Dimensions of tax fairness

Fairness, or equity, embodies the Australian concept of a “fair go” into the tax system. When designing a tax system, fairness is one of the key design considerations **[see our Tax Fact #1, “Principles of tax system design”]**. The 1975 Asprey Review **[1]** discussed two key concepts of fairness:

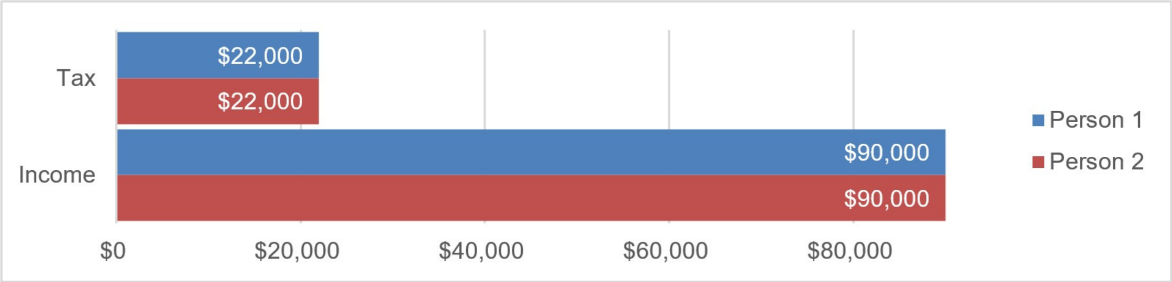
“As a quality of a tax or a tax system everyone demands fairness, or equity. But, in tax matters as in law and ethics, it is an ideal exceedingly difficult to define and harder still to measure. It is customary to distinguish the two dimensions of ‘horizontal’ and ‘vertical’ equity: the notions that it is fair that persons in the same situation should be equally treated, and those in different situations differently treated, with those more favourably placed being required to pay more.”

These concepts have endured the test of time and remain the predominant method to assess the fairness of different taxes in Australia, and indeed the tax and transfer system as a whole. Ideally, horizontal and vertical equity would best be measured with respect to an individual’s *lifetime wealth*. However, as this information is not available, we use current income as a proxy. A third concept is *"user pays"* which reflects that individuals should be charged for services rendered, e.g. rubbish collection or road usage.

Horizontal equity

Taxing people who are in the same situation in the same way is the basis of horizontal equity. Another way to express the concept of horizontal equity is that those with equal abilities to pay taxes should pay an equal amount of tax. For example, most Australians would expect that two people earning $90,000 per year should pay the same amount of tax – this is horizontal equity in practice.

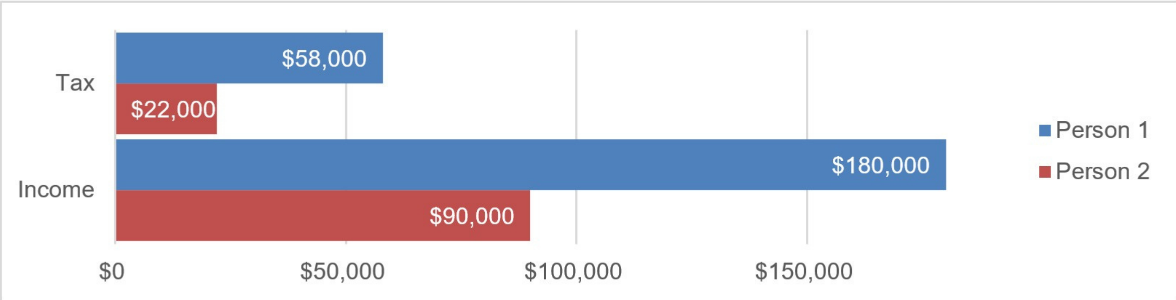
Figure 1. Horizontal equity



Vertical equity

That those with a greater ability to pay taxes should pay more is another widely accepted standard for fairness in a tax system. An example of vertical equity would be where someone who earns twice as much income as another individual pays at least twice as much tax. This is illustrated in Figure 2 where person one pays 2.6 times as much tax as person two.

Figure 2. Vertical equity



The vertical equity of a tax can be summarised as progressive, proportional or regressive. It is important to note that flat and regressive taxes can be combined with redistributive payments (e.g. welfare) to create a progressive system **[see our Tax Fact #20, "What is a progressive tax (and transfer) system?"]**.

Progressive

Figure 2 demonstrates progressive taxation. Where person 1 earns double the income of person 2, person 1 pays more than double the tax because each additional dollar is taxed at a higher rate. Specifically, this is progressive because person 1 earns more and pays 32% of their income in taxes, as compared to person 2 who earns less and pays 24% of their income in taxes. In other words, as someone earns more money they pay progressively higher rates of tax. Australia's personal income tax, which has marginal tax rates that increase with income, is an example of a progressive tax **[see our Tax Fact #19, "What is a progressive tax?"]**.

Proportional (flat)

If Australia had a proportional, or flat, tax on incomes and person 1 earnt twice as much as person 2, they would pay twice as much tax, e.g. less than a progressive tax. Specifically, this is proportional because person 1 and 2 pay the same share of their income (24%) in taxes. A proportional tax still delivers vertical equity, just not as much as a progressive tax. A key example of a proportional tax in Australia is the Goods and Services Tax (GST) which taxes consumption at a flat rate of 10% equally, irrespective of your income or level of wealth.

Regressive

It is unusual for taxes to be nominally regressive – that is, for the rate of tax to reduce as the base (e.g. income, consumption) increases. However some taxes, usually flat taxes, are often criticised for being regressive in practice.

The most famous example in modern history is Margaret Thatcher's "poll tax" which levied a flat dollar charge across Britain. The tax was seen as regressive in practice because it represented a greater proportion of low income individuals' income. The imposition of the tax led to mass non-payment of the charge as a form of protest, undermining trust in the tax system.

One of the criticisms of Australia's GST was that it was regressive in practice because those on lower incomes end up paying a higher proportion of their income in tax (because they consume a larger share of their income). However, as outlined in this tax fact, in judging 'fairness', it is important not to consider taxes in isolation but rather, the tax (and transfer) system in its totality. In the case of the GST, it was introduced alongside compensation payments for those on lower incomes. It is also important when considering the GST to think about impacts over the lifetime.

User pays

The "user pays" principle is that those who benefit most from a government service should pay the most for it. The clearest examples are components of local government rates for services, e.g. rubbish bin collection. An example with a less clear link is paying for car registration which is nominally used to fund road expenditure in state and territory governments (i.e. those without vehicles fund less road spending), however this is better categorised as a flat tax on vehicle ownership. A truly user pays version of registration charges would apply road user charges based upon kilometres driven.

TTPI appreciates the research assistance provided by Carter Sullivan for the preparation of this Tax Fact.

[1] Asprey, K. W., Parsons, R. W, Full Report January 31 1975, Taxation Review Committee Australia, Commonwealth Taxation Review Committee, Commonwealth of Australia, Canberra.

Cite as: TTPI (2021), *Dimensions of tax fairness,* Tax Fact #21, Tax and Transfer Policy Institute, Canberra.

More information

Contact the director at robert.breunig@anu.edu.au | Contact us at tax.policy@anu.edu.au
https://taxpolicy.crawford.anu.edu.au/
Visit our other Tax Facts at https://taxpolicy.crawford.anu.edu.au/taxpolicy-publications/tax-facts