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The Importance of Fairness in Tax Policy:
Behavioral Economics and the UK Experience

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ABSTRACT

One of the key areas where behavioral economics offers major insights into developing successful policy involves issues of fairness. Taxation offers many examples, ranging from the Boston Tea Party of 1773 to the UK's unsuccessful community charge, often called the 'poll tax', of the early 1990s, where a failure to appreciate fully taxpayers' perceptions of fairness led to unexpected outcomes. The use of behavioral economics to supplement mainstream economic analysis might not only reduce the risks of such tax disasters but also improve the development of tax reform more generally. This paper shows how such additional explanatory power contributes to our understanding of the success or failure of UK tax policy arising from the 'natural experiments' of the successful introduction of value added tax in 1973 and the contrasting difficulties associated with the community charge in 1990 and, more recently, the abolition of the 10% rate of income tax in 2008.

Keywords: *Behavioral Economics, Fairness, Tax Policy, United Kingdom (UK), Value Added Tax*

1. INTRODUCTION

James E. Meade, joint winner of the Nobel Memorial Prize in Economic Sciences in 1977, once stated: 'I am an economist and have tried to give you an economic solution for an economic problem. Please do not argue that I am a rotten economist on the grounds that the economic solution is politically unacceptable. The really difficult part of our present problem *is* political' (Meade, 1979, p. 9). To achieve successful tax reform a political solution may also be required as indicated by many episodes from the famous Boston Tea Party of 1773 and its role in the developments leading to the American War of Independence (see, for example, Labree, 1964) to the ill-fated UK community charge or poll tax examined below.

Economics has not always had such clear distinctions of the sort described by Meade. Edwin Cannan (1946, p. 4) took the view that there 'is no precise line between economic and non-economic satisfactions, and therefore the province of economics cannot be marked out by a row of posts or a fence like political territory or a landed property.' Indeed, Adam Smith

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has been described as a behavioral economist - his 'world is not inhabited by dispassionate rational purely self-interested agents, but rather by multidimensional and realistic human beings' (Ashraf *et al.,* 2005, p. 142). However, as an academic discipline, economics shifted substantially towards a narrower approach, beginning in the 19th Century. As Edgeworth (1881, p. 6) put it: 'Economics investigates the arrangements between agents each tending to his own maximum utility' and the 'first principle of Economics is that every agent is actuated only by self-interest' (p. 16). As Jevons (1881, p. 581) remarked: the 'fearless manner in which Mr Edgeworth applies the conceptions and methods of mathematical physics to illustrate, if not solve, the problems of hedonic science, is quite surprising'. Nonetheless, it was an approach that was widely followed for a range of reasons, not least because of the appeal of precise analysis which can also generate useful and powerful theories. However, there have been many distinguished economists who have acknowledged the possible role for behavioral factors. For instance, Herbert Simon (1986, p. S299) wrote 'it is sometimes useful to enrich the model of economic agents by explicitly introducing a behavioral factor that is ignored in the standard theory'. A very important area consists of issues of fairness. Kahneman *et al.* (1986, p.S285) point out that the absence of considerations regarding fairness from standard economic theory is one of the most striking contrasts between economic theory and other social sciences. It also means that standard economic analysis has significant limitations and in recent years behavioral economics has begun to extend the study of economics back towards territory it once occupied.

The number of contributions from behavioral economics has grown enormously in recent years. Introductions are provided by both Schwartz (2008) and Wilkinson (2008). Altman (2006), Loewenstein (2007) and Maital (2007) have edited books of behavioral economics papers. Taxation has also been the focus of analysis. McCaffery and Slemrod (2006) produced a book of papers on behavioral public finance and James (2006) a paper on behavioral economics and tax in general. Regarding particular aspects of taxation with respect to behavioral economics, Congdon *et al.* (2009) examined tax policy, Reeson and Dunstall (2009) the Australian tax and transfer system and James (2012b) some implications for tax administration.

Behavioral economics has been described as increasing the 'explanatory power of economics by providing it with more realistic psychological foundations' (Camerer & Loewenstein, 2004, p. 3) though it also draws on other disciplines. Its approach involves modifying 'the standard economic model to account for psychophysical properties of preference and judgement, which create limits on rational calculation, willpower and greed' (Camerer & Malmendier, 2007, p. 235) and further analysis is presented by Tomer (2007).

Fairness is a very significant aspect of behavioral economics and, to gain an idea of its relative importance, the present author surveyed the indexes of three standard behavioral economics texts - Camerer, Lowenstein and Rabin (2004), Schwartz (2008) and Wilkinson (2008) - to measure the number of pages referenced for each topic. Of course, this was not an exact exercise. A reference does not directly indicate the importance of a topic. Many of the concepts overlap – for example 'decision-making' is part of a variety of effects and there are differences in the way the books are indexed. Nevertheless, the number of pages on which different concepts were referenced varied enormously. Fairness was the topic the most frequently referenced by far – there were references to fairness on 136 pages. In addition, 'inequality aversion' - another description of fairness - had its own references to 44 pages of the three texts. It might be noted that references to fairness considerably exceeded those to the second most referenced topic, which was prospect theory (mentioned on 106 pages). Furthermore, the references to fairness included many pages of immediate relevance to the contribution of behavioral economics to tax reform.

The UK has experienced many natural experiments in tax reform. These include the introduction of value added tax (VAT) in 1973 which was successful. It also includes the unsuccessful community charge, most usually called the 'poll tax', which was introduced in Scotland in 1989 and England and Wales in 1990, It did not last long and was replaced in 1993. In fact, the poll tax was such a failure it also played a part in the downfall of Mrs. Margaret Thatcher as Prime Minister (Gibson, 1990). A more recent example is the abolition of the 10% income tax rate in 2008 which the taxpaying public considered to be so unfair on low income taxpayers that the government finally made further changes to offset the objections. The comparison between the successful introduction of VAT and the failure of the community charge has already been used to illustrate the contribution of behavioral economics to tax reform (James, 2012a). It has been said with regard to public administration that a 'good crisis should not go to waste'. In the present context, a serious tax disaster should not be wasted and this paper concentrates on the particular issue of fairness. VAT, the poll tax and the abolition of the 10% tax rate were all based on mainstream analysis of economic efficiency but their success or failure seems to have been primarily determined by the extent to which they matched taxpayers' views of fairness.

This paper therefore summarises issues of fairness in relation to public finance in the following section. The introduction of VAT in the UK is then examined in that light in Section 3, the community charge in Section 4 and the abolition of 10% tax rate in Section 5. Some conclusions regarding the role of fairness in taxation are presented in Section 6.

2. FAIRNESS, BEHAVIORAL ECONOMICS AND TAXATION

There is substantial evidence that economic agents take account of fairness rather than simply maximising short run profits though, of course, this could enable them to maximise long run profits (Kahneman *et al.,* 2004). However the view that individuals are motivated purely by immediate self-interest cannot explain a range of empirical anomalies (for example see Wilkinson, 2008). Observations are made of individuals acting in an altruistic way – where they benefit from the welfare of others even at a cost to themselves. The opposite behaviour can also be observed – spiteful actions where individuals will incur a cost in order to harm others. Different models have been designed to incorporate fairness and social preferences. Inequality-aversion models take account of individuals' envy of those who are better off than themselves and also that they feel guilty if they are better off than others. There are also reciprocity models where kindness (or the opposite!) depends on the perceived kindness of others. Other approaches include that of evolutionary psychology. Co-operation and concepts of fairness may have originally developed in hunter-gatherer groups and later more widely as an important factor in the success of the human race in a sometimes harsh environment. It may also, of course, be reinforced by the punishment of defectors and free riders.

The distribution of resources has long been a feature of public finance analysis. The economic justification for the public sector was summarised in Musgrave's (1959) classic three branch model consisting of allocation, distribution and stabilisation. The stabilisation branch is not of direct relevance in the present context but the allocation and distribution branches well describe two complementary approaches to tax policy. Allocation in this context relates to the inefficiencies in the market system and improving the allocation of economic resources, for example regarding the provision of public goods and dealing with external effects. As Musgrave (2008, p. 237) describes it, the allocation branch mirrors the spirit of the market and attempts to increase efficiency based on consumer preferences.

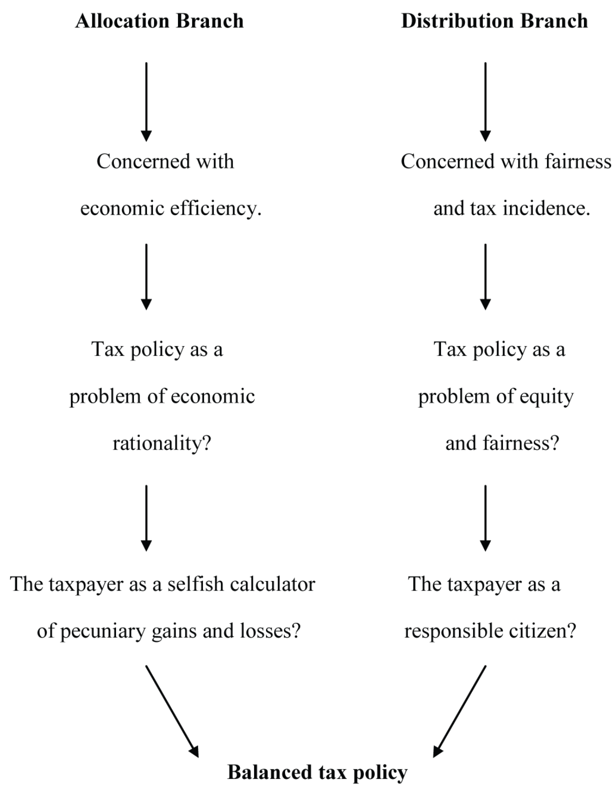
With the distribution branch, public finance leaves 'the safe haven of Pareto optimality'

(Musgrave *ibid*.) and moves to the less tangible area of distributive justice. This is concerned with the distribution of income and wealth. In terms of the revenue side of public finance, fair taxation has frequently been based on ideas related to ability to pay and there has been much discussion in terms of the sacrifice of taxation and whether fair taxation should be related to absolute, proportional or marginal sacrifice. The concept of horizontal equity, that people in the same position should be treated alike, may not have independent normative content (McDaniel & Repetti, 1993) but it is often the basis of much discussion (and frequently opposition to) particular aspects of taxation.

This classification is a useful basis on which to integrate the efficiency and equity aspects tax policy as illustrated in Figure 1. The allocation branch is concerned with economic efficiency and this is conventionally analysed using the assumption that individuals maximize utility. The distribution branch relates to equity and tax incidence and how these are affected by public expenditure and taxation. Rather than seeing taxpayers simply as calculators of their own economic gains and losses, when equity is also considered, taxpayers might be better considered in a more complex role of members of society with a range of possible views regarding fairness and the distribution of income.

An illustration of the importance of a balanced tax policy is the success of VAT in the UK and this is examined in the following section. This is followed by an indication of how badly things can go wrong if tax policy is not developed in this way as with the UK community charge.

Figure 1. Different approaches to tax policy



3. VALUE ADDED TAX

The proposal for the introduction of VAT in the UK was based firmly on mainstream economic principles. One of the main principles was that the tax should, as far as possible, be levied at the same rate on all goods and services in order to reduce economic distortions. Other arguments for introducing VAT included European tax harmonisation, enabling UK exports to be competitively priced by removing tax altogether from exports and the self-policing characteristics of value added taxes (James & Alley, 2009).

Historically, indirect taxes tended to be levied on goods rather services (Webber & Wildavsky, 2006). The anomaly of taxing goods but not services was less pronounced in developing economies when services generally formed a relatively small proportion of output that was easily taxable. However as the service sector grew, so did the distortion. In the UK in 1966 there was an attempt to rectify the situation by the introduction of the Selective Employment Tax (Reddaway, 1973) which discriminated against services but this was a very unsatisfactory tax and so contributed to the case for VAT. Value added tax can avoid many economic distortions if it is levied at a single rate on all goods and services but, as indicated below, this principle had to be modified enormously in the process of adapting the tax to take account of taxpayers' views of fairness.

This was possible since considerable care and time was taken regarding the development and implementation of VAT in the UK. The Government published a Green Paper (1971) giving details of the proposed tax two years before VAT was to be introduced. A period of consultation followed which generated a large number of contributions and led to the publication of a White Paper (1972) that set out the proposals in far more detail. The next stage was the provision of considerable publicity and taxpayer assistance which did a great deal to ease the introduction of VAT.

Such an approach was taken because value added tax was new to the taxpaying population and potentially complex in its operation. It has been examined in detail by Aaron, (1981), Lindholm (1980), Prest (1980), Schenk and Oldman (2007) and James and Alley (2009). The tax works on the basis that suppliers are required to charge VAT on their outputs and deduct VAT already paid on their inputs so that only tax on the value they have added is remitted to the tax authorities. Relief from VAT can be given in two main ways. One is by including particular goods or services in the VAT system but applying a zero rate. In this way goods and services can be completely free of tax because any VAT on inputs can still be claimed. Hence, for example, the advantage of VAT mentioned above regarding exports which can be zero rated to give them a competitive advantage. The other way of favouring supplies is exemption whereby particular goods and services are not covered by the VAT system at all. This is less advantageous than zero rating because, while VAT does not have to be charged on exempt outputs, the suppliers cannot reclaim any VAT paid on their inputs.

The extensive consultation in the UK allowed taxpayers' perceptions of fairness considerable influence in the development of the final structure of VAT. Many concessions were made by the use of the zero rate or exemptions. It became clear that, despite the economic advantages of a broadly based tax levied at a single rate, the taxation of certain items was simply not acceptable to UK taxpayers. This included food, children's clothes and domestic fuel and power. By avoiding the taxation of a whole range of such items, VAT became levied on only just over half of consumer expenditure (Davies & Kay, 1985) and the proportion has not increased a great deal since its introduction. Nevertheless, this had the political benefit that the effects on income distribution were much more acceptable to taxpayers than some had predicted. This was partly because those on low incomes spent a relatively high proportion of their income on items not subject to VAT. It was also partly because those on higher incomes spent a higher proportion on items that were.

Nevertheless there are almost certain to be difficulties where different items are treated differently for tax purposes. Not only does this increase the complexity of the tax in itself but further complexity arises as consumers try to take advantage of the disparities and the government responds by restricting their ability to do so. An example is zero rating for children's clothing which might benefit small adults but not large children. It is therefore subject to detailed regulations. These cover whether something can be defined as an article of clothing or footwear, whether it was designed for young children and whether it is suitable only for young children. It can be very difficult to achieve the right degree of regulation. The less regulation there is in such cases the more likely the concession will have unintended beneficiaries. However the more regulation there is, the less likely the concession will always reach the intended beneficiaries. What is clear is that there are significant costs involved in using the tax system as a policy instrument in this way but these can be acceptable in the interests of fairness.

The result has been a tax that is considerably more complex than originally envisaged and further changes have been made over the years. These began soon after the tax was introduced in 1973. One related to the concession for food which originally included confectionary, ice cream, soft drinks and potato crisps. These became subject to VAT in 1974. Such changes further illustrated the point that when substitutes are taxed at different rates there is not only an economic distortion but also potentially a difficulty in maintaining the integrity of the tax. A well reported example was the tax treatment of small cakes with chocolate coverings. Although cakes were subject to the zero rate of tax, the revenue authorities treated them as chocolate covered biscuits and taxed them at the standard rate of VAT. As one implication of the case later came before the House of Lords in 2005 on its way to the European Court of Justice, Lord Hoffman said:

The supply of food is in general zero-rated for VAT... But there are exceptions. One exception is confectionery…. But there is an exception to that exception: cakes or biscuits are in general also zero-rated. There is however an exception to that exception to the exception, namely biscuits wholly or partly covered with chocolate. They are standard-rated. (Marks and Spencer plc v. Customs and Excise, [2005] UKHL 53)

Naturally this led to some serious dispute about the definition of a biscuit and the definition of a cake. One supplier held that biscuits go soft when stale but cakes go hard. The supplier also baked a special large version of its cake/biscuit in an attempt to show that it was really a small cake. The authorities accepted this argument in 1994 but the whole thing became much more complex and further disputes continued for many years. Whether such an item of food was a cake rather than a biscuit depended not just on the test of staleness but also on factors such as appeal to children, ingredients, texture, size, marketing, presentation, the name and the manufacturing process. Such cases provide further evidence that taxpayers prefer taxes they consider fair, even if it involves such economic and administrative burdens.

Taxpayer preferences regarding fairness have also prevented other attempts to extend the VAT base. For instance, when VAT was introduced, domestic fuel and power were taxed at the zero rate. However, as worries about the use of fossil fuels increased, the rate of tax on domestic fuel and power was increased to 8 per cent in 1994 and it was also stated that it would be further increased to the full rate. Nevertheless it soon became clear that this was not politically acceptable and, indeed, the rate was reduced to 5 per cent from 1995. This lower rate has also been used with respect to a whole range of items from energy saving materials for home insulation to children's car safety seats. Of course, such differential taxation may increase economic distortions but it does make the tax appear fairer to taxpayers and therefore more acceptable.

The clear lesson from the VAT experience in the UK is that while a broadly based single rate of tax has economic advantages, responsiveness to taxpayer views indicated that perceptions of fairness were also important. The result has been widespread acceptance of the tax and, compared to other taxes, relatively little resistance when the rates of VAT have been increased. For example, it was quite remarkable that the increase of VAT from 17.5% to 20% in January 2011, which was expected to raise an additional £13 billion, aroused remarkably little observable protest or resistance as compared to many other tax changes which involved raising much less revenue. There seems to be little doubt that UK taxpayers are much less concerned about the efficiency and complexity of taxation than they are about what they consider to be its fairness.

4. THE COMMUNITY CHARGE OR POLL TAX

There is little doubt that the UK community charge provides a vivid example where considerations of economic efficiency were given precedence over fairness with disastrous results. It was to be a major source of local government finance and it replaced a local property tax that can be traced back to the Elizabethan Poor Law of 1601. It was introduced initially in Scotland in 1989 and then in England and Wales the following year. The tax is described in more detail by Smith (1991) and Butler *et al.* (1994) but basically it was levied at the same rate on all adults in a local authority area. This is why it became known as the 'poll tax' and led to considerable protest and even civil disobedience to such an extent that as soon as 1991 the government decided to repeal it and it was actually replaced in 1993.

Perhaps it was surprising that more care had not been taken to ensure the community charge was acceptable to taxpayers. The fact that its predecessor had survived for nearly three centuries should have indicated it was a robust form of taxation. However, the community charge had strong support. It was government policy to control public spending and around a quarter of this was local public spending. Although the previous system of local taxation has survived for so long, it was thought to create upward bias in local authority spending since the beneficiaries of that spending outnumbered those who paid the tax. The aim of the community charge was therefore was to link directly local public spending with local tax liability. Individuals could still, of course, vote for high spending local councils, but it would mean they were voting for higher tax bills not just for others but also for themselves.

While it was quite clear that taxpayers might not consider fair a tax which demanded the same payment from everyone in a local area, academic economists did not subject the proposals to much serious criticism. This seems to be because the tax, apart from fairness, met all the mainstream economic criteria for a good tax (James & Nobes, 2012). Since everyone paid the same amount, the marginal rate of tax and therefore the substitution effect were zero and the community charge would not normally have direct adverse effects on economic efficiency or the supply of labour or capital. It also met the criteria that could be applied to a good form of local taxation. These are all based on the idea that local public authorities should have a significant degree of autonomy over local decisions regarding public spending and taxation. In addition to meeting the usual economic criteria for a good tax, a tax that is suitable for local government should therefore have the three other characteristics (James, 2004). The first is that there should be a tax base large enough to generate sufficient finance for local authorities. The second is that the tax base has to be reasonably spread across jurisdictions to avoid revenue sharing arrangements that might impede local decision-making. Thirdly, the tax should be such that it can be levied at different rates in different areas so that local areas can decide for themselves the level of local taxation and local public spending. The community charge met all these criteria well. It had a potentially large tax base. It would be well distributed if local areas are considered to be local populations rather than geographical areas. Finally, as with a local property tax, it would be possible for each area to set its own rates without fear of serious adverse outcomes as a result of different rates in different local jurisdictions.

An argument put forward for the community charge concerned the benefit approach to taxation. In this context it was suggested that the local tax burden of individuals ought to be related to the benefit they obtained from local public spending. A similar point was concerned with accountability. The Layfield Committee (1976), among others, had examined increasing the accountability of local government to the local electorate by replacing some central government grants to local authorities by higher levels of local taxation. Such changes might reduce 'fiscal illusion' by which voters are not aware of the true tax costs of public expenditure as the link between local taxation and local spending was enhanced (Gemmell *et al.,* 2002).

Despite such theoretically elegant concepts deployed in support of the community charge, when taxpayers started to receive increased tax demands these led very quickly to considerable opposition which included widespread refusals to pay, public demonstrations and even a major riot in London (Smith, 1991; Butler *et al.,* 1994). As already indicated above, the community charge was a factor in the resignation of Mrs Thatcher as Prime Minister in November 1990, less than a year following the introduction of the tax in England and Wales and her replacement by John Major who had promised to review it.

A closer look at the issue indicates a number of problems not just with the tax itself but also in the form that it was actually introduced. The relevance of the benefit approach to taxation is limited – as discussed by classical economists such as Adam Smith and John Stuart Mill – not least because it is extremely difficult, if not impossible, to measure the benefit of government spending on public goods and so on (James, 2004). In addition, under the UK community charge, every individual paid the same regardless of their benefit from local public spending. Bramley *et al.* (1989) revisited the theory of local public finance and found that it gave some, but not overwhelming, support for the community charge as a 'benefit tax'. In examining household survey evidence Bramley *et al.,* came to the conclusion that the incidence of the community charge was such that as a benefit tax it scored less well than the local property tax it replaced. This conclusion was echoed by Cullis *et al.* (1991) looking at the issue from a public choice perspective. They considered it questionable that voters knew more about the poll tax than they did about the local property tax and, even if they did, whether the poll tax performed better as a benefit related tax. Cullis *et al.* (1993, p. 423) concluded, while the community charge 'did not conform closely to a benefit principle it similarly [failed] to correspond to an ability to pay criterion'. Authors such as Vanistendael (1996) have also attributed the rejection of the community charge by UK taxpayers directly to its failure to reflect the ability to pay principle. As already stated, tax liability was not related to individuals' financial circumstances (except for some relief for the poorest) and fell relatively heavily on those with the lowest incomes. Not only was such a tax considered by the public to be unfair, but the objections were magnified by the relatively high level of the tax and that a large proportion of the population were made worse off while the media gave attention to the fact that many of the wealthy were made very much better off.

The process of introducing the tax was also likely to increase opposition. Originally it had been thought best to phase the change over a number of years to allow taxpayers and their expectations time to adjust. However in the end it was decided to replace the existing local property tax with the community charge in a single step. This sudden substantial change magnified another reason for the failure of the tax. One of the original intentions was that it should be a direct tax strongly perceptible to taxpayers and thus reduce fiscal illusion. Indeed it did, and its very perceptibility was part of the cause of the vehement adverse public reaction (McGee, 1998). However perceptibility was not the only reason for that response since, of course, other direct taxes, particularly income tax, do not normally arouse the same level of hostility. A further failure was to spend sufficient resources making case for the community charge to the public (Gibson, 1989). Taking the nature of the tax as well as its unfortunate introduction, as Smith (1991, p. 435) concludes, the tax was 'a salutary lesson in the importance of designing tax schemes that enjoy widespread acceptance'.

5. THE ABOLITION OF THE 10% INCOME TAX RATE

More recently in the UK there was the case of the abolition of the lowest rate of income tax of 10%. In 2007, the government proposed to simplify the income tax by increasing the lowest rate to bring it in line with the main 20% rate and this came into effect in 2008. Again there was an intellectual argument on efficiency grounds in terms of simplifying the income tax structure. However, the government failed to anticipate the strength of the adverse public response that it was unfair that taxpayers on low incomes would be starting to pay income tax at 20% rather than 10%. Members of Parliament successfully campaigned against the new arrangement and finally this was modified through an increased personal tax free allowance to compensate those adversely affected. A higher personal allowance is more effective in helping those on low incomes than the 10% tax band since it takes many of those on the lowest incomes out of tax altogether. The eventual result was therefore an improvement (Johnson, 2008) but it would have been far better for tax morale, and the government itself, if more account had been taken of taxpayers' views of fairness at an earlier stage. Instead, the issues involved were left to emerge in a chaotic political process until public opinion finally prevailed, though with unintended side-effects (Adam *et al.,* 2008). There does not seem to be much doubt that taking account of taxpayers' perceptions of fairness at the beginning would have improved the chances of an orderly, well designed and acceptable reform.

6. CONCLUSION

The fiscal experiences examined in this paper indicate that behavioral economics can make a very important contribution to tax reform. The development and implementation of value added tax in the UK provides a major illustration of the advantages of following a balanced approach to tax reform, even if it means considerable modification from the ideal tax in terms of economic efficiency to one that fits more closely to taxpayer views of fairness. VAT in the UK has continued to be a very successful tax even though the main rate has now been increased to 20 per cent. The failure of the community charge in the UK was a vivid and sometimes violent example of the advantages of taking account of taxpayer views on fairness before rather than after a particular tax reform has taken place. However, the political upheaval associated with the abolition of the 10% income tax rate in 2008 suggests there is still considerable room for improvement in the way taxes are reformed. One other conclusion from these experiences is that it is insufficient to assume most taxpayers will make their views known before tax legislation actually takes effect. In the case of VAT there was a deliberate attempt to take account of different views in designing the tax and this worked well. In the case of the community charge, such lobbying as there was during the development of the tax came from very narrow sections of the taxpaying population. Although the form of the community charge was known well before it was actually implemented, the full force of the public response did not come until the tax demands were actually received by taxpayers. By then it was too late to ensure the success of the reform.

Finally, there have been suggestions to the European Commission that VAT exemptions and reduced rates are 'weakness' and 'problems' in the VAT system (see, for example, European Commission, 2011, p.14). In terms of economic efficiency narrowly defined this is undoubtedly true. However, to reform VAT by limiting the scope of such exemptions and reduced rates may run serious risks of adverse taxpayer responses and undesirable outcomes. The UK, having got it right the first time with VAT, may not welcome such a development and its taxpayers certainly would not.

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