



Could flatter taxes be socially equitable?

Proposals to create a ‘flat tax’ system, which taxes everyone at the same rate, are sometimes seen as benefiting the better-off. But in Britain, it is poorer families who face the highest withdrawal rates as income rises. JRF Special Adviser Donald Hirsch has looked at how flattening these rates could help the less well-off to progress. In an ideas paper (summarised here) drawing on modelling work by the Institute for Fiscal Studies, he shows that:

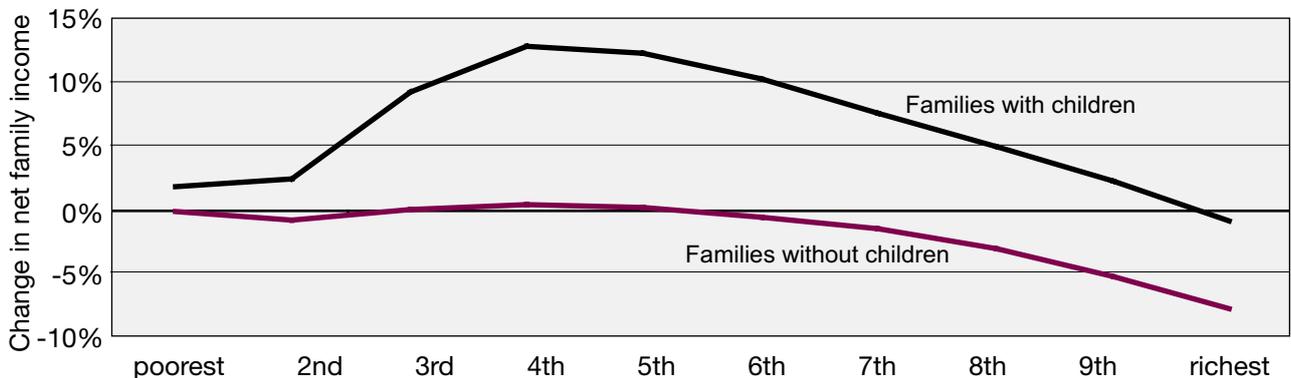
- Our present system for taxing personal income is already quite ‘flat’ by historic standards, in terms of the marginal tax rate applied to people at different income levels. When National Insurance contributions are included, someone earning £20,000 a year pays 33p on each extra pound earned, while someone earning £800,000 a year pays 41p – not a big difference.
- The most important exception to this is not at the top but near the bottom of the income distribution, where people eligible for tax credits face steep effective marginal tax rates.
- If we really want to flatten and simplify the tax system, and to improve work incentives, we should consider whether the tax credit system could be turned into a ‘negative income tax’* with a constant marginal tax rate. This would mean accepting a substantially higher marginal rate for the majority of taxpayers, although for medium to low earners, not necessarily a higher tax burden overall.
- The required tax rate under such a system would be 37 per cent, compared with the basic rate of 22 per cent today, if public revenues were to remain the same and working behaviour did not change. If National Insurance contributions were also flattened with no upper limit, the flat tax rate would be 35 per cent. However, the creation of ‘universal’, non-means-tested tax credits would compensate these losses for many families, and those on modest incomes with children would see substantial gains. The main losers would be people without children on high incomes.

* A ‘negative income tax’ describes a system where everybody gets paid a fixed sum from the tax authorities to cover basic needs, but pays back into the tax pot according to their income.

The purpose of modelling a 'flat tax' system incorporating tax credits is not to propose this as a reform, but to illustrate how a flatter tax structure could benefit the worse-off. In particular, the paper highlights the fact that low income families, who have taken a first step out of poverty by moving into work and having their pay supplemented by tax credits, find it very difficult to take a second step and to raise their incomes above just-adequate levels. For some families, over 90p in every extra pound earned is lost in taxes, National Insurance and withdrawal of tax credits and benefits.

In the version of flat taxes modelled in this exercise, tax credits would be paid to families regardless of their incomes, with a higher marginal tax rate doing the job of ensuring equity between richer and poorer groups. A couple with three children in which both partners were working on modest incomes of £15,000 a year would end up £120 a week better off. A couple without children each earning £38,000 a year, on the other hand, would end up £112 worse off. These are the extremes, and for most people, gains and losses would be modest. Figure 1 shows that overall, the system would advantage families with children and families with low incomes. (This exercise excluded families with someone aged 60 or over.)

Figure 1 **Gainers and losers by decile group**



Families with children on modest to middle incomes gain over 10%
 Families without children in the highest tenth by income lose 8%

Source: Adam and Browne (2006)

The effect on work incentives would be mixed. The number of people losing over half of any increase in their income would be reduced by 70 per cent. However, most taxpayers would see rises in their overall marginal rates, typically from between 30 and 40 per cent to between 40 and 50 per cent.

The paper concludes that a flat tax system would be politically difficult if not impossible to implement, but flattening the rates at which taxes, National Insurance and the withdrawal of tax credits and benefits are imposed on different individuals could make a contribution to future reform. In particular, a 'universal' rather than income-tested form of tax credit could potentially resolve many of the complexities and administrative tangles that have plagued our present system.

For more details

A fuller paper is also published by the Joseph Rowntree Foundation. **Flatter taxes: Rich giveaway or new deal for poor?** by Donald Hirsch is available as a free download on www.jrf.org.uk.

Modelling work was carried out at the Institute for Fiscal Studies by Stuart Adam and James Browne, and is reported in greater detail in Stuart Adam and James Browne (2006), **Options for a UK 'flat tax': some simple simulations**, www.ifs.org.uk/projects_research.php?project_id=206

Published by the Joseph Rowntree Foundation, The Homestead, 40 Water End, York YO30 6WP.

Other formats available. Tel: 01904 615905, Email: info@jrf.org.uk