

STUDY GUIDE A1: THE OVERALL FUNCTION AND PURPOSE OF TAXATION IN A MODERN ECONOMY

Get Through Intro

Tax is a financial charge imposed by the government. The fundamental purpose of taxation is to finance government expenditure. Any money the government spends mostly comes from taxation.

You will agree that having to pay tax from your earnings is a painful experience. You must also have wondered why the government needs to collect taxes. What is the purpose behind collecting a part of our hard-earned money? Most of the tax payers feel that paying taxes is a waste of their money.

This Study Guide explains the various economic and social purposes of taxation. You are advised to understand the Study Guide thoroughly so that you can encourage your clients to pay taxes regularly and help your country to grow.

Learning Outcomes

- a) Describe the purpose (economic, social etc) of taxation in a modern economy.

Introduction

Case Study

This man is counting money. How happy he looks! If the income of this man is £100, some part of this £100 will go to the government in the form of tax on his income.



The fundamental purpose of taxation is to finance government expenditure. The tax system can be used for purposes other than revenue rising. In certain situations, imposing a tax may potentially increase efficiency if markets fail to price factors such as pollution or congestion, or the health costs of particular types of behaviour such as cigarette smoking. The government uses the process of taxation to encourage or discourage public activity in specific ways.

So, even if this man has to pay tax, i.e. money goes from his pocket, he should not feel bad because the government uses this tax money for the economic and social benefits of the country as a whole. Therefore, it is the taxpayer himself who ultimately enjoys the benefits of paying taxes.

(Source: <http://comparativetaxation.treasury.gov.au/content/report/html>)

1. Describe the purpose (economic, social etc) of taxation in a modern economy.^[2] [Learning Outcome a]

General introduction

The UK tax system has developed over the years as each successive government makes changes to the legislation to reflect its political objectives. The UK tax system is managed by Her Majesty's Revenue and Customs (HMRC). These are appointed officers of the government to administer and collect taxes. They are charged with the responsibility of implementing and enforcing the legislation of the government.

The imposition of taxation by governments withdraws money from the economy, and their expenditure returns the money to the economy. The overall position of the UK economy is affected by the tax policies and in turn will influence the success or failure of the country's economy.

The level of economic activity in the UK is affected by:

- the government's net position regarding taxation and expenditure, and
- public sector borrowing policies

1.1 Economic purpose of taxation

The government used to change its taxation policies in response to short-term changes in, for e.g., levels of employment, imports and exports. This was not always effective, and the current government prefers to plan ahead over a longer term. It publishes a plan for its expenditure over the next three years. This plan shows the proportion of the economy's resources that will be left for the private sector to make decisions on after the government has fulfilled its spending plans.

The government's spending plans will influence the demand for health and education, the demand for consumer goods is influenced by private spending. Changing levels of demand will affect employment and profitability.

The government imposes taxation policies to:

1. Encourage

- a) saving by individuals
- b) taking risks in investments by entrepreneurs
- c) entrepreneurs building their own businesses
- d) donations to charities
- e) investment in industrial buildings (e.g. factories, warehouses)

2. Discourage

- a) motoring e.g. to minimise pollution
- b) smoking and alcohol

A government does not intend taxes to be neutral but to encourage or discourage certain activities. The objectives will change over time and successive governments. Increasingly the UK government tax policy is influenced by worldwide economic influences such as international defence policy and overseas aid.

1.2 Social purpose of taxation

Politicians use taxation policies to encourage social justice; however, there are many different ideas as to what constitutes social justice. The taxation system within the UK would suggest that it operates on an equitable basis. The taxation policies are intended to redistribute income and wealth. In a bid to direct funds away from the rich and towards the poor, the UK government adopts a process of redistributing wealth through its taxation policies. This is the Robin Hood Principle.

There are various principles to consider when debating the social justice of taxation:

1. The progressive / regressive principle

- a) **Progressive:** a tax such as the income tax demonstrates the progressive principle. As income rises so does the proportion of tax i.e. the rate of tax rises as well as the amount of tax. This can be considered as just and fair, as the higher tax payments are made by those with higher incomes. Taxes which take a higher percentage of the incomes of higher income earners are said to be progressive.
- b) **Regressive:** as income rises, the proportion of tax decreases, e.g. the tax on a packet of cigarettes remains the same, regardless of the income of the consumer. Regressive taxes can be justified in that smokers are likely to require additional hospital care, so only they should contribute towards the cost of it. Taxes which take a higher proportion of the incomes from lower income earners are said to be regressive.

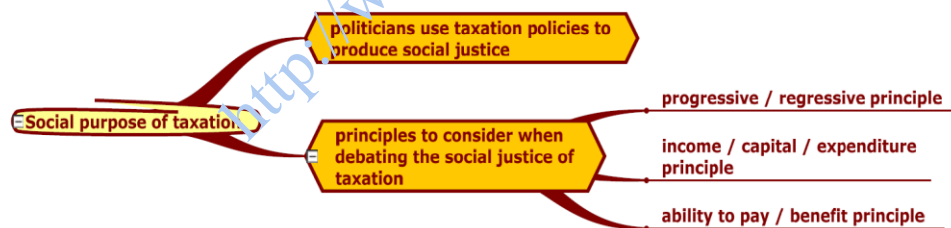
2. The income / capital / expenditure principle

- a) **Income:** tax on income is just, because it is only paid by people who have income. People who have very low incomes can be taken out of the tax net by the use of personal allowances and effective tax rates.
- b) **Capital:** tax on capital is just, as it ensures that people are not avoiding tax by having no income and living off the disposal of capital assets.
- c) **Expenditure:** tax on expenditure is just, because it is only incurred by those who spend, not those who save.

3. The ability to pay / benefit principle

- a) **Ability to pay:** tax is only paid by people who have the income to pay.
- b) **Benefit:** people should only contribute to those types of government expenditure from which they are going to benefit.

SUMMARY



1.3 Environmental concerns

A specific use of taxation in influencing behaviour is in relation to the environment. These are commonly referred to as "Green Taxes". Currently there are environmental concerns about renewable and non-renewable energy and global warming.

It is considered unlikely that individuals will contribute voluntarily to protect the environment as they are unlikely to be affected in their lifetime by the changes taking place. As a result, the government aims to protect the environment through taxation and spending policies.

These policies include:

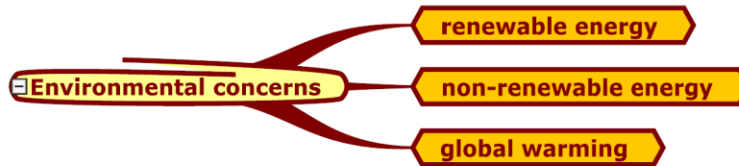
- a) **Taxation on vehicles and fuel provided by companies:** taxable benefits are based on the CO₂ emission.
- b) **Climate change levy** which relates to the proportion of energy consumed by businesses.
- c) **Landfill tax** charged on operators of landfill sites to encourage recycling.

These taxes are part of the UK's Climate Change Programme published by the Government on 17 November 2000.

Tax policies are formulated with an aim to increase government revenues. They are framed on the basis of clear principles such as:

- a) savings and investments
- b) fairness
- c) equality
- d) enhancing work efficiency

SUMMARY



Quick Quiz

Fill in the blanks.

1. The UK tax system is managed by _____.

Answer to Quick Quiz

1. Her Majesty's Revenue and Customs (HMRC).

Self Examination Question

Question 1

What are the various principles to consider when debating the social justice of taxation?

Answer to Self Examination Question

Answer to SEQ 1

The various principles to consider when debating the social justice of taxation are:

- the progressive / regressive principle
- the income / capital / expenditure principle
- the ability to pay / benefit principle