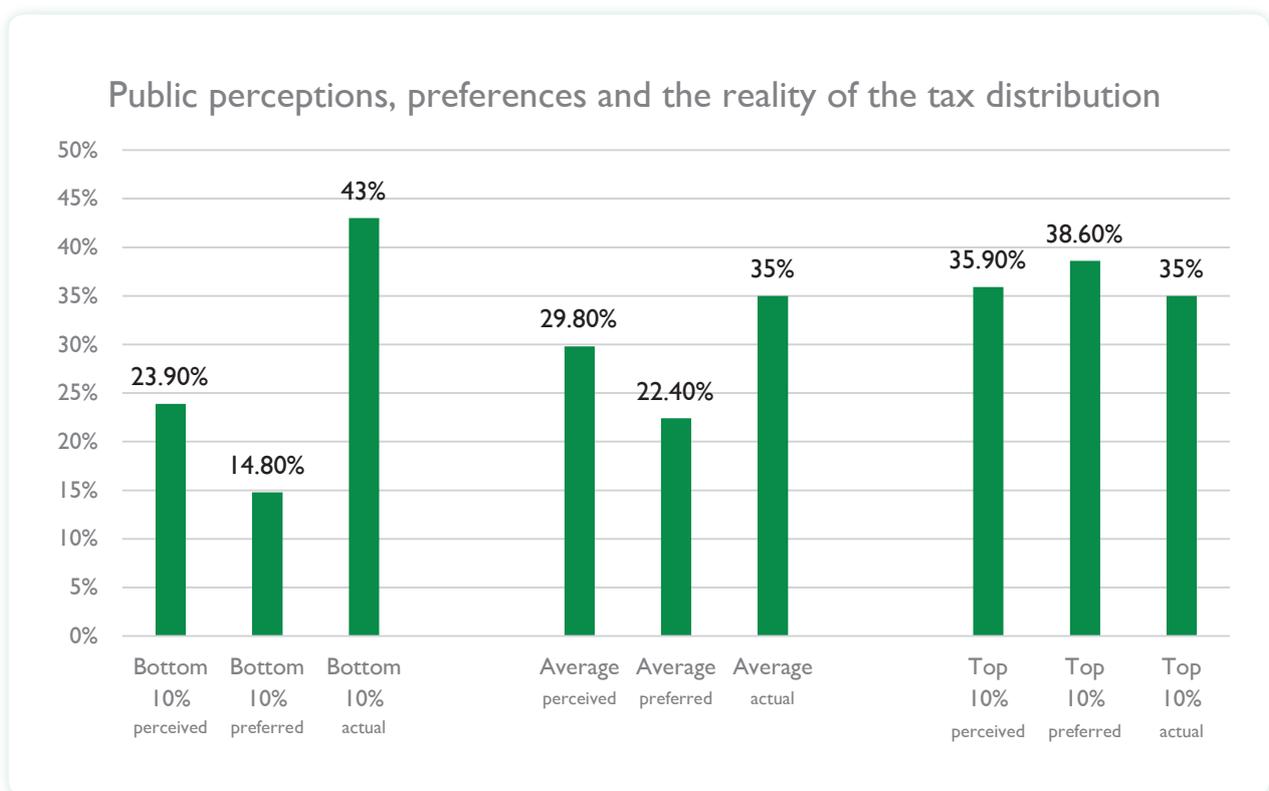
**Figure 14:** 2011/12 proportion of gross household income taken in duty on tobacco for all household types at 1st, Mean and 9th decile.  
**Source:** ONS Effects of Tax and Benefits on Household Income, 2013

# THE UK TAX SYSTEM - KEY QUESTIONS

## HOW MUCH DO PEOPLE KNOW?

Public perceptions and preferences of the UK tax distribution differ greatly from the reality. This is most pronounced in relation to the bottom 10% household income group, where on average public perception and preference differ by 19 percentage points and 28 percentage points respectively from reality (see Figure 15). There is a smaller but still substantial gap between expectation, preference and reality regarding taxes faced by the average household.

On average, people believe that households in the highest 10% income group are paying 36% of their income in tax, more or less the same as they actually do (35%), while it is felt that they should pay more than they do (39%). Despite this divergence, perception is more in line with reality for households in the highest 10% income group than for households in the lowest 10% income group and households of average income.



**Figure 15:** Public perceptions and preferences of the tax distribution and the actual tax distribution compared.

**Source:** Ipsos MORI polling and ONS Effects of Tax and Benefits on Household Income, 2013

## WHAT ARE THE REASONS FOR THE GAP BETWEEN PUBLIC PERCEPTION AND REALITY?

From an analysis of the distribution of different types of taxes paid by households it is possible to infer that public perception, and its inaccuracy, is partly attributable to people's tendency to disproportionately focus on income tax in any consideration of the overall tax burden.

Public perceptions of the tax distribution seem to align closely with income tax rates despite survey respondents being provided with a clear definition of the multiple taxes paid by households and asked specifically to evaluate the entire tax system. Public perceptions of the total tax paid as a proportion of gross household income by the bottom 10% of households and average households are close to the 20% basic income tax rate, while public perceptions of tax paid by the top 10% of households are closer to the 40% higher rate of tax. Although this may be an accurate representation of the income tax rate of the household in question, it is neither an accurate description of the proportion of their income paid in income tax – this is a matter of the average not the marginal tax rate applied to the household – nor an accurate representation of the total tax paid by this household.

The tax system diverges from the shape perceived and preferred by the public once taxes other than income tax are included, suggesting some misunderstanding of the functioning of the tax system as a whole. Unlike income tax, Employee National Insurance Contributions are progressive only up to the 8th decile, before becoming regressive, while Council Tax and most indirect taxes are regressive, albeit to differing degrees.

## WHAT ARE THE IMPLICATIONS OF THE DISTRIBUTION OF OUR TAX SYSTEM?

Households in the bottom 10% income group pay roughly 23% of their gross household income in indirect taxes on consumption. Indirect taxes are now characteristically flat rate whereas historically they were often higher on 'luxury goods'. It is mainly as a result of spending such a relatively high proportion of their income on consumption that households in the lowest 10% income group pay high indirect taxes. The high proportion of income paid by this group in Council Tax, even after Council Tax Benefit and Account Rate Rebates have been taken into account, is more surprising. Importantly, the data analysed in this report is from 2011-12, when those in receipt of many means-tested state benefits were eligible for 100% rebates on Council Tax. It is likely that the recent reform of council tax benefit will have made Council Tax more regressive and increased the proportion of their income that the bottom 10% pay in tax.

The relatively large amount of their income paid in all taxes by the bottom 10% is related to public misunderstanding of the entire tax and benefit system and the tendency for public and political debate to largely focus on the benefits and tax credits received by this group, not the taxes paid. The bottom 10% receive a high proportion of their income in state benefits and tax credits and it is on this that the tax-benefit debate mainly focuses, not on the gross tax paid by this group.

Although it is important to note that the lowest decile are net beneficiaries of the tax and benefit system, tax rates and benefits are debated and constructed largely in silos. When the 'generosity' of benefits is debated this is done by looking at gross benefit amount and is ignorant of the effect of taxation on this group. It is important for the public to understand the amount of taxation that is paid by those who receive social security and for this to be a crucial part of ongoing debate.

# POLICY RECOMMENDATIONS

There is a stark divergence between people's perception of the amount of tax paid by both themselves and others, their preferred distribution of tax across the income spectrum and the reality of the tax distribution under the current system. In short, people perceive the tax system to be progressive and would like it to be more progressive than they think it is. The tax system is, in fact, broadly regressive.

There are two particularly worrying conclusions from the findings which should be of concern to politicians and policy-makers: most people believe the current distribution of tax to be different to the reality; and the tax system in its current form is not fit for purpose.

These findings arguably suggest that the current tax system has little, if any, public mandate. For the system to better acknowledge the desires of the electorate, policy must aim for a tax system that is progressive.

In light of this, we recommend that:

- **Parties seeking to form the government from 2015 should commit to the principle that any changes in tax policy are progressive.**
- **Council tax should be transformed into a progressive property tax** by re-evaluating properties and creating new bands with higher rates for higher value properties. As identified in this report, council tax is highly regressive and, hence, its reform should be central to any wider tax strategy which aims for a broadly progressive tax system.
- **Government should aim to reduce VAT when it has a budget surplus.** Our analysis highlights that Value Added Tax (VAT) weighs more heavily on those at the bottom than the top of the income distribution. Although it is slightly less regressive than Council Tax, it occupies a larger proportion of household incomes and should be a cause for concern.
- **The upper limit of National Insurance Contributions should be raised** to ensure that the tax is progressive across all deciles.

This report is part of the Fairer Tax strand of The Equality Trust's Fairer Stronger Economy project anticipating the 2015 general election. More information on this project and further policy recommendations are available on our website: [www.equalitytrust.org.uk](http://www.equalitytrust.org.uk)

# CONCLUSION

The British Social Attitudes Survey published in 2013 revealed that inequality is an issue of serious concern to the electorate, with over 80% now believing the gap between rich and poor is too big<sup>6</sup>. Our new data and analysis now also makes clear that the UK's current tax system exacerbates this inequality and differs greatly from the desired tax system of the UK population.

By addressing the regressive nature of the tax system, politicians will be able to ensure that their policies have a public mandate. And, by creating a more progressive tax system, they will also be able to better tackle the UK's extreme economic inequality, a move likely to be popular with the electorate.

However to achieve this, tax policy must address not only the bottom, middle and top of the income distribution as outlined in this report, but also the very top, the richest 1%. Inequality today can no longer be seen as just a question of the overall distribution. Even within the group of top-income earners, incomes over the past three decades have become more concentrated, tilting towards the richest of the rich. In an upcoming report 'Course Correction: the pre-distributive case for the 50p top tax rate, will look specifically at this very high income group, to address not only what tax rates should apply to those at the top and why, but also the economic implications of these top tax rates.

The gap between perceptions, preferences and reality when it comes to the UK's current tax system should be of deep concern to politicians. Building a system that is fit for a fair society must now be a priority.

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