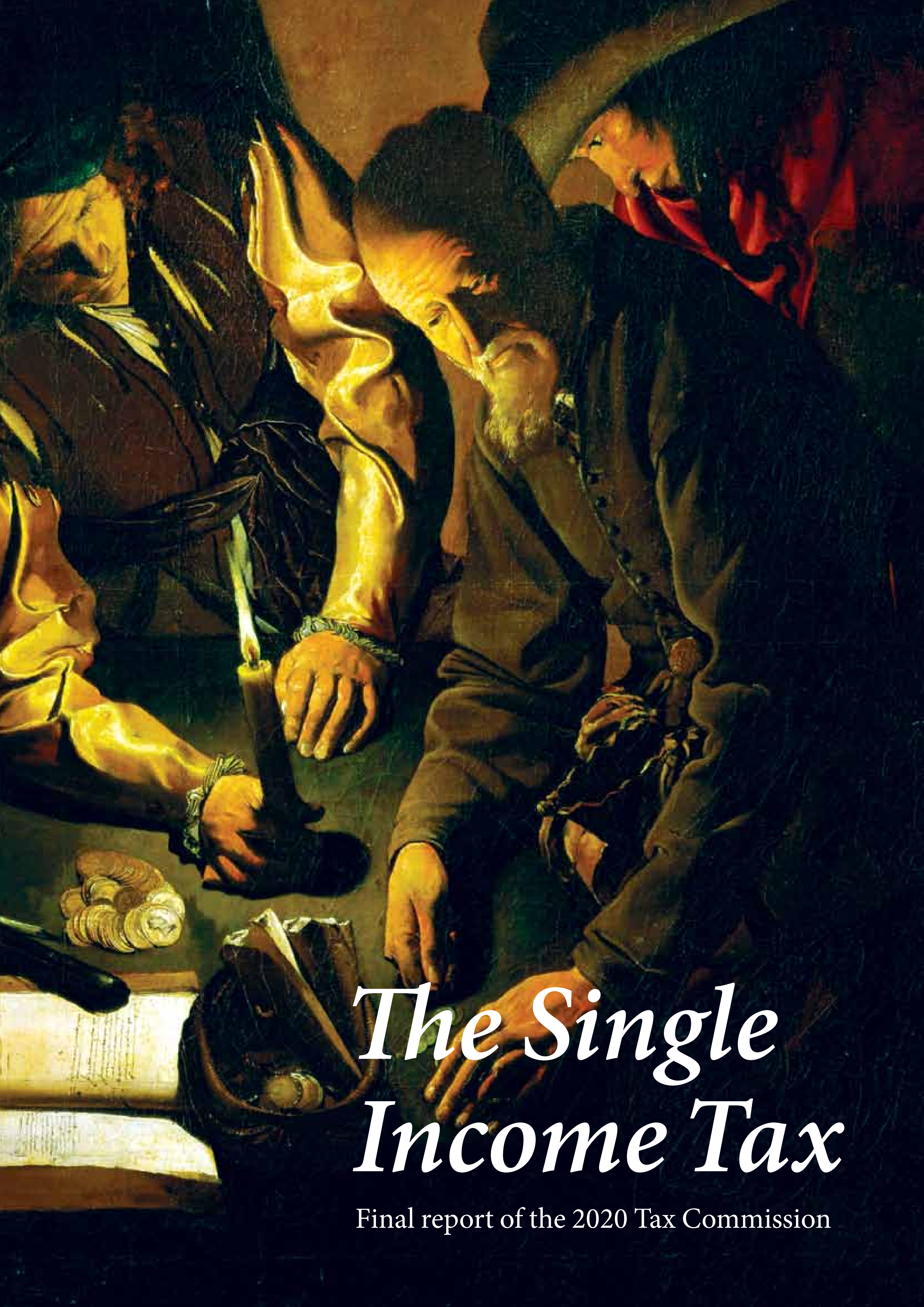


The Single Income Tax

Final report of the 2020 Tax Commission

The TaxPayers' Alliance
55 Tufton Street, London SW1P 3QL
0845 330 9554

info@2020tax.org
www.2020tax.org

The 2020 Tax Commission is part of the TaxPayers' Alliance,
a Company Limited by Guarantee in England No. 04873888

Published May 2012

ISBN 978-0-9563920-2-2

Cover image: *The Payment of Taxes* by Georges de la Tour, c. 1624
(photo: akg-images/Erich Lessing)

Designed by Soapbox, www.soapbox.co.uk

Printed by Impress Print Services, www.impressprint.net

£50.00

The Single Income Tax

Final report of the 2020 Tax Commission

May 2012

Chairman: Allister Heath

Commissioners: Andrew Allum, Richard Baron, Kevin Bell, Rosemary Brown, Mike Denham, Martin Durkin, Matthew Elliott, Anthony J. Evans, David Frost, Graham Hampson Silk, Graeme Leach, Andrew Lilico, Mark Littlewood, Douglas McWilliams, Fraser Nelson, Stephan Shakespeare

Chief Economist: David B. Smith

Principal Editor: Matthew Sinclair

Lead researchers: Rory Meakin, John O'Connell

Other contributors: Eamonn Butler, Scott Corfe, Arvid Malm, Tom Packer, Matt Ridley, Bilal Sambur, Nima Sanandaji, Tino Sanandaji, Corin Taylor, Tom Welsh

tpa The TaxPayers' Alliance

IoD

Prologue

To create the conditions for stronger economic growth and more jobs, while treating taxpayers fairly, the Government must reform taxes to make them lower, simpler and more transparent.

To achieve this, the 2020 Tax Commission recommends the Single Income Tax, which can be introduced in six steps:

1. Taxes should be cut to 33 per cent of national income
2. Marginal tax rates should not exceed 30 per cent, and the personal allowance should rise to £10,000
3. Taxes on capital and labour income disguised as business taxes should be abolished, and replaced with a tax on distributed income
4. Transaction, wealth and inheritance taxes should be abolished
5. Other consumption taxes need to stay for now, but transport taxes should be cut
6. Local authorities should raise half of their spending power from local taxes

Contents

Contents

Forewords

Allister Heath
Editor of *City A.M.* and Chairman of the 2020 Tax Commission

It is time for Britain to make a vital choice. Our economy is stagnant, crippled by excessively high public spending, high levels of leverage, a mismanaged and inefficient public sector, an extraordinarily complex and punitive tax system and a public mood that has become increasingly anti-capitalist. There are two options. We can either decide to tweak the status quo – try and keep a lid on public spending, reform bits of the public sector and hope for the best. The problem with such a soft option is that it may stave off an immediate budgetary crisis but it will condemn Britain to permanent relative economic, social and cultural decline.

Or we can drastically change course: reduce public spending much more significantly, adopt an entirely new tax system fit for the 21st Century and establish the UK as a global trading hub, generating renewed prosperity for all those who live and work here. We at the 2020 Tax Commission are firmly in this second camp: the old order is broken and needs radical reform. But we are also realists: our proposals, while far-reaching, are practical. They are within the realms of what a competent, ambitious and principled government could deliver over the next decade.

Our starting point is the Chancellor's long-term forecasts: he hopes to see public spending as a share of GDP fall from 48 per cent in 2009–10 to 39 per cent by 2016–17 on the Treasury's measure. Our proposals would take this further, reducing public spending to 33 per cent of GDP by 2020 or thereabouts. That will partly be achieved by economic growth, but will require further cuts in public spending as well. It is impossible to detach levels of public spending from tax reform – one of the early findings of the Commission was that it simply was not possible to move towards a truly rational tax system while retaining extremely elevated levels of public spending.

Our next step is to map out a dramatically reformed tax system to raise one third of GDP in tax – we advocate a radical new system that taxes all income from labour and capital only once at a flat rate of 30 per cent, above a generous personal allowance for individuals and with no loopholes. National Insurance and Income Tax are merged into this new system; Corporation Tax, which doesn't work properly and has led to the legitimacy of the entire tax system being questioned, is repealed and replaced by an unavoidable tax on distributed income from capital, be it equity, debt or property. Several other taxes – including Stamp Duty and Inheritance Tax – are also repealed. We also advocate substantially increased fiscal autonomy for local government, explain why wealth and financial transaction taxes are damaging and counter-productive and much else besides. The aim is to produce the simplest and fairest, most economically efficient and transparent tax system possible with limited possibilities for avoidance and a dramatic reduction in the double or even triple-taxation that plagues the current system. However, our findings remain grounded in realism: we decided to retain VAT exactly as it currently is, despite its administrative costs, to keep a lid on marginal tax rates. Yet our revolutionary reforms to the rest of the system, as we explain drawing on the latest economic theory and evidence, would substantially boost economic growth, productivity, investment, jobs, real wages and political accountability.

The level of economic and policy debate has long been poor in the UK. There is very little awareness of the oodles of academic research on how high marginal tax rates or punitive income or capital taxes reduce growth and jobs. There is even less of a debate on the optimal size of government, or on the moral case for small government and lower taxes.

In the very rare instances when they are mentioned, respectable and important studies are dismissed out of hand or not properly understood; the only "moral" arguments ever referred to are those that advocate the state seizing ever greater proportions of individuals' incomes. The report's second big mission is to tackle this poverty of debate head-on. It includes the most comprehensive and thorough review and analysis of the economic, psychological and philosophical literature on the relationship between tax rates, public spending and economic growth and well-being available anywhere. We cite and refer to many dozens of reputable studies from academics from all over the world and the message is loud and clear: the current levels of spending and tax are dangerously high and need to come down. Many of the taxes currently in place or being proposed have been shown to be bad for the economy and public welfare. Last but not least, we draw on the lessons from previous tax reforms and political history to show how change can be implemented – and how it can help those politicians brave enough to advocate it.

I wish to extend my warmest thanks to the TaxPayers' Alliance and the Institute of Directors for making this outstanding piece of work possible – and to all of the 2020 Tax Commission's commissioners, staff and witnesses for their hard work, rigour and unstinting effort and good humour over the past two years. I heartily recommend this report to all readers – it is the blueprint for the tax revolution Britain so desperately needs.

Allister Heath, May 2012

Matthew Elliott
Co-founder and Chief Executive of the TaxPayers' Alliance

The first priority of the Government has to be creating the conditions for stronger economic growth. Everything from keeping your home warm to driving to work has become more and more expensive but wages haven't kept up so families have been left struggling to make ends meet. Too many parents worry that their children won't enjoy the same opportunities they did, while saving for your retirement too often looks like a mug's game.

The tax system can't just maximise economic growth though. It has to be fair, and seen to be fair. At the moment too many taxes that really affect people's standard of living are hidden away in higher prices, or disguised as levies on business. And despite counterproductive high tax rates on the rich, many taxpayers have a sense that they exploit loopholes and don't pay their fair share.

The Single Income Tax can change all that: a single tax on labour and capital income, at the same rate; abolishing eight taxes and creating only one in return; a much simpler and more transparent tax code. It is a serious plan for a tax system that can restore Britain's economic fortunes.

Matthew Elliott

Graeme Leach
Chief Economist and Director of Policy at the Institute of Directors

The UK tax system undermines competitiveness. The tax burden is too high and far too complex and fundamental change is required to make it fit for purpose in the 21st Century. One of the key reasons the IoD has joined forces with the TaxPayers' Alliance, to form the 2020 Tax Commission, is the belief that tax will be a more important issue in the future than in the past. Flexible labour markets, structural change and the global economy suggest that future economic behaviour will be more sensitive to tax influences.

The 2020 Tax Commission project is exciting because it sets out a future tax system that really could transform the UK's competitiveness and boost the incentive to work, save and invest. We recognise the challenges to implementing the 2020 Tax Commission's proposals, but the economic rewards surely justify the effort. We hope you agree.

Graeme Leach

Biographies of the Commissioners

Biographies of the Commissioners

Allister Heath, Editor of *City A.M.* and Chairman of the 2020 Tax Commission

Allister Heath is Editor of *City A.M.*, the daily business newspaper distributed in and around London and available worldwide at www.cityam.com. Under his editorship, the paper, which has now grown to a print circulation of around 130,000 copies per day, has become an influential voice in London's business community. Heath's trenchant daily column in the paper covers economics, finance, politics, geopolitics, business strategy and other subjects and has gathered an increasingly large following.

He has long had an interest in tax reform. His first book *A Flat Tax: Towards a British model*, with a foreword by Steve Forbes, was published in 2006.

Heath has become an increasingly regular presence on British TV and radio, with recent appearances on BBC Radio Four's *Today* Programme; BBC Two's *Newsnight* and *Daily Politics*; the BBC and ITV News Bulletins; the BBC News Channel; Sky News; and CNBC, among others. Heath is a frequent public speaker and conference chairman, specialising in the UK and global economy, the outlook for the City, business trends and financial literacy. In addition to *City A.M.*, he has written for a wide range of newspapers. He also serves as a contributing editor of *The Spectator*.

He was awarded the 2011 Free Enterprise Award by the Institute of Economic Affairs and was voted the 2012 SIMA Financial Journalist of the Year in the City of London Wealth Management Awards. Prior to taking over at *City A.M.* in March 2008, he was Editor of *The Business* magazine. He was also a regular contributor to *The Scotsman* and *Scotland on Sunday*. While at *The Business*, he also served a two-year term as a Wincott visiting professor of financial journalism at the University of Buckingham.

Heath was born and schooled in France. He moved to the UK to attend university, graduating with a BSc in economics from the London School of Economics and an M.Phil in economics from Hertford College, Oxford.

Andrew Allum, Co-founder and Chairman of the TaxPayers' Alliance

Andrew Allum is Co-founder and Chairman of the TaxPayers' Alliance. He currently works as a Partner at a leading strategy consulting firm.

Richard Baron, Head of Taxation at the Institute of Directors

Richard has worked as a tax professional in a variety of roles for over 20 years. He was Head of Taxation at the IoD from 1996 to 2002, and then spent three years working on corporation tax policy for HM Revenue & Customs. He returned to the IoD as Head of Taxation in 2005.

Kevin Bell, Chairman of Maitland Political and Trustee of the Institute of Economic Affairs

Kevin Bell is the Chairman of Maitland Political; former President of Fleishman-Hillard UK, Africa, and the Middle East; and a trustee of the Institute of Economic Affairs (IEA). He began his career with Michael Forsyth Associates in 1980, was a founding director of Westminster Strategy in 1987 before establishing Lowe Bell Political (later Bell Pottinger Public Affairs) in 1994.

Rosemary Brown OBE, Chairman of the Gabbitas, Truman & Thring Educational Trust
Rosemary has wide-ranging business, public sector, media and voluntary work experience. Among other senior roles, she was Founder and Managing Director of Enterprise Dynamics Ltd., Executive Chairman of Gabbitas Educational Consultants Ltd., Board member of the Occupational Pensions Board and is currently Chairman of the Gabbitas, Truman & Thring Educational Trust.

Mike Denham, Research Fellow at the TaxPayers' Alliance
Mike Denham is a former Treasury economist who has worked extensively on public spending and fiscal analysis. He also worked in the City as an investment manager, closely following fiscal and monetary policy developments.

Martin Durkin, Managing Director at WAG TV
Martin Durkin is film producer and media entrepreneur. He has produced and directed many factual TV programmes for Channel 4, the BBC, Discovery, National Geographic and other broadcasters.

Matthew Elliott, Co-founder and Chief Executive of the TaxPayers' Alliance
Matthew launched the TaxPayers' Alliance in 2004 and Big Brother Watch in 2009. In September 2010, Matthew took a sabbatical from the TPA and BBW to lead the NOtoAV campaign in the nationwide referendum on changing Britain's electoral system. The NO campaign defeated proposals to introduce the Alternative Vote by 67.9 per cent to 32.1 per cent.

Anthony J. Evans, Associate Professor of Economics at ESCP Europe Business School
Anthony J. Evans is Associate Professor of Economics at ESCP Europe Business School. His research interests are in corporate entrepreneurship, monetary theory, and transitional markets. He has published in numerous journals and co-authored a book called *The Neoliberal Revolution in Eastern Europe: Economic Ideas in the Transition from Communism*.

David Frost CBE, Chairman of the National Centre for Entrepreneurship in Education and Trustee of Ufi Charitable Trust
David Frost is the former Director General of the British Chambers of Commerce. Prior to this he was Chief Executive of Coventry and Warwickshire Chamber of Commerce and Business Link. He is a member of the National Employer Advisory Board for the Reserve Forces.

Graham Hampson Silk, Chairman of Hampson Holdings
Graham Hampson Silk is Chairman of Hampson Holdings, a private company with investments in a number of varied businesses across the UK. He has invested in many new, smaller organisations to help them develop and grow. Graham now spends a great deal of time chairing the blood cancer charity he founded.

Graeme Leach, Chief Economist and Director of Policy at the Institute of Directors

Graeme Leach is Chief Economist and Director of Policy at the Institute of Directors, which he joined in 1998. Prior to joining the IoD, he was an economics director and managing editor of futures publications at the Henley Centre. In 1998 he was awarded the WPP Atticus Award for original published thinking.

Andrew Lilico, Director and Principal at Europe Economics

Dr Andrew Lilico is a Director and Principal of Europe Economics where he has directed major projects on financial services regulation, the cost of capital, pharmaceuticals, competition, and impact assessment. He has also published working papers on short selling, risk-sharing contracts in pharmaceuticals, housing, debt, and the regulation of markets with short-sighted agents.

Mark Littlewood, Director General of the Institute of Economic Affairs

Mark has worked in political communications, public relations and public affairs – variously for the European Movement, the Environment Agency and the London Bus Initiative. Mark has also been Head of Media for the Liberal Democrats. Mark became the IEA's fourth Director General in December 2009.

Douglas McWilliams, Chief Executive of the Centre for Economics and Business Research

Douglas McWilliams is Chief Executive of the CEBR, one of the UK's leading specialist economics consultancies, which he founded in 1993. He was the Chief Economic Adviser to the Confederation of British Industry from 1988 to 1992, Chief Economist for IBM UK (1986–88) and in the 12 years to 1986 held various posts at the CBI.

Fraser Nelson, Editor of *The Spectator*

Fraser Nelson is Editor of *The Spectator* and a columnist for the *Daily Telegraph*. A journalist for 15 years, he started as a business correspondent for *The Times* and was Political Editor at *The Scotsman* before joining *The Spectator* in 2006 as the magazine's Political Editor.

Stephan Shakespeare, Co-founder and Chief Executive Officer of YouGov plc

Stephan is Chief Executive Officer and Co-founder of YouGov plc, a leading market research and polling company. Stephan is one of the pioneers of Internet research and drives the company's innovation-led strategy.

Matthew Sinclair, Director of the TaxPayers' Alliance

Matthew Sinclair is the Director of the TaxPayers' Alliance, responsible for managing its day-to-day research and campaigning work. He edited the book *How to Cut Public Spending (and Still Win an Election)* and wrote *Let Them Eat Carbon*, both published by Biteback Publishing, and has produced a wide range of influential research.

David B. Smith, Beacon Economic Forecasting and Derby Business School

David B. Smith studied Economics at Trinity College, Cambridge and the University of Essex. He was then employed for nearly four decades as an economist in the City of London, starting at the Bank of England. David is currently a Visiting Professor in Business and Economic Forecasting at the University of Derby and chairman of the IEA Shadow Monetary Policy Committee, and maintains his own macroeconomic model of the international and UK economies at Beacon Economic Forecasting.

Chapter one

Recommendations

1. Recommendations

To create the conditions for stronger economic growth and more jobs, while treating taxpayers fairly, the Government must reform taxes to make them lower, simpler and more transparent.

To achieve this, six steps are needed:

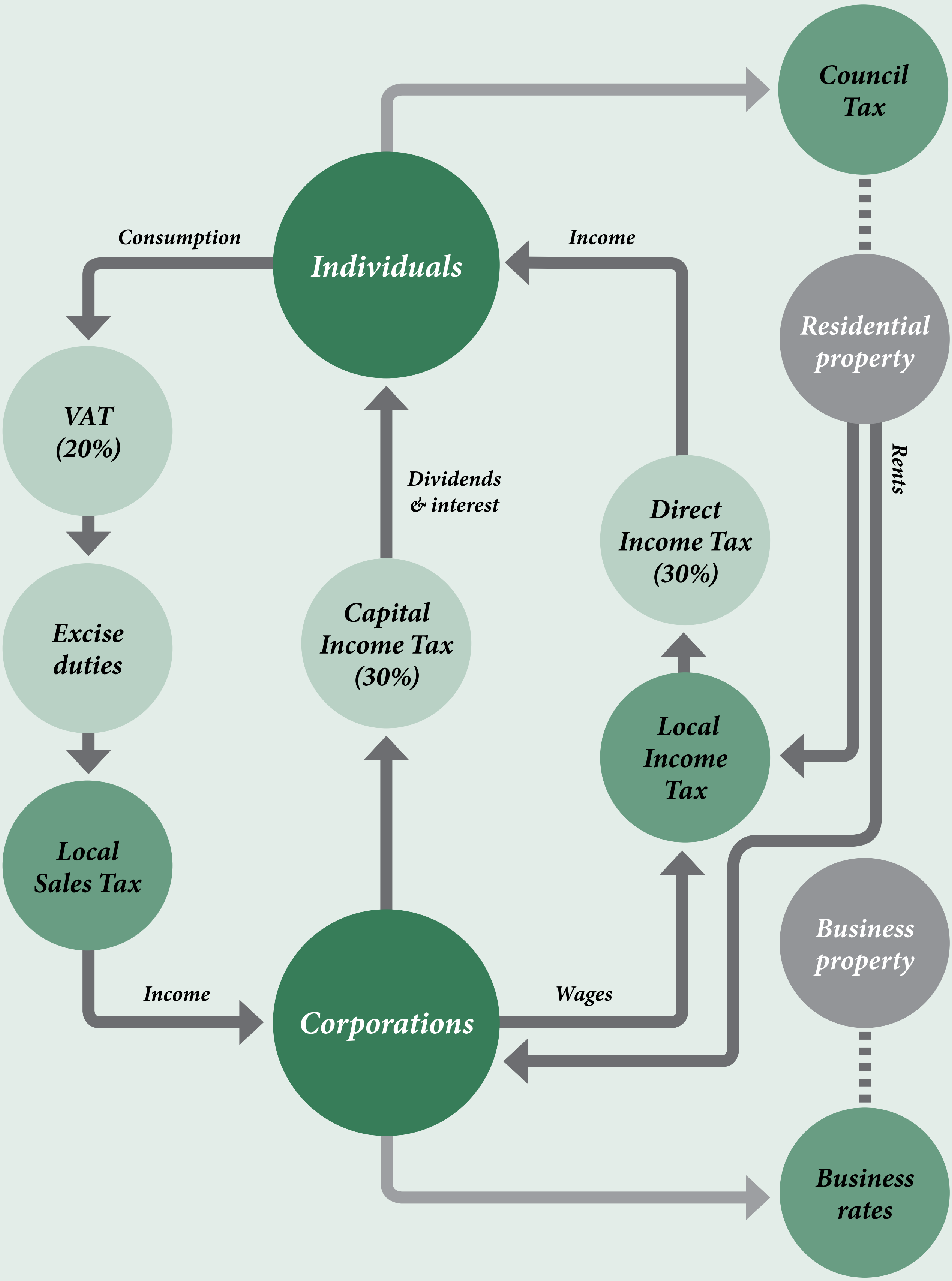
Marginal tax rates should not exceed 30 per cent

- Taxes should be cut to 33 per cent of national income (Chapter 3)
- Marginal tax rates should not exceed 30 per cent, and the personal allowance should rise to £10,000 (Chapter 4)
- Taxes on capital and labour income disguised as business taxes should be abolished, and replaced with a tax on distributed income (Chapter 5)
- Transaction, wealth and inheritance taxes should be abolished (Chapter 6)
- Other consumption taxes need to stay for now, but transport taxes should be cut (Chapter 7)
- Local authorities should raise half of their spending power from local taxes (Chapter 8)

The tax system in Britain is highly dysfunctional. Marginal rates – the amounts that people pay on each additional pound of income – are much too high, with even those in poverty paying combined rates of around 40 per cent. That distorts behaviours away from creating jobs, growth and wealth. The tax code is highly complex. No taxpayer has a realistic prospect of assessing how much they pay. And revenue is underwhelming given how many taxes are set at high rates. The 2020 Tax Commission's reforms would change that and they can be enacted through a practical set of policies:

- Cutting the ratio of spending and taxation to 33 per cent of national income, supported by reforms including:
  - Introducing spending targets
  - Reflecting the cost of raising revenue in spending decisions
- Levying a single tax on labour and capital income:
  - Abolishing Employees' and Employers' National Insurance contributions, and merging them into a single tax on labour income at a rate of 30 per cent – with arrangements to ensure the abolition of Employers' National Insurance is reflected in salaries but does not artificially inflate benefits
  - Abolishing Corporation Tax and Capital Gains Tax and replacing them with a single tax on capital income – dividends, interest and rent – at a rate of 30 per cent
- Abolishing Inheritance Tax, Stamp Duty Land Tax and stamp taxes on shares
- Cutting Fuel Duty by 5p a litre and abolishing Air Passenger Duty
- Cutting local authority grant funding such that they raise 50 per cent of their spending power locally, allowing further cuts in national taxes, and giving them new powers to raise necessary revenue:
  - A Local Income Tax
  - A Local Sales Tax
  - Decentralisation of non-domestic rates

Figure 1.1: Streams of income and national and local taxes under the Single Income Tax



Those proposals would result in substantial tax cuts for households across the income distribution (Section 4.3.1). A two earner household, with an income of around £28,000, would receive a tax cut of around £3,400, for example.

The 2020 Tax Commission also proposes introducing a Family Transferable Allowance to ensure fair treatment of families with children or a single earner, allowing them to transfer part of their personal allowance.

The final tax system proposed would, as far as possible, tax each stream of income once at a reasonable rate, rather than allowing some to avoid tax entirely while others are taxed repeatedly. The way in which different streams of income would be taxed is shown in Figure 1.1.

Earlier reviews have suggested potential tax reforms in Britain and other countries (Appendix), but the recommendations of the 2020 Tax Commission are distinctive in a number of ways:

- **Tax cuts**. These proposals are not revenue neutral. The dysfunction of the tax system is to a large extent an inescapable function of the amount of revenue it is trying to raise. Tax reforms also need to be not just fiscally and technically practical, but also politically possible. Tax reforms without tax cuts will always be politically vulnerable, while tax cuts without tax reform are a missed opportunity.
- **Transparency**. Jean-Baptiste Colbert was famously quoted as saying that: "The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least possible amount of hissing."[1] That approach creates two problems. It undermines the legitimacy of the system as people are unable to understand their relative position overall and often believe they are being unfairly singled out. It also means that they do not fully appreciate the amount they are paying and the price they are paying for public spending, as well as distorting decisions over how best to raise necessary revenue.
- **Taxing income once**. In order to ensure that everyone pays their fair share and avoids distortions, politicians can take two approaches: levy lots of taxes on the grounds that if people manage to avoid some of them, some revenue will still be collected by other taxes. Or, as far as possible, tax each stream of income once and keep the system simple to limit the number of loopholes that can be used to avoid tax. The former approach can work but has contributed to undermining the legitimacy of the British tax system, as people see others avoiding taxes. It also means some people are taxed repeatedly which is unfair.
- **Proportionality**. We believe that it is fair that if someone earns twice as much, they should pay twice as much in tax, except for a personal allowance that means low earners in particular pay less or no tax at all. That will also allow for a simpler and more efficient tax code.
- **Avoiding dry tax charges**. Taxes that do not fall on flows of income, but other things like property, will not necessarily affect those best able to pay them, when they are best able to pay them. The 2020 Tax Commission's proposals are intended to tax flows of income, where those engaged in the transaction will have money on hand to pay the taxes. That means property rights will not be reopened by the tax system.

1. The original source is unclear but the quote, in French, is: "*L'art de l'imposition consiste à plumer l'oie pour obtenir le plus possible de plumes avec le moins possible de cris*".

The overall economic results would be impressive. Dynamic modelling by the Centre for Economics and Business Research (CEBR) has found that, if the measures were introduced with no spending cuts:

- After five years, GDP would be 1.8 per cent higher; business investment would be 14.6 per cent higher; and public sector net borrowing would be £23.1 billion a year higher.
- After 10 years, GDP would be 5.9 per cent higher; business investment would be 26.0 per cent higher; and public sector net borrowing would be £6.9 billion a year higher.
- After 15 years, GDP would be 8.4 per cent higher; business investment would be 61.2 per cent higher; and public sector net borrowing would be £35 billion a year lower.

The proposals would need to be phased in and/or accompanied by further restraint in public spending, but the economic results are impressive. The increase in GDP of 8.4 per cent after 15 years is equivalent to an additional nearly £5,000 per family in 2012–13.[2]

Chapter 2 looks at the background: how the government finances its spending; how spending and taxes have increased across the developed world; how spending and taxes have increased particularly dramatically in Britain recently; how the complexity of taxes exacerbates that burden; and the philosophical approaches to understanding ethical concerns raised by tax policy that will be used throughout the report.

After that, the remaining chapters look at each of the proposed changes, setting out the results that can be expected, the reasons they are needed and a detailed explanation of how the new taxes could be implemented.

1.1. Implementing the 2020 Tax Commission's overall proposals can be practical, productive and fiscally responsible

While the rest of this report looks at the evidence for the likely economic effects of the individual 2020 Tax Commission proposals, the CEBR has also looked at the overall effect using the dynamic model of the UK economy it developed for an earlier TaxPayers' Alliance report.[3] The nature of that dynamic modelling, and the impressive results, are set out in Section 1.1.1.

After that, Section 1.1.2 looks briefly at the transitional arrangements that might be needed to implement the 2020 Tax Commission proposals.

1.1.1. The overall economic results of the 2020 Tax Commission recommendations

The CEBR points out that modelling of this kind is a more approximate process than normal economic modelling because the academic research tends to show that most of the behavioural changes only take place after a long period of time. Because they take so long to appear fully, their impacts tend to be difficult to test statistically and

2. Based on 8.4 per cent of 2012–13 nominal GDP, which was estimated to be £1,576 billion in Budget 2012.
3. *The dynamic impact of the 2007 Budget and a comparison with the impact of gradually introducing an Irish level of corporation tax*, TaxPayers' Alliance, April 2007

so the elasticities are central estimates within large margins. Despite this, the use of dynamic modelling is essential to understand the impact of major tax changes, since otherwise the full impacts of such changes are unknown.

1.1.1.1. The dynamic model of the UK economy

This section describes the integration of supply side effects from taxation changes into UKMOD, the CEBR macroeconomic model of the UK economy.

1.1.1.1.1. A brief description of UKMOD

UKMOD is the CEBR's model of the UK economy. It is an integrated macroeconomic model which reflects the relationships in the economy between its different sectors such as consumers, producers, government, trade, investment and capital markets.

Its basic approach is a conventional monetarist/Keynesian one, using interest rates to bring supply and demand into equilibrium and to stabilise inflation.

The supply side in the model is the overseas side, with the trade equations providing the response of supply to changes in the economy and in demand.

1.1.1.1.2. Areas to be changed to incorporate the supply side

Based on research into the impact of tax on the economy, it was decided to adjust the following areas of the model:

- The production function, so as to incorporate the possibility of a shift from the shadow economy into the measured and taxed economy depending on the burden of taxation;
- The labour supply function, to integrate an incentive to work element, which depends on post tax income;
- Corporate investment, to make investment dependent on the corporate tax regime (mainly for internationally footloose investment); and
- The trade account, to make UK net exports a function of the UK's competitiveness, into which the overall tax burden was an element.

1.1.1.1.3. Elasticities

The adjustments to the model were made to achieve the following elasticities:

- An elasticity with respect to the overall tax burden of -0.4 after five years for shifting between the shadow economy and the real economy;
- An elasticity of the labour supply with respect to marginal disposable incomes of 0.6 on labour supply after five years;
- An elasticity of business investment with respect to the corporate tax burden of -0.5;
- An elasticity through the competitiveness route that would influence net exports sufficiently to change GDP by -0.15 per cent after 10 years with respect to a unit change in the tax burden.

In all these calculations, the tax burden is measured as government receipts as a percentage of GDP.

1.1.1.2. The results produced using dynamic modelling

The Tax Commission's proposed changes were modelled making the following simplifying assumptions:

- The tax changes are implemented in 2013 in their entirety;
- Because ultimately the tax changes will generate increased revenue, the first round assumption is of no public spending cuts to finance them. In fact the modelling shows that the ultimate beneficial impact of increased revenue largely comes about between year 10 and year 15 after the tax changes are implemented, so one clear lesson from this modelling exercise is that there would need to be some spending adjustments initially and that the tax changes should probably be phased in.

The base run for the economy is the CEBR's April 2012 forecasts. The short term results of this are included in the CEBR's contribution to HM Treasury's Comparison of Economic Forecasts, April 2012. The long run forecasts are from the CEBR's official forecasts for the Rail Industry.[4] The years beyond 2018 are assumed in the base run to have a constant rate of growth at the UK's rate of growth of productive potential. This is not a forecast but a conventional modelling assumption. In practice, growth is likely to be much more cyclical.

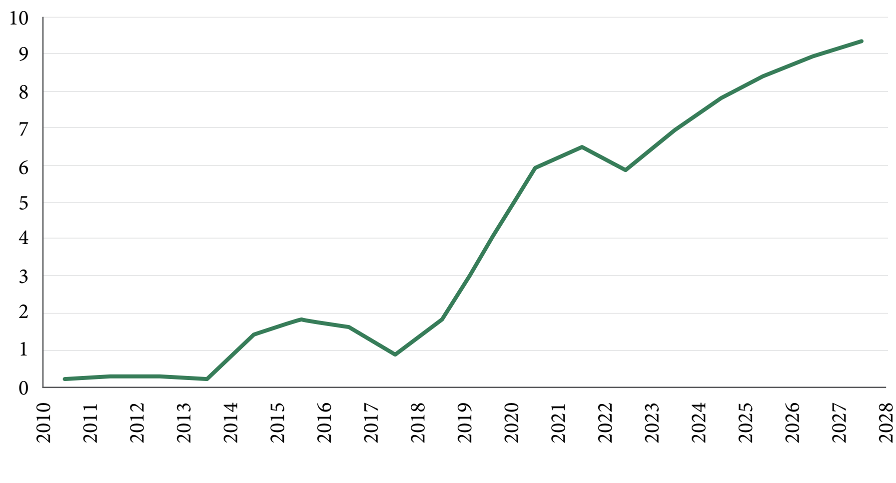
The effects of the simulation are to create a cycle. This is an automatic modelling assumption because models are designed to produce cyclical responses to economic stimuli. Obviously if there were such cyclical effects in real life, policy would be expected to adjust to smooth them out.

The results are impressive. Ultimately, in 2030, GDP is 9.3 per cent higher

The results are impressive. First, GDP is boosted in each year by the changes. Ultimately, in 2030 GDP is 9.3 per cent higher and the growth rate is permanently about 0.4 per cent of GDP higher than would otherwise be the case. This is shown in Figure 1.2. The boost to GDP is relatively small in the first five years but then starts to build up and is particularly strong in the period between five and 15 years after the changes are announced.

The most significant effect of the tax changes is to boost business investment. Here the effect is dramatic for two different reasons. First, the boost to the economy from the tax reduction is at its biggest in its impact on business investment. This is a standard result from most economic research as the economic incentives to invest change. Second, the boost to GDP from a range of different sources also itself boosts investment, which is highly procyclical.

Figure 1.2: Cumulative Impact on GDP from Tax Commission Proposals, % difference from base case



4. These forecasts are produced for the UK rail industry, the Department for Transport and the Train Operating Companies. For commercial reasons the forecast detail is unpublished.

As Table 1.1 shows, the impact on business investment is particularly large in the period between 10 and 15 years after the introduction of the Single Income Tax. Thereafter it levels off at just over 60 per cent above the level of investment in the base case.

The impact on public finances is also interesting. Obviously the initial effect is to increase the deficit. In the first year, the impact is – without either phasing in the tax changes or cutting public spending – to boost the deficit by £49.1 billion. But this impact is more than halved after five years to only £23.1 billion, and virtually disappears to only £6.9 billion after 10 years. After 15 years, the proposals actually reduce overall public borrowing by £35 billion and continue to do so by an amount that increases by approximately £5 billion a year beyond the period shown in Table 1.1.

The reason that these tax changes eventually cut public borrowing (and by implication eventually cut the stock of public debt) is that they reduce the scale of the shadow economy, increase the incentive to work and boost economic growth. All of these increase tax receipts.

Table 1.1: Impact of Tax Commission Proposals, for GDP and business investment percentage difference from base run, for PSNB difference from base run for financial year in £ billions

	GDP (%)	Business Investment (%)	PSNB (£bn)
After five years	1.8	14.6	23.1
After 10 years	5.9	26.0	6.9
After 15 years	8.4	61.2	-35.0
After 17 years	9.3	60.3	-33.2

The dynamic modelling suggests an order of magnitude by which the UK economy could be transformed if the 2020 Tax Commission proposals were implemented. While spending restraint, or a phasing in of the tax cuts, would be necessary (Section 3.6), the proposals would not endanger the long term health of the public finances.

1.1.2. Timeline for the transition

The timing for the introduction of the 2020 Tax Commission's proposals would obviously depend in large part on when the Government intended to introduce them, and felt they were affordable. However there would need to be a delay before the introduction of some of the recommendations, so that individuals and businesses that have made decisions based on the current tax system do not face too much disruption. Other measures would have to take immediate effect when they were announced, to avoid freezing markets.

A timeline for implementation of the key recommendations is set out in Table 1.2, based on the assumption that the process begins in the 2013 Budget.

That timeline is based purely on structural considerations. Many of the measures could be delayed if that were felt to be more practical for fiscal or political reasons, while the dynamic modelling does suggest there would need to be some kind of phased adjustment while new restraint is placed on public spending. But there is no structural reason why they have to be introduced in a certain year.

It would be important that Stamp Duty Land Tax, stamp taxes on shares and particularly Capital Gains Tax are abolished quickly after those policies are announced; and that some time is allowed for an adjustment to the new taxes on labour and capital income. There are no real timing concerns with cuts to Fuel Duty or the abolition of Inheritance Tax and Air Passenger Duty.

While we think the main transitional arrangement needed for highly leveraged firms is a simple delay, if problems remain there could be some kind of discount or exception for legacy debt.

Some of the measures proposed in this report, particularly around the detail of the changes to capital taxation, may violate existing EU rules. Reconciling the proposed changes with that set of regulations, and making proper amendments to bilateral tax treaties to reflect changes like the abolition of National Insurance, would take some work and may introduce further delays. However there is no fundamental clash with the spirit of Single Market regulation and the Government should not be dissuaded from effective tax reforms by any unreasonable regulatory obstacles.

Table 1.2: Timeline for the introduction of 2020 Tax Commission proposals

Recommendation	Year	Timing
Increase the transparency of Employers' National Insurance	2013	Those changes should be made as soon as possible, to maximise the amount of time in which greater transparency can help the public understand the incidence of Employers' National Insurance and the nature of the change being made
Merge Income Tax and National Insurance and cut the rate to 30 per cent	2016	There will need to be a delay in order for pay and pensions to be adjusted to reflect Employers' National Insurance being incorporated in earnings. While some earnings may be delayed, that is normal with other changes such as the introduction and potential repeal of the additional rate
Replace Corporation Tax with a capital income tax	2016	There will need to be a delay in order for firms to adjust to the change in the tax treatment of debt interest, in particular. There will need to be some anti-avoidance measures to limit the shifting of profits, particularly within the year the measure is introduced
Abolish Inheritance Tax	2013	No serious timing concerns
Cut Fuel Duty by 5p a litre	2014–18	1p a year over five years
Abolish Air Passenger Duty	2013	No serious timing concerns
Abolish Capital Gains Tax	2013	Implement immediately
Abolish stamp taxes on shares	2013	Implement immediately
Abolish Stamp Duty Land Tax	2013	Implement immediately

Chapter two

Taxes in Britain are too high and have become increasingly complicated

2. Taxes in Britain are too high and have become increasingly complicated

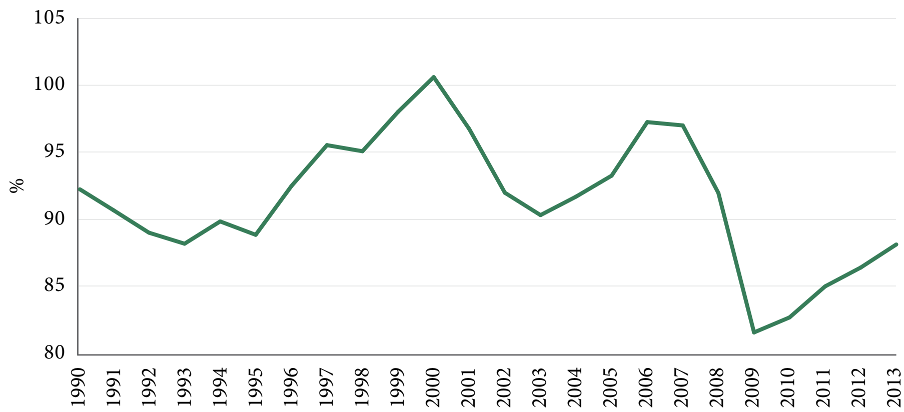
2.1. Governments have to pay for their spending by taxing, borrowing, printing money or owning assets

Virtually all public spending has to be paid for directly by families and businesses

The state has few assets of its own that generate an income.[5] Virtually all public spending has to be paid for directly by families and businesses, or funded through the domestic and international capital markets, and more taxes in the future. There are three basic methods by which government spending can be financed. The most important is taxation, which is the main concern of this report. The next most important method is through borrowing in the bond markets. The consequences of public sector debt and deficits are considered in Section 3.6.

The third way of funding public expenditure consists of borrowing from the banking sector, including the central bank. Borrowing from the central bank used to be known as resorting to the printing press and has frequently been associated with hyperinflation in the past. Until recently, this third option was regarded as a historic curiosity, associated with the two World Wars and their immediate aftermaths. However, there is now an active international debate as to how far the Quantitative Easing (QE) engaged in by leading central banks since 2008 is its modern equivalent.

Figure 2.1: Proportion of OECD area general government expenditure funded out of taxes and non-tax receipts, 1990–2011, with OECD forecasts for 2012 and 2013



After the First World War, buying and selling government debt was more common and a legitimate monetary tool to inject or remove liquidity from the banking system. However, this differs from the present situation for four reasons: the government debt stock then resulted specifically from the First World War, not ongoing budget deficits; government spending was less than half the share of national income

5. Historically, monarchs used to derive much of their income from the ownership of land, the 'Royal Domain'. In addition, state-controlled railways in Continental Europe and Britain's post office and municipally-owned water and gas works generated revenues in the 19th Century. The rent, interest and dividend receipts of the state are now around two per cent of national income in the UK and 3.1 per cent in the OECD area as a whole.

it is today and did not exceed the taxable capacity of the economy (Section 3.1.1.1); governments were committed to balanced budgets, which limited the future supply of debt; and the gold standard meant that the price level was tethered, so that covert default through inflation or devaluation was not an option.

The main justification for QE nowadays is to prevent a collapse in commercial banks' balance sheets in the aftermath of the 2008 global financial crash, but over time concerns are likely to grow that QE could be being abused to monetise debt resulting from overspending, while disregarding the longer-term inflation risks.

Despite these alternative funding methods, taxation remains the predominant source of finance in most developed countries, followed by funding through bonds and instruments such as National Savings. In the 32 OECD economies, taxes paid for 78 per cent of general government expenditure in 2011, while taxes and non-tax receipts paid for 85 per cent. This left the typical OECD economy with a general government financial deficit of 6.6 per cent of national income last year.

2.2. Taxes and spending rose substantially in developed countries over the 20th Century

Table 2.1 shows the ratio of general government expenditure to the market price measure of national output back to the late 19th Century for a range of leading industrial countries.[6]

The broad trend of a massive rise in the share of government in national output is clear, with public spending in the 12 economies for which continuous data exists increasing from 10.7 per cent in the late 19th Century to 46.8 per cent in 2010 as a share of national income.

There are also substantial differences in the spending ratios in 2011. Switzerland has a spending ratio of 34 per cent and its neighbour France a spending ratio of 56.2 per cent, for example. There have been sharp increases in the British and US spending ratios in the 21st Century, while the increase in Germany has been far smaller. Germany's social market capitalism used to be contrasted with more liberal economic policy in Britain and the United States, but Britain has had a higher spending ratio than Germany since 2007, before the global financial crash.

Unfortunately, it is not possible to get long run figures for the tax burden in such a wide range of countries as far back as the spending figures used in Table 2.1. The conventional wisdom in favour of balanced budgets between the late 19th Century and the mid-1960s probably means that the spending and tax burdens developed in parallel for much of that period, apart from during the World Wars and the depression of the 1930s. Tanzi summarises the situation:[7]

> *There had been significant increases in the levels of taxation during World War I (to finance part of the huge spending for the war), followed by slow growth until World War II when, as happened in the First World War, but in larger amounts, taxes were increased to finance the new war. Tax levels*

6. Tanzi, V. & Schuknecht, L., *Public Spending in the 20th century: A Global Perspective*, Cambridge University Press, 2000. The historic figures have been updated using OECD data. There are noticeable discrepancies between the Tanzi and Schuknecht data and the most recent OECD figures for the overlap year of 1996, apparently as a result of new ways of calculating national accounts. This means that the figures should be regarded as illustrative only. The 2010 figure for Ireland has been distorted by the bank bailout and the 2011 New Zealand figure by the Christchurch earthquake. The OECD forecast for the New Zealand spending ratio in 2012 is a more representative 43.5 per cent.
7. *Op. cit*

for general government were only 11 per cent of Gross National Product (GNP) in 1925–29 in the United States; 20 per cent in France in 1924–25; and less than 10 per cent until 1930 and still below 20 per cent up to 1950 in Sweden. They were about 25 per cent of GNP in 1924–25 and around 30 per cent of GNP in the 1960s in the United Kingdom. In the United States, they were around 28 per cent of GNP in the 1960s, a large increase from the 1920s.

Table 2.1: Ratios of general government expenditure, including transfers, to money GDP at market prices, %

	1870	1913	1920	1937	1960	1980	2000	2010	2011
Australia	18.3	16.5	19.3	14.8	21.2	34.1	33.9	36.4	35.0
Austria	10.5	17.0	14.7	20.6	35.7	48.1	51.9	52.6	51.7
Belgium	–	13.8	–	21.8	30.3	58.6	49.1	52.9	52.2
Canada	–	–	16.7	25.0	28.6	38.8	41.1	44.1	43.2
France	12.6	17.0	27.6	29.0	34.6	46.1	51.6	56.7	56.2
Germany	10.0	14.8	25.0	34.1	32.4	47.9	45.1	48.0	45.5
Italy	13.7	17.1	30.1	31.1	30.1	42.1	45.9	50.3	50.1
Ireland	–	–	–	–	28.0	48.9	31.2	66.8	45.9
Japan	8.8	8.3	14.8	25.4	17.5	32.0	39.0	40.4	42.5
Netherlands	9.1	9.0	13.5	19.0	33.7	55.2	44.1	51.2	50.5
New Zealand	–	–	24.6	25.3	26.9	38.1	38.3	43.1	49.3
Norway	5.9	9.3	16.0	11.8	29.9	43.8	42.3	46.1	43.8
Spain	–	8.3	9.3	18.4	18.8	32.2	39.2	45.6	42.7
Sweden	5.7	10.4	10.9	16.5	31.0	60.1	55.1	52.9	51.8
Switzerland	16.5	14.0	17.0	24.1	17.2	32.8	35.1	34.2	34.0
UK	9.4	12.7	26.2	30.0	32.2	43.0	36.5	50.6	49.8
USA	7.3	7.5	12.1	19.4	27.0	31.4	33.9	42.5	41.9
Average for countries with no missing figures	10.7	12.8	19.9	23.0	28.5	43.1	42.9	46.8	46.1

Tanzi has also published estimates of the tax to national income ratio as far back as 1925 for a group of high tax Nordic countries, the UK and Germany which are reproduced in Table 2.2.[8]

8. Tanzi, V. *Government versus Markets: the Changing Economic Role of the State*, Cambridge University Press, 2011, Table 13.2, pg. 278; OECD *Revenue Statistics* 1965–2009

Table 2.2: Ratios of total tax receipts to money GDP, selected countries, 1925–2006, %

	1925	1933	1950	1960	1970	1980	1990	2000	2006
Sweden	16.0	18.9	21.0	28.7	39.8	47.5	53.6	54.2	49.1
Denmark	19.6	20.1	19.8	25.3	40.4	43.9	47.1	48.8	49.1
Norway	20.9	25.1	–	32.0	34.9	42.7	41.8	40.3	43.9
Finland	21.6	20.1	27.8	27.5	32.5	36.2	44.7	46.9	43.5
UK	22.6	25.2	33.1	27.3	37.0	35.2	35.9	37.4	37.1
Germany	17.8	23.0	30.1	33.9	32.9	33.1	32.6	37.9	35.6

OECD figures showing rising tax burdens from 1965 are summarised in Table 2.3 for the same set of countries used in Table 2.1. The main conclusion is that these tax ratios have risen sharply. However, most of the rise was concentrated in the period from 1965 to 1995, as shown in Figure 2.2. The tax ratio in the OECD area as a whole in 2011 seems to have been around 34.3 per cent, which was slightly lower than it had been in 2000,[9] despite the growth in the OECD government spending ratio from 38.8 per cent to 44 per cent over this period. The difference between the two suggests that either the limits of taxable capacity have now been reached or that politicians have simply become willing to borrow more as a consequence of the recent recession.

However, there is substantial variation in the tax ratios between countries as well. In 1965, for example, they ranged from 10.6 per cent in Turkey to 33.9 per cent in Austria. In 2010, Austria, Belgium, Denmark, Finland, France, Norway and Sweden all had tax ratios greater than 40 per cent – the record was 46.2 per cent in Denmark – while at the other extreme Mexico had a tax ratio of 18.1 per cent, Chile 20.9 per cent and Turkey 26 per cent.[10]

Table 2.3: Ratios of general government tax receipts to money GDP at market prices, %

	1965	1975	1985	1995	2000	2007	2008	2009	2010
Australia	20.4	25.1	27.5	28.1	30.3	29.4	27.0	25.9	–
Austria	33.9	36.6	40.8	41.4	43.0	41.8	42.8	42.7	42.0
Belgium	31.1	39.5	44.2	43.5	44.7	43.6	44.1	43.2	43.8
Canada	25.7	32.0	32.5	35.6	35.6	33.0	32.2	32.0	31.0
France	34.2	35.5	42.8	42.9	44.4	43.7	43.5	42.4	42.9
Germany	31.6	34.3	36.1	37.2	37.5	36.0	36.4	37.3	36.3
Italy	25.5	25.4	33.6	40.1	42.5	43.4	43.3	43.4	43.0
Ireland	24.9	28.8	34.6	32.5	31.2	31.0	29.1	27.8	28.0
Japan	18.0	20.7	27.1	26.8	27.0	28.3	28.3	26.9	–

9. On the basis of the figures for tax and non-tax receipts given in Annex Table 26 of the December 2011 OECD *"Economic Outlook"* it is likely that the OECD tax burden was 33.6 per cent in 2010 and 34.1 per cent in 2011, compared with 35.5 per cent in 2000. The OECD forecasts imply tax ratios of 34.1 per cent this year and 34.3 per cent in 2013. Non-tax receipts were 3.1 per cent of GDP in 2009 and this figure has been deducted from the figures for total tax *plus* non-tax receipts published by the OECD.
10. OECD *Revenue Statistics 1965–2009*, Table A

	1965	1975	1985	1995	2000	2007	2008	2009	2010
Netherlands	32.8	40.7	42.4	41.5	39.6	38.7	39.1	38.2	–
New Zealand	23.9	28.4	30.9	36.2	33.1	34.9	33.6	31.5	31.3
Norway	29.6	39.2	42.6	40.9	42.6	43.8	42.9	42.9	42.8
Spain	14.7	18.4	27.6	32.1	34.2	37.7	37.0	37.4	37.7
Sweden	33.3	41.3	47.4	47.5	51.4	47.4	46.4	46.7	45.8
Switzerland	17.5	24.4	25.8	27.7	30.0	28.9	29.1	29.7	29.8
UK	30.4	34.9	37.0	34.0	36.1	36.0	35.7	34.3	35.0
USA	24.7	25.8	25.6	27.8	29.5	27.9	26.3	24.1	24.8
OECD	25.4	29.4	32.4	34.6	35.3	35.2	34.8	33.8	34.3

Tax ratios alone do not necessarily provide a reliable indicator of the absolute or relative burden being placed on an economy for a number of reasons. One is that tax receipts tend to be more cyclical than the wider economy, reflecting the progressive nature of large parts of the tax system. This means that an apparent fall in the tax ratio may have nothing to do with changes in rates of tax but, instead, reflect the fact that the economy concerned is in recession.

There are also other costs created by regulation, which can be another way of government achieving its objectives. For example, it can insist that energy companies buy a certain amount of renewable energy, passing on the cost to consumers, instead of raising taxes and then subsidising them directly; or it can require money to spend on things like new infrastructure in return for planning permission: councils do that with what is known as a Section 106 agreement. The Burdens Barometer 2010, produced by the British Chambers of Commerce, found that the total net cost of the major regulations to business, approved since 1998, is £88.3 billion. This cumulative cost has grown from £10 billion in 2001.[11]

As a result, Britain's regulatory structure is becoming steadily less competitive. Writing for Civitas in 2005, Leach discussed this principle and concluded that in a range of studies the regulatory burden in the UK was large and growing. By international standards, Government regulations were making the UK far less competitive.[12] This is a continuing trend. The Global Competitiveness Report 2011–12, produced by the World Economic Forum, found that the UK ranked 83rd in terms of the burden of government regulation, placed below countries such as Pakistan and Nicaragua.

Including a measure of regulatory burden alongside Government spending is often referred to as the Intervention Index and is the concept underlying the Americans for Tax Reform Cost of Government Day in the United States. In a paper for the Institute of Economic Affairs in 2000, Leach cited three measures that needed to be gauged to calculate a cost of regulation:[13]

- The direct administrative and compliance costs incurred by the private sector.

11. British Chambers of Commerce *Burdens Barometer 2010*
12. Leach, G. *The red tape economy*, Civitas, 2005
13. Leach, G. *The Devil or the deep blue sea?* in *Regulation without the State*, Institute of Economic Affairs, 2000

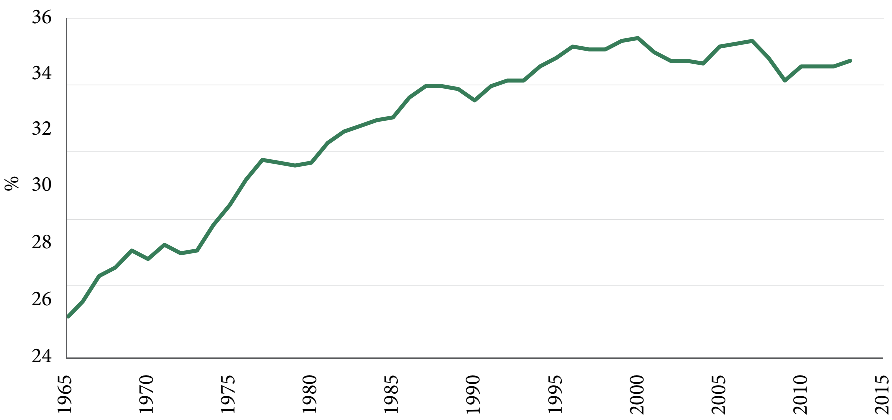
- The labour and capital costs incurred by the public sector regulatory bodies.
- The indirect costs incurred by private sector companies and consumers as a result of the implementation of regulations.

Average workers would have to work until 26 July 2012 to pay for their share of the cost of Government that year

Using OECD and Institute of Directors figures, the TaxPayers' Alliance produced an estimate of the cost of government expenditure and regulations combined for 2012, which was equivalent to 57 per cent of GDP. That is the equivalent of 208 calendar days out of a 366 day year, meaning average workers would have to work until 26 July 2012 to pay for their share of the cost of government that year.[14]

There is also the possibility that excessive marginal rates of tax can reduce taxable income (Section 4.2). In this situation, a decline in the tax ratio reflects an excessive tax burden, not its easing. This consideration also works in reverse in that tax cuts and supply side reforms are often followed by a surge in receipts. The fall in the US and British tax ratios since 2007, during a period when tax rates have gone up, can probably be explained by cyclical and dynamic effects acting together.

Figure 2.2: Ratios of OECD tax receipts to OECD GDP at market prices 1965 to 2011 with OECD forecasts for 2012 and 2013



The main theoretical limitation of tax ratios is that they reflect the *ex post* effects of taxes after they have worked their way through the economy. However, what is really needed is an *ex ante* measure of the supply-side and demand pressure being imposed by taxes.

It is possible to construct such a measure using a weighted average of the various rates of tax. However, many countries' tax systems are so complex that it is almost impossible to construct a satisfactory measure of the *ex ante* tax burden. This is a particular problem when attempting to assess the impact of taxes on the wider economy using econometric methods (Section 3.4). This practical measurement difficulty implies that empirical studies will inevitably underestimate the extent of the adverse effects of higher taxes on wider economic performance and also their statistical significance.[15]

14. O'Connell, J. *Cost of Government Day 2012*, TaxPayers' Alliance, December 2011
15. Technically, this is a measurement-induced 'errors in variables' problem when taxes are being used to explain the behaviour of an aggregate such as economic activity. Barro, R. J. & Redlick, C. K. *Macroeconomic Effects from Government Purchases and Taxes*, Harvard Discussion Paper, October 2009 addresses this issue by constructing an average marginal US income tax rate series from 1912 to 2006

Table 2.4 shows the extent to which the different main categories of taxation are used by mature developed countries.[16] Income and profits taxes in Britain are slightly above the OECD average share of national income and property taxes take the largest share of national income of any of the countries shown. Social security and payroll taxes are lower than average and closer to the US than the much higher payroll levies in other European countries, whilst indirect taxes on goods and services are slightly below the OECD average share of national income, possibly because large categories of expenditure are subject to zero or reduced rates (Section 7.1.4).

Table 2.4: Attribution of tax revenues as shares of national income and as a percentage of total tax revenues in 2008

	Share of market price GDP				Share of total taxes				
	Income & profits	Social security & payroll	Property	Goods & services	Income & profits	Social security & payroll	Property	Goods & services	Other
Australia	16.0	1.4	2.2	7.4	59.3	5.1	8.2	27.4	0.0
Austria	13.1	17.1	0.5	11.6	30.7	40.0	1.3	27.1	0.6
Belgium	16.8	13.9	2.2	10.8	38.0	31.5	5.0	24.5	0.0
Canada	15.9	5.5	3.4	7.6	49.1	16.7	10.5	23.6	0.0
France	10.4	17.3	3.4	10.6	24.1	40.1	7.8	24.5	3.3
Germany	11.5	13.9	0.9	10.5	31.1	37.6	2.3	28.5	0.0
Italy	14.9	13.5	1.9	10.6	34.4	31.2	4.3	24.5	5.3
Ireland	10.8	5.3	1.8	10.7	37.6	18.5	6.4	37.1	0.0
Japan	9.5	10.9	2.7	5.1	33.7	38.6	9.4	18.0	0.3
Netherlands	10.6	14.5	1.6	11.8	27.2	37.0	4.2	30.3	0.5
New Zealand	20.4	0.0	1.9	11.4	60.4	0.0	5.8	33.8	0.0
Norway	21.6	8.9	1.2	10.9	50.8	20.9	2.7	25.6	0.0
Spain	10.3	12.1	2.3	8.3	30.9	36.4	6.8	25.1	0.4
Sweden	16.8	15.4	1.1	12.8	36.3	33.2	2.3	27.7	0.1
Switzerland	13.9	6.7	2.2	6.3	47.7	23.0	7.5	21.7	0.0
UK	14.3	6.8	4.2	10.3	40.0	19.0	11.6	28.8	0.6
USA	11.8	6.5	3.2	4.6	45.2	25.1	12.1	17.6	0.0
OECD	12.5	9.4	1.8	10.8	35.8	26.4	5.4	31.7	0.6

16. OECD *Revenue Statistics*, 2010

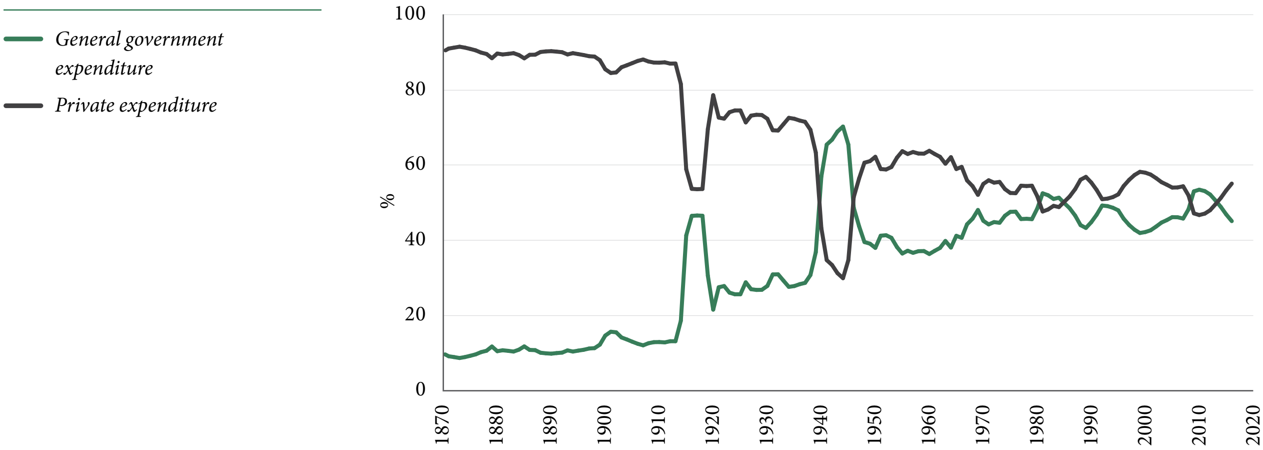
2.3. Taxes in Britain are far too high

Table 2.5 sets out the forecasts for public spending and receipts in Britain in 2011–12 from the March 2012 Budget. It shows the size of the total public sector, including public corporations, unlike Table 2.1 which uses the rather cleaner concept of general government (central and local government only). Two measures of national output are used: GDP at market prices, which is gross of indirect taxes like Value Added Tax and subsidies; and GDP at factor cost that excludes them. The market price measure has the drawback that it exaggerates the size of the economy, and the relative size of European economies with high indirect taxes compared to others with lower indirect taxes.

The factor cost measure of national output is the best way of measuring the resource costs involved. It is also more consistent over time. This is why it has been employed for Figure 2.3 – which shows the relative shares of UK factor cost GDP accounted for by the public and private sectors since 1870 – and Table 2.6 – which shows historic UK tax and spending ratios. That table also recasts the March 2012 Budget forecasts onto the same consistent definitions for the period up to 2016–17.

The main reason why the factor cost measure is not generally used for international comparisons, despite its conceptual advantages, is that it requires more information to construct and many international statistical services do not compile the relevant figures.

Figure 2.3: Ratios of UK general government expenditure and private expenditure to UK GDP at factor cost with implied March 2012 Budget forecasts for 2012 to 2016



A striking feature of Table 2.5 is the massive contribution made by Income Tax and National Insurance contributions to the government's revenues with a joint contribution of just over 44 per cent (Income Tax alone contributes 26.2 per cent). If the two were combined, no other single tax would be anywhere near as important. However, VAT also delivers a significant 17.2 per cent of total receipts. Other taxes also have harmful effects on the economy though, especially when marginal rates are high or liability for the tax bears little relation to the ability to pay.

Table 2.5: March 2012 Budget forecasts for UK public spending by function and government receipts, 2012–2013

	(£bn)	(%)	Ratio to GDP at market prices (%)	Ratio to GDP at factor cost (%)
Total managed expenditure (TME)				
Social protection	207	(30.3)	13.1	15.1
Personal social services	33	(4.8)	2.1	2.4
Health	130	(19.0)	8.3	9.5
Transport	22	(3.2)	1.4	1.6
Education	91	(13.3)	5.8	6.6
Defence	39	(5.7)	2.5	2.8
Debt interest	46	(6.7)	2.9	3.4
Industry, agriculture & employment	19	(2.8)	1.2	1.4
Public order & safety	32	(4.7)	2.0	2.3
Housing & environment	21	(3.1)	1.3	1.5
Other	43	(6.3)	2.7	3.1
TME	683	(100.0)	43.3	49.8
Government receipts				
Income Tax	155	(26.2)	9.8	11.3
National Insurance	106	(17.9)	6.7	7.7
Excise duties	48	(8.1)	3.0	3.5
Corporation Tax	48	(8.1)	3.0	3.5
VAT	102	(17.2)	6.5	7.4
Business rates	26	(4.4)	1.7	1.9
Council Tax	26	(4.4)	1.7	1.9
Other	84	(14.2)	5.3	6.1
Total receipts	**592**	**(100.0)**	**37.6**	**43.2**

Table 2.6: Ratios of main categories of UK general government expenditure and non-oil taxes to money GDP at factor cost, %

	Government final current expenditure	Grants to persons	Subsidies	Debt interest	Government investment and other items	Total general government expenditure	Non-oil taxes
1870	5.3	0.0	0.0	3.6	0.9	9.8	–
1900	10.1	0.3	0.0	1.8	2.3	14.5	8.2
1910	8.9	0.4	0.0	2.0	1.5	12.8	9.9
1920	9.0	2.5	2.1	6.0	1.8	21.4	20.1
1930	10.8	4.9	0.5	8.2	3.3	27.7	20.4
1938	15.5	4.9	0.8	5.6	3.9	30.7	22.4
1950	19.7	5.6	4.0	4.7	3.9	37.9	37.7
1960	19.0	6.2	2.1	4.4	4.6	36.3	30.5
1970	21.3	8.8	2.0	4.5	8.5	45.1	42.5
1980	25.4	11.6	2.4	5.3	3.9	48.4	39.7
1990	23.3	11.9	1.0	4.1	4.5	44.7	39.4
2000	23.7	12.9	0.5	3.1	1.9	42.1	41.4
Wartime peaks							
1917	39.3	0.9	0.5	4.4	1.4	46.5	16.3
1944	57.7	5.0	2.7	4.5	0.3	70.2	40.6
Recent years							
2001	24.2	13.1	0.5	3.1	1.7	42.6	41.1
2002	25.4	12.9	0.6	2.6	2.1	43.6	39.4
2003	26.2	12.9	0.7	2.3	2.5	44.6	39.0
2004	26.8	12.9	0.6	2.2	2.8	45.3	39.6
2005	27.4	12.8	0.7	2.4	2.8	46.1	40.5
2006	27.3	12.5	0.8	2.3	3.1	46.0	40.4
2007	26.7	12.6	0.7	2.5	3.2	45.7	40.1
2008	27.7	13.2	0.7	2.6	3.9	48.1	39.7
2009	29.6	15.0	0.8	2.1	5.4	52.9	37.9
2010	29.4	15.2	0.7	3.3	4.5	53.1	39.4
2011	28.7	15.5	0.6	3.7	3.8	52.3	40.4
Implied OBR 2012 Budget Forecasts							
2011–12	28.8	15.7	0.6	3.6	3.6	52.3	40.3
2012–13	28.3	15.9	0.8	3.3	1.1	49.4	40.3
2013–14	27.3	15.3	0.8	3.3	3.0	49.7	40.5
2014–15	25.8	14.9	0.8	3.6	2.9	48.0	40.7
2015–16	24.1	14.5	0.8	3.8	2.8	46.0	40.5
2016–17	22.7	14.2	0.8	3.8	2.8	44.3	40.7

2.4. Britain's taxes are highly and increasingly complicated

"... new methods to enforce the collection have in vain been tried; the public expectation has been uniformly disappointed"

Alexander Hamilton

The burden imposed by the tax system cannot simply be measured by rates of tax or the amount of revenue taken in. There is also the additional hidden cost arising from the legal obligation to comply with often complex tax codes.

Alexander Hamilton, the first US Secretary of the Treasury, wrote in *The Federalist Papers* in 1788 that:

> *[Tax] laws have in vain been multiplied; new methods to enforce the collection have in vain been tried; the public expectation has been uniformly disappointed.*

Slemrod argues that the persistence of tax complexity is because Adam Smith's tax principles – discussed in Section 2.5 – are often in conflict with each other. For example, some of the rules that complicate the tax system could be necessary to respond to particular circumstances and ensure the results are fair.[17]

Despite the long history of concerns about tax complexity, Chittenden et al. note that no serious analysis into the hidden costs of taxation was undertaken until the 1970s.[18] Since then though, numerous studies have been conducted.

Practically speaking, the costs of complying with taxes are clearly significant. There is little doubt that businesses are unduly burdened by a more complex system. The only theoretical objection to this view is that a simpler tax system would mean more businesses would file returns and that could increase overall compliance costs. But the compliance costs imposed on individual complying firms would fall if taxes were simpler and that is very important, particularly to smaller businesses.

Compliance costs result from the legal obligation to fill in tax forms and ensure that you understand and comply with the regulations involved. This has three elements:

- The unpaid time devoted to these activities, which can amount to 36 hours per month for the typical very small business according to evidence provided to the 2020 Tax Commission by the Forum of Private Business. Such costs are ignored in the national accounts but represent a clear loss of welfare.
- The cost of employing accountants and tax advisers. For instance, the number of members of the Chartered Institute of Taxation – an organisation for tax professionals – has increased by 52 per cent between 1996 and 2010. That rise is shown in Table 2.7.
- The psychological cost, or the distraction and stress, of dealing with complicated taxes.

Chittenden et al. found that the total operating costs of the British tax system were over £11 billion.

17. Slemrod, J. Did the Tax Reform Act of 1986 simplify tax matters?' *Journal of Economic Perspectives,* pgs. 45–57, 1992

18. Chittenden, F., Foster, H. & Sloan, B. *Taxation and Red Tape: the Cost to British Business of Complying with the UK Tax System*, Institute of Economic Affairs, 2010

Table 2.7: Chartered Institute of Taxation, membership numbers

Year	Membership of the Chartered Institute of Taxation
1996	10,155
1997	10,444
1998	10,805
1999	11,094
2000	11,456
2001	11,953
2002	12,524
2003	12,915
2004	13,393
2005	13,734
2006	14,015
2007	14,275
2008	14,665
2009	14,989
2010	15,400

There is no single person who understands more than a fraction of the UK tax code. As such, compliance costs are particularly high for firms and individuals that cannot afford dedicated compliance departments or tax lawyers. Attempts have been made to make tax law more understandable though, since a key source of simplicity is 'the expression of the rules', according to Cooper.[19] Lord Howe of Aberavon chaired the Tax Law Rewrite Project, a committee set up in 1997 by the then Inland Revenue with the task of re-writing tax legislation in plainer language, to make it more understandable. The project was disbanded in April 2010 after delivering the following pieces of legislation:

- The Capital Allowances Act 2001 (effective from April 2001)
- The Income Tax (Earnings and Pensions) Act 2003 (effective from April 2003)
- The Income Tax (Pay as You Earn) Regulations 2003 (effective from April 2004)
- The Income Tax (Trading and Other Income) Act 2005 (effective from April 2005)
- The Income Tax Act 2007 (effective from April 2007)
- The Corporation Tax Act 2009
- The Corporation Tax Act 2010
- The Taxation (International and Other Provisions) Act 2010

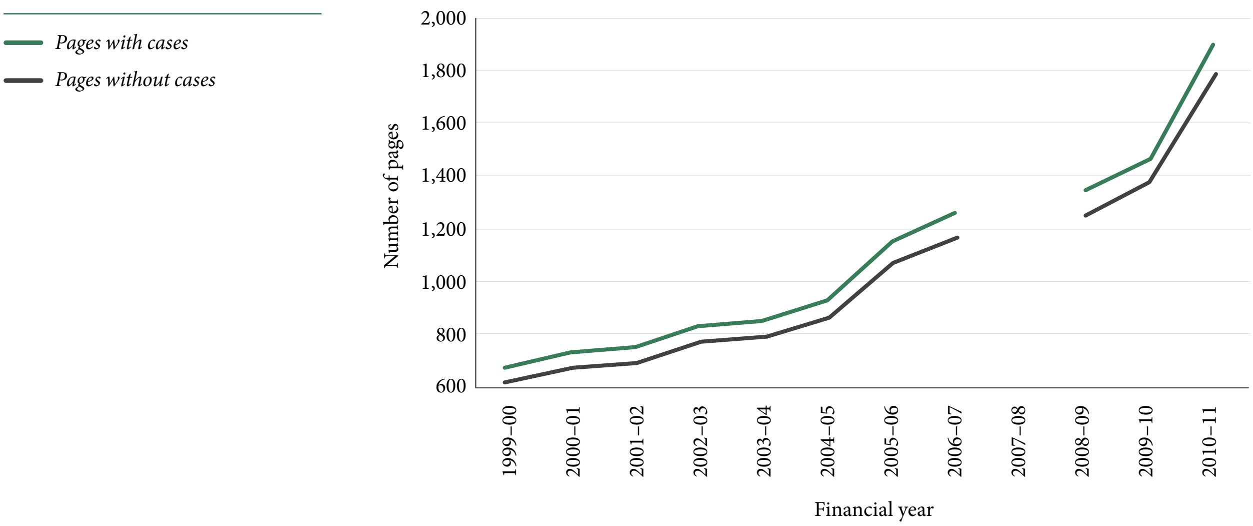
19. Cooper, G. Themes and issues in tax simplification, *Australian Tax Forum*, pgs. 417–460, 1993

The work of the Howe Committee was widely praised during the time it was in operation. Adam Broke, in an article for *Tax Adviser* in 2005, said that there was an "immediate impact in the use of short sentences, avoidance of elaboration and dependent clauses, simpler English and logical progression."[20] He added that other important techniques helped readers navigate redrafted legislation, such as "sign-posting", which directs readers to the provisions for which they are looking. It was an effective attempt to make tax more understandable and accessible.

While the Howe Committee achieved some very useful legislative changes, the UK's tax system is still largely incomprehensible to most firms and individuals and is growing steadily longer. In June 2011, the TaxPayers' Alliance released research on the length of Tolley's tax guides.[21] The length of those guides to the UK's tax legislation can be used as a crude, but informative, indication of whether taxes are becoming more or less complex. The last estimate in 2009 had the total length at 11,520 pages, more than double the number of pages of the 1997 editions.

Tolley's also produce guides for individual taxes. The Corporation Tax guide for 2010–11 was 1,897 pages long, 185 per cent longer than it was in 1999–00.

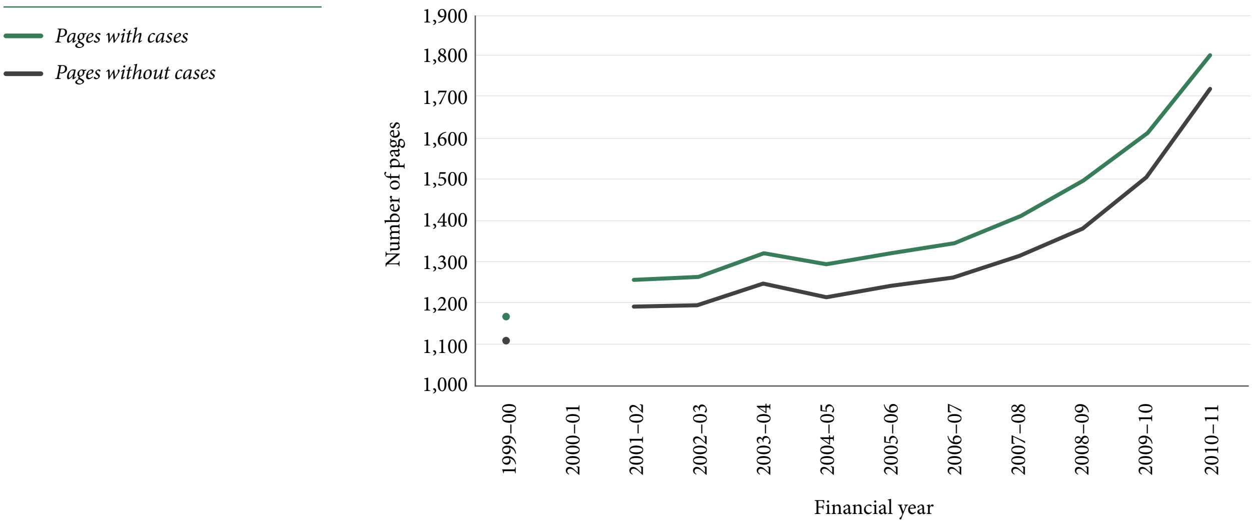
Figure 2.4: Length of Tolley's tax guide, Corporation Tax



The guide for Income Tax in 2010–11 was 1,801 pages long, 54 per cent longer than it was in 1999–00.

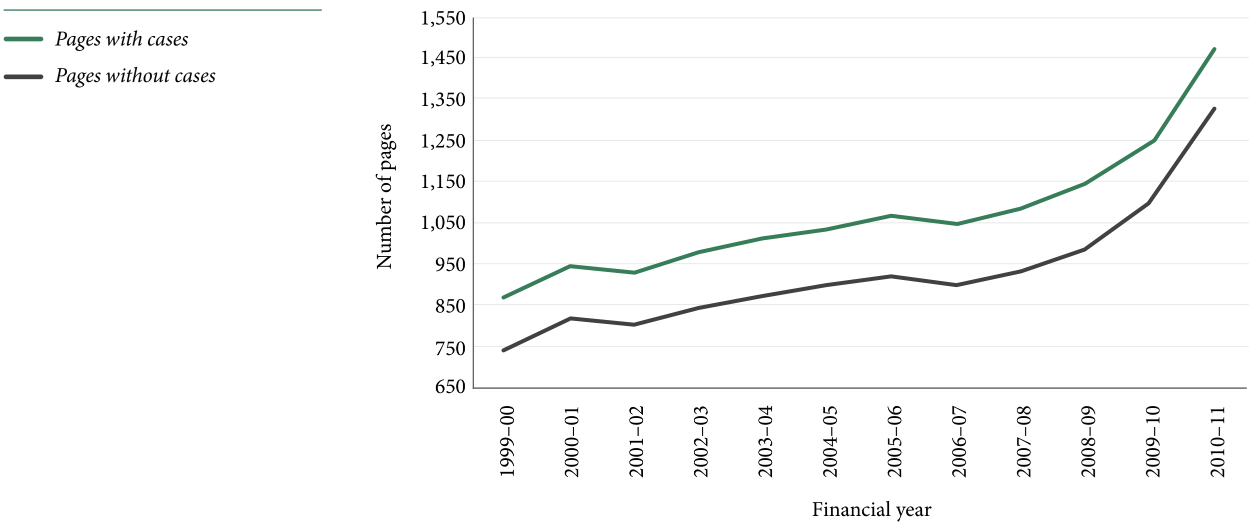
20. Broke, A. The Tax Law Rewrite Project, *Tax Adviser*, December 2005
21. O'Connell, J. *The length of Tolley's individual tax guides*, TaxPayers' Alliance, 2011

Figure 2.5: Length of Tolley's tax guide, Income Tax



Tolley's Capital Gains Tax guide in 2010–11 was 1,463 pages long, 70 per cent longer than it was in 1999–00.

Figure 2.6: Length of Tolley's tax guide, Capital Gains Tax



Tolley's Inheritance Tax guide is now 958 pages long, 63 per cent longer than it was in 2001–02. Just the Inheritance Tax guide would take the world's fastest speaker 10 straight hours to read aloud.

The tax system has also becomes less stable. The Institute for Fiscal Studies has looked at the number of 'main' tax changes made at Budgets and Pre-Budget Reports over the years, calculating that there have been 309 such changes since 1979, almost ten a year.[22] These are only the headline tax changes, and their count disregards the many other changes contained in the annual Finance Acts. The Finance Acts are hundreds of pages long each year, as shown in Table 2.8, setting out a large number of changes that make it harder for businesses and individuals to plan for the long term.

22. Institute for Fiscal Studies *Tax measures introduced in each Budget and PBR since 1979*, Fiscal Facts

Table 2.8: Length of Finance Acts, 2000–2011

Finance Act	Number of Pages
2000	622
2001	340
2002	503
2003	467
2004	650
2005	382
2006	518
2007	317
2008	461
2009	458
2010	302
2011	404
2012	670
Total since 2000	**6,094**

In July 2010, the Chancellor of the Exchequer, George Osborne, set up the Office of Tax Simplification (OTS). He described the tax system as a 'spaghetti bowl'. The first major OTS report analysed 155 tax reliefs out of the 1,042 available, and recommended the removal of 47 deemed out of date or unnecessary. The report provided a number of examples where the tax system appeared to have been used to indulge policy whims. There were tax reliefs for companies on the meals they provide to staff on designated 'cycle to work' days. Two other reliefs – on angostura bitters and black beer – only benefited one company apiece.

The Chancellor announced at the 2011 Budget that he was abolishing a few meaningless pieces of legislation such as the now redundant Millennium Gift Aid relief, as recommended in the OTS report, along with some others. Any move to rid the tax code of needless legislation is a welcome simplification. But the rules that do have to be complied with are far more of a burden on business than those which are merely an irrelevant distraction; and other measures announced at the same time actually led to an overall Budget where the complicating measures had a similar value to the simplifying ones.[23]

Other reviews of the British tax system have been similarly critical of its complexity. The Meade Report in 1978 found that there were "a number of anomalous complications and inconsistencies" and that "these anomalies can have very grave and important effects on the economy".[24]

The October 2006 report of the Tax Reform Commission, set up by then Shadow Chancellor George Osborne and chaired by Lord Forsyth of Drumlean, was similarly critical:[25]

23. TaxPayers' Alliance *Post Budget Briefing 2011: Welcome tax cuts and hidden nasties* , 22 March 2012
24. Institute for Fiscal Studies *The Structure and Reform of Direct Taxation*, 1978, pg. 3
25. Forsyth, M. et al. *Tax Matters: Reforming the tax system*, 2006, pg. 7

> *The last decade has also seen an eye-watering increase in UK tax complexity and instability. New income tax rates have been created. New corporate tax rates have been created and then removed. Employee share option schemes have been changed almost annually. The controlled foreign company legislation has been changed repeatedly. Since 2000, the tax law for intangibles, substantial shareholdings, stamp duty, leasing and film credits have all undergone major rewrites. The list goes on and on.*

"The last decade has also seen an eye-watering increase in UK tax complexity and instability"

Michael Forsyth

That report also highlighted that complexity in the tax system is unfair, as it means tax is only understandable to a handful of experts. It cited the example of a small business that might not bother to apply for research and development tax reliefs to which it was entitled because the process was too complicated and arduous.

There has been a recent example of that problem with the introduction of a highly conditional National Insurance holiday. The scheme, which exempted small firms (those with 10 or fewer staff) from having to pay National Insurance for a 12 month period, had attracted just 10,000 registrations out of a total of 400,000 expected to benefit from the scheme. It was thought that it would help to create 800,000 jobs. Prime Minister David Cameron admitted that it hadn't worked as hoped:[26]

> *The scheme has not worked as well as we hoped.... It was too complicated and too targeted at specific businesses. It resulted in around 1,000 jobs but that was not enough.*

The Mirrlees Review found that the UK's system currently distorts people's behaviour by treating similar activities differently without very good reason. This can "create inefficiency, complexity and opportunities for avoidance." In general, the Review found that the tax system works for most people, most of the time, but that:[27]

> *[The] UK system is still unnecessarily complex and distorting. Tax policy has for a long time been driven more by short-term expedience than by any long-term strategy. Policymakers seem continually to underestimate the extent to which individuals and companies will respond to the financial opportunities presented to them by the tax system. They seem unable to comprehend the importance of dealing with the system as a whole. And real and effective reform remains politically extremely difficult.*

The academic literature overwhelmingly finds that complexity begets more complexity. Policy announcements are made to address political concerns and this creates substantial compliance costs for firms and sometimes individuals. Once loopholes are found, politicians are then encouraged to try and close them down with yet more legislation. Complexity can also be the result of attempts to make the tax system more progressive. But that is often counterproductive. If, for instance, the wealthy can make systematically better use of loopholes to avoid taxes in more sophisticated ways, whereas the poor will instead evade taxes through simple methods such as paying 'cash in hand', then greater complexity in the tax system will make it less progressive.[28]

---

26. Pay & Benefits *Cameron concedes NI holiday flop*, 31 January 2012
27. Institute for Fiscal Studies *Tax by Design: Report of the Mirrlees Review*, 2011, pg. 7
28. Andreoni, J., Erard, B. & Feinstein, J. Tax Compliance, *Journal of Economic Literature*, vol. 36 No. 2, 1998, pg. 818

Surrey and Brannon wrote that it must appear to an observer of tax policy that simplification is the most widely quoted but the least widely observed of the goals of tax policy.[29] Simplifications also appear to be more politically vulnerable after major tax reforms than cuts in rates (Section 3.5.3). In the US, the National Taxpayer Advocate, Nina Olsen, in her 2005 annual report to Congress, identified tax law complexity as the greatest single problem facing taxpayers and tax administrators. The British Federation of Small Businesses (FSB) found that small firms face:[30]

> *[Cumulations] of regulation as well as the costs of administering employment tax and other bodies of legislation (PAYE, NIC, Employment Law, V.A.T., Climate Change Levy etc). The disproportionate administrative costs relating to such legislation make small firms even less able to cope with regulatory costs.*

The FSB cited Inland Revenue research which showed that firms with between one and four employees spent £288 per employee per annum on administration to comply with legislation, compared to a little over £5 per employee for those firms with more than 5,000 employees. The OECD has also reported that the UK spends £4 billion a year on aggregate administrative costs for tax functions. Table 2.9 shows this administrative cost relative to net revenue collections.[31]

Table 2.9: Administrative costs for tax functions

Year	Administrative costs for tax functions/net revenue collections (costs per 100 units of revenue)
2001	1.06
2002	1.11
2003	1.04
2004	0.97
2005	1.10
2006	1.12
2007	1.10
2008	1.12
2009	1.14

Administrative costs for tax function in the UK in 2009, at 1.14 per 100 units of revenue, were substantially higher than they are in, for example: Norway at 0.50; Estonia at 0.40; and Switzerland at 0.31. Germany, Denmark, New Zealand and the US all have lower administrative costs for tax functions too.

In 1960, Derick Heathcoat-Amory, 1st Viscount Amory and then Chancellor of the Exchequer, told the House of Commons that the "cost of collecting taxes in the financial year 1958–59" was about "£65 million for the Customs and Excise and Inland Revenue together" or, "as a percentage of the revenue collected", "1.38 per cent in the case of the Inland Revenue Department and 0.86 per cent in the case

29. Surrey, S. & Brannon, G. Simplification and equity as goals of tax policy, *William and Mary Law Review*, 1968, pgs. 915–921
30. Baldwin, R. *Better regulation: Is it better for business?*, Federation for Small Businesses, 2004
31. OECD, *Tax administration in OECD and selected non-OECD countries: Comparative information series*, 2010

of the Customs and Excise Department".[32] Given that the Inland Revenue raised around £3 billion and Customs and Excise around £2 billion that year,[33] the weighted average by revenue of those two figures is 1.16 per cent. In other words, the cost of raising a pound of tax revenue appears to have fallen by less than two per cent in fifty years, fifty years in which – among other things – the microprocessor was invented.

The figures may not be perfectly comparable, but this still suggests that there has been a disappointing failure to match the improvement in productivity seen in the wider economy in tax collection. That is likely the result of a combination of the rising complexity of the system, and new policies like tax credits that have been incorporated into it, and the wider problems that often lead to inefficiency in bureaucracies (Section 3.3.3).

"I sought to abolish a tax at every Budget"

Nigel Lawson

While successive governments have tried to simplify the tax system, to make it easier and cheaper to administer, James and Wallschutzky have argued that without an overall strategy for simplification no long-term improvement is likely.[34] While consultation and proper deliberation is necessary, it is important that the process is not too slow. The OTS has proposed some simplifications but more substantial change in the tax system will be needed to address the problem of tax complexity.

The clearest way of simplifying the tax code is to abolish entire taxes. Former Chancellor Lord Lawson of Blaby has described it as "the ultimate simplification", and as a result he "sought to abolish a tax at every Budget" and "was able to do it in six successive Budgets."[35] The 2020 Tax Commission's recommendations would abolish eight taxes:

- Employers' National Insurance
- Employees' National Insurance
- Corporation Tax
- Capital Gains Tax
- Inheritance Tax
- Stamp Duty Land Tax
- Stamp Duty on shares
- Air Passenger Duty

Excluding National Insurance, these taxes are responsible for 499 exemptions or reliefs, out of a total of 1,042. The latest individual Tolley's guides for Capital Gains Tax, Corporation Tax and Inheritance Tax alone contain 4,318 pages, and abolishing them should therefore allow the tax code to be shortened substantially.

The new system would maintain a single tax on labour income (Section 5.2.5) and create one new tax on capital income (Section 5.1.5).

Many of the existing reliefs for National Insurance and Income Tax would have to be maintained within the new combined Income Tax, although some could be scrapped. The single tax on capital income would mean that some of the reliefs stripped out for Capital Gains Tax and Corporation Tax would be replaced, but the single capital income tax replacing it is far simpler.

It is not possible to calculate precisely the scale of the reduction in the size of the tax code but it is clear that the reduction in the number of taxes alone is likely to mean a major simplification.

32. Parliamentary Debates, House of Commons, Vol 616, col 781, 2 February 1960
33. Parliamentary Debates, House of Commons, Vol 604, cols 36–37, 7 April 1959
34. James, S. & Wallschutzky, I. Tax law improvement in Australia and the UK: the need for a strategy for simplification, *18 Fiscal Studies*, 1997, pgs. 445–460
35. Lawson, N. *The View from No. 11: Memoirs of a Tory Radical*, 1992, pgs. 349–350

2.5. Many earlier reviews have found there is a strong case for significant tax reform

In *The Wealth of Nations*, Adam Smith set out four principles for how taxes should be designed and implemented:

1. *The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.*
2. *The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person.*
3. *Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it.*
4. *Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state.*

These principles have been reflected in many considerations of tax reform since then. More recently, an extensive economic literature has developed looking at the optimal structure of taxes. Mankiw, Weinzierl and Yagan identify eight key lessons from contemporary academic studies:[36]

1. **Optimal marginal tax rate schedules depend on the distribution of ability**. Other things being equal, an increase in a marginal tax rate is more attractive when fewer people will be affected at the margin, and more will be affected inframarginally, i.e. when it will affect fewer people's decisions over whether to work or not, and how much to work.
2. **The optimal marginal tax schedule could decline at high incomes**, although they argue that some recent work has yielded different results that fit better with existing policy.
3. **A flat tax, with a universal lump-sum transfer, could be close to optimal**. That means the average tax rate rises while the marginal tax rate does not.
4. **The optimal extent of redistribution rises with wage inequality. Some reservations over this finding have already been noted**. For example, it tends to be built on a theory that people have homogenous preferences, whereas preferences are actually very heterogenous, which reduces the case for redistribution.
5. **Taxes should depend on personal characteristics as well as income**. Other characteristics might produce a system that is better informed about someone's income-earning potential, as opposed to just their income. Such "tags" are used – disabled people and the elderly are taxed differently – but less than economic theory suggests they should be.
6. **Only final goods ought to be taxed, and typically they ought to be taxed uniformly**. This is the argument for a Value Added Tax, though

36. Mankiw, G. N., Weinzierl, M. & Yagan D. *Optimal Taxation in Theory and Practice*, NBER Working Paper No. 15071, June 2009

most Value Added Taxes are not uniform across all goods due to reduced and zero-rated items.

7. **Capital income ought to be untaxed, at least in expectation**. While some economists have justified capital taxes, the argument for keeping them low is powerful as "the supply of capital is highly elastic, capital taxes yield large distortions to intertemporal consumption plans and discourage saving, and capital accumulation is central to the aggregate output of the economy".
8. **In stochastic, dynamic economies, optimal tax policy requires increased sophistication**. More recent work has suggested that optimal taxation may even depend on the income histories of individuals and require a number of different taxes to interact. They report that "so far, the effect of this branch of the literature on policy has been modest."

The optimal tax theory literature is helpful in considering how to build a better tax system but there are limitations. The studies tend to rely on assumptions which may not reflect the real circumstances under which taxes operate. They often assume homogenous preferences, for example (Section 4.3.4). Equally they can justify taxes that might be efficient in theory but would likely strike people as arbitrary in practice, such as taxes on height[37] or random taxes.[38] Slemrod argues that the "first-best solution is to impose a lump-sum tax on the representative taxpayer" but that is "ruled out by assumption".[39] This 2020 Tax Commission needs to recommend a tax system that is economically rational but also simple and legitimate.

There have been numerous investigations of the potential for major tax reform carried out in Britain and other countries in recent decades, although the 2020 Tax Commission's approach is highly distinctive, as set out in Chapter 1. An account of those reviews is provided at the end of this report (Appendix).

2.6. There are a number of different ethical approaches to understanding taxes and spending

What are the rights and wrongs of asking so many people to pay so much?

The ethical dimension of taxation reflects the fact that it creates an important relationship between the citizen and the state. It also creates a significant financial relationship between fellow citizens of a nation. These relationships are not voluntary; taxation is imposed by law. Taxes therefore need to be examined closely, in order to see whether they impose ethically acceptable or unacceptable relationships between the citizen and the state, and among citizens.

There are many ethical questions that can be asked about a tax system

There are many ethical questions that can be asked about a tax system. We will cover the following:

- What should the upper limit on the overall level of taxation be? (Section 3.1)
- Which social, economic and political objectives can legitimately be pursued through the use of taxation? (Section 3.2)

37. Mankiw, N. G. & Weinzierl, M. *The optimal taxation of height: a case study of utilitarian income redistribution*, NBER Working Paper No. 14976, May 2009
38. Weiss, L. The Desirability of Cheating Incentives and Randomness in the Optimal Income Tax, *Journal of Political Economy*, 84, 6, December 1976
39. Slemrod, J. *Optimal taxation and optimal tax systems*, NBER Working Paper No. 3038, July 1989

- How should taxpayers conduct themselves? (Section 7.1.3)
- How should a government conduct itself in running a tax system? (Section 5.2.4)
- How do existing taxes fare when considered from an ethical point of view? (Section 4.2.4)

In answering these questions, we will draw on a range of ethical theories, including:

- Utilitarianism, which sets as an objective the maximisation of utility across the whole population (Section 2.6.1)
- Deontology, which bases ethics on duties (Section 2.6.2)
- Virtue ethics, which focus on the virtues we should have and on what constitutes a virtuous life. A broad conception of the virtues is to be used, encompassing not only virtues such as honesty, but also virtues such as using one's talents (Section 2.6.3)
- Libertarianism, that aims to minimise coercion (Section 2.6.4)
- Religious perspectives (Section 2.6.5)

2.6.1. Utilitarianism sets as an objective the maximisation of utility across the whole population

The guiding principle of utilitarianism is that we should act in order to promote the greatest utility of the greatest number of people. The objective is traditionally worded in terms of maximising happiness, but that word now has the connotation of feeling good, and that is too narrow to capture the essence of utilitarianism of anything more than the most crudely hedonistic sort. We may therefore think in terms of the satisfaction of preferences, with an expectation that those preferences will be ones that reflect education and careful consideration of what will really benefit the subject.

2.6.2. Deontology bases ethics on duties

The deontological approach to ethics starts by identifying a set of duties. The expectation that we must, on particular occasions, fulfil our duties is not grounded on extraneous considerations, such as the fact that it may be to our advantage, or that it might be to the advantage of the majority of people if we all fulfilled our duties. A set of duties must be derived from somewhere. It may be derived from a religious tradition, from some other tradition or from a general principle, such as Immanuel Kant's categorical imperative. This principle has several formulations, but the basic idea is that moral duties are universal. You can only regard a rule as a moral maxim if you can wish it to be everyone's maxim.[40] Once the duties have been derived, from whatever source, the deontologist says that they are binding simply because they are duties.

There are some obvious candidates for a list of duties – so obvious that it is not surprising to see them listed in both religious and secular codes. We should not do physical violence to others, or steal, or break promises, or bear false witness. These are some of the basic rules by which the members of any society need to abide, if it is to function well. The official derivation of a set of duties may not mention the need

---

40. Kant gives his various formulations of the categorical imperative in *Groundwork of the Metaphysics of Morals*, pgs. 421, 429 and 438, Prussian Academy edition. (These page numbers are reproduced in several editions and translations, and are used throughout this report.)

for a society to function, but an ethic which did not respect that need would have no credibility.

2.6.3. Virtue ethics focus on the virtues we should have and on what constitutes a virtuous life

Virtue ethics place the focus on the virtues that we should have. The tradition is an old one, stretching back to the ancient Greeks, and it has enjoyed a resurgence in the past 50 years following the publication of Elizabeth Anscombe's paper "Modern Moral Philosophy".[41] Philosophers who produce lists of virtues, as distinct from those who just discuss the project of virtue ethics in general terms, produce different lists. For example, some would include humility, while others would exclude it. But there is still widespread agreement. Most lists would include virtues such as honesty, courage and a willingness to use one's talents productively. The ideal is to be the right kind of person, who will make appropriate choices in whatever circumstances may occur, and who will therefore live a life that is both morally good and good in the broader sense of being a flourishing life.

Virtues can play two different roles in our ethical lives. First, they can be characteristics that we stand ready to exhibit when we find ourselves in demanding situations. Second, the practice of virtues can itself constitute an element in the everyday good life. For example, someone who possesses the virtue of using their talents productively will lead a better life by exercising this virtue.

It will be apparent from this that we should work with a fairly broad conception of the virtues, and should not restrict ourselves to virtues like honesty and courage, virtues that only really come to the fore in demanding situations. But there is nothing wrong with this. The notion of a virtue has been broad as far back as the ancient Greeks, admittedly using a different term, *aretē*, which may be translated as "excellence". Aristotle gave catalogues of both moral and intellectual virtues.[42] Indeed, the possession and practice of virtues shades into living a good life, with "goodness" having the sense of human flourishing rather than either pleasure or saintliness. Again, the tradition goes back to the ancient Greeks, and particularly the concept of *eudaimonia*, flourishing. This shading into living a good life persists in modern virtue ethics.

By and large, it is the practice of virtues in the broader sense, and human flourishing, that we can expect both to be exhibited in economic activity and to be influenced by the level of taxation. Distinctively moral virtues, such as honesty, are of course practised in economic activity, and they are reinforced because people do not wish to do business with dishonest people, but the level of taxation is likely to have little influence on this practice, except when that level is so high that people are routinely inclined to lie to tax authorities.

We therefore concentrate on a range of these broader virtues, and ask how their practice is likely to be promoted, or hindered, by different levels of taxation.

2.6.4. Libertarianism aims to minimise coercion

Libertarianism is the moral view that agents initially fully own themselves and have certain moral powers to acquire property rights in external things. Libertarians believe in full control self-ownership, the full right to control the use of your person. Most libertarians then extend that to the view that people own property they acquire and that property right should not be violated without a very good cause, such as

41. *Philosophy*, 33, 124, January 1958, pgs. 1–19
42. *Nicomachean Ethics*, Books 3 to 6

the infringement of the rights of others. In terms of tax policy, libertarianism is most significant for its objection to coercive taxation.

2.6.5. Religions have their own philosophical perspectives

Religious thinkers have drawn on, and influenced the development of, all of the major schools of philosophical thought. While few religions are monolithic, and there have been famous debates within most of them, their adherents and key texts tend to have distinctive ethical outlooks.

For the purposes of this report, Graeme Leach (Section 3.1.2.7) and Bilal Sambur (Section 3.1.2.8) have discussed the potential limits of taxation from the perspectives of Christianity and Islam respectively, Britain's two largest religions by population.

One topic on which we may not get consensus is the ideal final result, but where we do get consensus as to what to do in the short to medium term, is the overall level of taxation. The different ethical perspectives may suggest different upper bounds to acceptable overall levels of taxation. That does not, however, leave us unable to draw robust conclusions. The arguments all suggest an overall level of taxation that is significantly lower than the current level in the UK. They all recommend reductions over the next decade.

In addition to our discussion of ethical concerns at appropriate points in the main text, we have included essays by a series of authors that set out specific perspectives on the ethics of taxation. As mentioned above, Bilal Sambur and Graeme Leach discuss religious perspectives. Then Eamonn Butler argues that taxation is an immoral coercion and that it undermines people's own generosity in Section 3.1.2.5. Finally, Matt Ridley argues that you shouldn't do your altruism through the tax system in Section 3.1.2.6.

2.7. Tax evasion is immoral as well as illegal, and in some cases legal tax avoidance is also immoral; but governments have a responsibility to minimise the opportunity to avoid taxes

One ethical issue that we can discuss immediately, before getting into the details of the tax system, is that of tax evasion and avoidance.

Tax evasion is illegal and immoral. Tax avoidance is legal, but in some cases is also immoral

Most taxpayers simply pay their taxes, without fuss. Many have no option, because tax is deducted at source from their earnings under PAYE, or from interest that they receive on savings. And when they are asked to fill in forms to report their financial position, they simply do so. But not all taxpayers act in this way. We need to ask whether either of two other forms of behaviour can be ethically acceptable.

Tax evasion involves knowingly misreporting transactions or wealth, for example declaring an income of £50,000 when the true figure was £60,000. Evasion can also be more complex. For example, in an elaborate sequence of transactions, the tax liability might depend on the precise order in which they were carried out. If a group declared that one company repaid a loan before another issued some shares, when in fact an accidental failure to implement the sequence correctly meant that the repayment occurred after the share issue, that would also be evasion.

No ethical system would directly condone evasion, except perhaps an implausible variant of utilitarianism, under which it could be argued that taxpayers should make their own judgements as to whether the money that would be due in tax might do more good if it were retained by the taxpayers.

The only other way to give an ethical justification for evasion would be to argue that the state, in imposing taxation, engaged in theft, and that one could lie to the state just as one could lie to a thief in order to prevent theft. This argument would have some plausibility in the context of a regime that was imposed, rather than democratically chosen in free elections. That is, it is possible to see a regime that is not freely elected as a gang of bandits, even if they are sometimes benevolent bandits. But that is not the position in the UK.

Tax avoidance, unlike evasion, does not involve lying or concealing information. Instead, it involves structuring transactions in ways that ensure that less tax is payable than one might expect. It works through compliance with the letter of the law, not through breaking the law.

The use of tax reliefs in ways that were obviously intended by Parliament cannot be called avoidance

There is a very wide range of things that one can do to reduce tax liabilities, many of which cannot even be candidates for stigmatisation as avoidance. The use of tax reliefs in ways that were obviously intended by Parliament cannot be called avoidance. Thus if someone decides to put money into tax-free investments such as individual savings accounts (ISAs), or into a house that is his or her main residence (so that the gain on its eventual sale will be tax-free), that is barely even tax planning. Decisions on how to draw money from a family company in order to reduce tax liabilities might amount to tax planning, but hardly avoidance. But one can move on to schemes of greater and greater sophistication, until one reaches the schemes that are obviously contrived to produce tax effects without the economic effects that one might expect to accompany them – as for example when a tax-deductible loss arises even though there has been no economic loss. Such schemes often involve substantial numbers of entities in several jurisdictions, many of which are set up purely to achieve the desired tax result, or trust deeds or contracts with very strange clauses in them. The effects may follow from the words of the law, but it is clear that if Parliament had considered the possibility of such a scheme when legislating, it would have acted to render the scheme ineffective. Serious ethical questions do arise in relation to such contrived schemes.

Avoidance or evasion?

The UK head office of a multinational group enters into a scheme to save UK tax. It is highly debatable whether the scheme would work. The group took opinions from three lawyers. Two said that the scheme would be effective, and one said that it would not be effective. The scheme involves companies in several countries, each of which is obliged to report its transactions to its revenue authorities. The companies fulfil those obligations, but no company is obliged to report the whole scheme to any authority, and no company does so. (The scheme falls just outside the terms of the UK rules requiring disclosure of certain schemes.) As a result, the UK authorities do not see that they could mount a legal challenge. No law has been broken.
Is this avoidance, or evasion?

A utilitarian, concerned with aggregate welfare, might well be quite relaxed about tax avoidance. After all, if tax is avoided, wealth is not destroyed, apart from the consumption of professional advisers' brain power on arranging schemes instead of doing something more productive. Wealth is merely kept in the private sector, instead of being transferred to the public sector. The main utilitarian concern would probably be that the result of avoidance was an unintended distribution of the tax burden. Avoidance might shift some of the burden from people with high incomes, who could afford expensive tax advisers, onto people on modest incomes. That would reduce utility because the utility to be gained from an extra pound in the hands of a person on a modest income would be greater than that to be gained from the same extra pound by someone on a high income. But even that loss of utility might not happen. If, for example, shares in companies are held by pension funds, the pensions of ordinary people can be boosted when those companies avoid tax.

A virtue ethicist would be likely to view tax avoidance with disfavour. It is, after all, hardly virtuous to exploit rules, knowing that one is exploiting them in unintended ways and redistributing the tax burden away from oneself.

A deontologist would not positively favour tax avoidance. It is, after all, not the sort of thing that could be universally prescribed: the only effect would be to require an increase in tax rates. But what could be universally prescribed is obedience to the law. That is something the tax avoider takes care to do. So it is not clear that the deontologist would condemn the tax avoider.

One thing that all ethicists could agree on is that it would be fine to change the law to close loopholes, either one by one, or with some more general provision that closed several loopholes at one fell swoop – for example, the rule that interest payable in order to save tax is not deductible.[43] But however the law develops, there will always be scope for people to engage in transactions of which one may disapprove, but which are not illegal. There is no point in regretting the fact that they were not illegal.

Any sophisticated tax system is prone to sophisticated avoidance. One possible response, the closure of specific loopholes and construction of a simpler tax code, is ethically unproblematic. But other responses have been considered, by governments, and there is more of an ethical debate to be had about them.

2.7.1. General anti-avoidance rule

A general anti-avoidance rule, or GAAR, would say that transactions that met a certain standard of artificiality would not have the tax effects that the law governing those specific types of transaction would imply, but instead would lead to a higher amount of tax being payable – probably the amount of tax that would have been payable if the underlying commercial aim, for example to dispose of an asset that had risen in value, had been achieved in a more straightforward manner.

The central objection to a GAAR is that it may leave people unable to tell in advance what the tax consequences of their transactions may be. It is no answer to say that they should just steer clear of all sophisticated tax planning. After all, why should they not engage in planning that would not be subject to a GAAR?

The case against uncertainty is partly a utilitarian one. The case is that commerce will run more smoothly, and resources will be allocated more efficiently, if everyone is as clear as they can be, in advance, about the consequences of possible actions. If, for example, a valuable asset can be sold without a high tax burden, and the seller knows that, it may well be sold to someone who can make better use of it than the current owner. If, on the other hand, the seller is uncertain about the tax consequences, it may be harder to agree a price, and more likely that the asset will remain with the seller, leading to economic inefficiency.

43. *Corporation Tax Act 2009*, sections 441 and 442

"It is said one of Emperor Nero's nasty practices was to post his edicts high on the columns so that they would be harder to read and easier to transgress"

Antonin Scalia

Uncertainty can also produce injustice as it undermines the rule of law. US Supreme Court Justice Antonin Scalia wrote in an influential paper that:[44]

> *Even in simpler times uncertainty has been regarded as incompatible with the Rule of Law. Rudimentary justice requires that those subject to the law must have the means of knowing what it prescribes. It is said one of Emperor Nero's nasty practices was to post his edicts high on the columns so that they would be harder to read and easier to transgress. As laws have become more numerous, and as people have become increasingly ready to punish their adversaries in the courts, we can less and less afford protracted uncertainty regarding what the law may mean. Predictability, or as Llewellyn put it, "reckonability", is a needful characteristic of any law worthy of the name. There are times when even a bad rule is better than no rule at all.*

Raz has written about how that means certain rules are better than principles where the implications may be uncertain:[45]

> *Since the law should strive to balance certainty and reliability against flexibility, it is on the whole wise legal policy to use rules as much as possible for regulating human behaviour because they are more certain than principles and lend themselves more easily to uniform and predictable application.*

A GAAR may therefore be acceptable if it is clear in advance what will be caught and what will not be caught. It may also be acceptable if the areas of uncertainty are such that the only transactions that people would wish to avoid are those that are clearly so contrived as to be ethically objectionable – although that ground for the acceptability of a GAAR would depend on understanding what was clearly objectionable, and it is not clear that such an understanding would be available. Otherwise, there are clear utilitarian arguments against a GAAR.

A GAAR has recently been proposed for the UK by the Aaronson Report, and the Government is consulting on introducing it.[46] The proposed GAAR is designed so as not to lead to a high level of uncertainty. It would only apply to transactions that were markedly contrived, and the authorities would have to jump several hurdles before using it. Such a GAAR might well be acceptable, but any claim that it would not lead to uncertainty would have to be tested. And such a rule would be more practical and ethically acceptable if the tax system itself were simpler with fewer loopholes, and tax rates were more competitive, so any avoidance was more clearly unethical. Finally, very strong controls would need to be in place to ensure a GAAR was not abused by future governments.

2.7.2. Alternative minimum or 'tycoon' tax

Deputy Prime Minister Nick Clegg proposed what he called a tycoon tax, an additional minimum rate designed to catch some high earners who appear to pay lower rates. He argued that:[47]

44. Scalia, A. The rule of law as a law of rules, *The University of Chicago Law Review*, Volume 56, Number 4, 1989, pg. 1179
45. Raz, J. Legal Principles and the limits of law, *Yale Law Journal*, Volume 81, No. 5, 1972, pg. 841
46. Aaronson, G. *A study to consider whether a general anti-avoidance rule should be introduced into the UK tax system*, study for HM Treasury, London, 2011; HM Treasury *Budget 2012*
47. Pearse, D. Nick Clegg calls for introduction of 'tycoon tax', *Guardian*, 10 March 2012

If you're earning millions per year, if you're able to pay an army of lawyers and accountants to basically pick and choose what tax you are paying, if you are paying as low as 25 per cent, 20 per cent or even less in tax, there should be a minimum fair share that you should pay to society.

To a certain extent that premise is simply false. As set out in Section 4.2.1, higher earners pay substantial amounts of tax and a much higher share of total income taxes than their share of total income.

There are some ways that high earners, particularly foreigners, can avoid some taxes like Stamp Duty. It is hard to see how that would be captured by an alternative minimum tax though, as it is not related to their annual income. It would be better to either find a way of closing the Stamp Duty loophole, as the Government claimed to have done in Budget 2012, or to abolish Stamp Duty for British people too, as the 2020 Tax Commission recommends.

There are other loopholes but there are also situations where low tax rates are charged because the income is taxed in other ways. For example entrepreneurs pay a low rate of tax on capital gains when they sell businesses that they have established. But that income is already taxed because expected taxes on future profits depress the value of the shares they are selling (Section 5.2.2.1). If we add to the double tax on growing businesses, it will mean fewer jobs, less innovation and lower wages for workers. Sometimes tax bills are also lower because money has been taxed abroad.

It is also unlikely that the tax would really only affect "tycoons" either. In the United States, there is a tax called the Alternative Minimum Tax, a more accurate description of what has been proposed in Britain. Representative Paul Ryan spoke to the Cato Institute about why that tax should be abolished:[48]

The AMT is a federal income tax that is imposed on top of the existing income tax system. In 1969, AMT was passed to go after 155 rich people who were using deductions and loopholes to avoid paying any taxes. And while subsequent tax reform closed those loopholes, the AMT remained. Most critically, the AMT was never tied to inflation, so that today the AMT is targeting an ever-increasing fraction of the middle class.

About 20 million Americans were subject to AMT in 2006; 23 million in 2007. Their estimated increased tax liability was about $2,000 per person. According to the Congressional Budget Office, by 2010, if nothing is changed, one in five taxpayers will have AMT liability. Nearly every married taxpayer with income between $100,000 and $500,000 will owe the alternative tax.

So the AMT represents an enormous tax hike on the middle class. Going forward, it will represent an even larger tax increase. That is a major reason it must be repealed.

At Budget 2012, the Government pledged to introduce such an alternative tax on a limited basis, by capping unlimited reliefs (pension contributions would therefore not be included as that relief is limited). Ministers have acknowledged that it could create problems for charities, pledging to "explore with philanthropists ways to ensure this new limit of uncapped reliefs will not impact significantly on charities that depend on large donations".[49] John Low, Chief Executive of the Charities Aid Foundation, said that the relief was not avoidance and is "supporting major dona-

48. Ryan, P. Repealing AMT, *Reforming the Tax Code*, Cato Policy Report, March/April 2008
49. HM Treasury *Budget 2012*, pg. 59

tions by people who, in some cases, are donating the proceeds of a lifetime's work to charity. Such a change risks reducing major donations by Britain's richest individuals at a time when charity budgets are being squeezed."[50] Limiting loss relief could also create serious problems for those with unstable incomes. With a big gain one year, and a big loss the next, they could end up paying a substantial amount of tax on no net income.

It is far better to build a simpler tax system with fewer loopholes, and more equitable treatment of different taxpayers, than apply this kind of patch to the existing system. Accountants from every major UK firm have attacked the likely results of an alternative minimum tax. Alex Henderson at PricewaterhouseCoopers attacked the premise, saying that "one reads headlines saying that people aren't paying the full amount of tax, but it's actually quite difficult to hide tax – and high earners are paying a high rate". David Kilshaw at KPMG supported that, saying a "lot of people are actually paying 50 per cent or more". He argued that the "sort of person who would be really badly hit [by a comprehensive alternative minimum tax] would be someone on £60,000 who pays a £20,000 pension contribution", people who are "a long way away from being a tycoon". Patrick Stevens from Ernst and Young argued that it was a misplaced attempt to replicate the Alternative Minimum Tax but that deductions were "nowhere near as prevalent" in the UK so it was "an answer looking for a problem".[51]

50. Charities Aid Foundation *Tax changes could strangle major donations – says charity*, 21 March 2012
51. All quotes from Harris, J. Accountants hit out at Clegg's tycoon tax, *City A.M.*, 12 March 2012

Chapter three

Taxes should be cut to 33 per cent of national income

3. Taxes should be cut to 33 per cent of national income

3.1. There should be an upper limit on the level of tax

There appear to be limits to the taxable capacity of the British economy, and taxes do not seem to be able to raise more than 40 per cent of national income (Section 3.1.1.1). That is the result both of political constraints and of taxes harming the economy and thereby shrinking the tax base. High marginal rates of tax lead to the migration of economic activity to lower tax jurisdictions (Section 3.1.1.2), create a deadweight loss of economic activity that does not take place (Section 4.1.3), and reduce taxable income (Section 4.2.1). That puts a certain practical limit on spending as a share of national income.

3.1.1. There is a limit on the amount of tax that can sustainably be raised

3.1.1.1. There appears to be a limit on the taxable capacity of the British economy at around 40 per cent of national income

A reasonably close relationship between the ratio of general government spending to GDP and the ratio of taxes to national output might be expected in theory, if politicians decide how much they want to spend and then raise the taxes needed to pay for that level of spending.

In practice, however, the proportion of government spending in the OECD area that has been funded out of taxes (including non-tax receipts, such as rents and interest receipts) has averaged 91.7 per cent over the period 1990 to 2011, with a range of 81.6 per cent to 100.3 per cent and a standard deviation of 4.8 percentage points. This is not a particularly close relationship and it implies that there is a considerable amount of independent movement between the two variables. The state of the business cycle is one obvious explanation. Government receipts tend to be weak in a recession while public spending tends to rise, because welfare payments go up with rising joblessness and because of attempts to pursue supposedly expansionary demand management policies.

Looking at the statistical relationship between the spending and tax burdens, there is evidence of a maximum taxable capacity: practical political or economic limits on the amount of spending politicians can finance with higher taxes.

The short period for which annual data was available meant that it was not feasible to do any elaborate time series modelling, but a simple static regression equation was estimated over the period 1990 to 2011 and some experiments carried out with more elaborate error-correction equations containing a limited number of lags on the tax and spending burdens, which produced broadly comparable results. The simple static equation had the properties that the burden of OECD tax and other receipts expressed in percentage terms equalled a constant of 47.19 but that each one percentage point rise in the government spending ratio was associated with a fall of 0.23 percentage points in the tax and other receipts ratio. This negative relationship may appear to be a strange result. However, it can be explained if the tax base only consists of the private sector. The 't' ratio test of statistical significance on the constant was 15.16 while that on the spending burden was 3.01, so that both variables were statistically significant.[52]

However, the R-bar-squared was only 27.7 per cent – implying that some three quarters of the annual variation in the OECD tax burden was not explained – while the standard error of the regression equation was 0.58 percentage points, and the value of the Durbin Watson test was only 0.60 rather than the desired value of around 2. This implies that there was a large element of unexplained systematic disturbance in the residuals from the equation.

The main conclusion from this analysis is that there is a relatively weak – and negative – relationship between government spending and taxation rather than the strong – and positive – one that might have been expected if politicians first decided what to spend and could then raise the tax burden accordingly without causing any adverse supply side effects.

However, there is an interesting corollary of the fact that politicians seem unable to fine tune the share of national output taken in taxes. This is that one might then expect there to be a reasonably close link between the budget deficit expressed as a share of national output and the ratio of spending to GDP. To test this hypothesis, a simple static regression equation was first estimated between the two variables using annual data from 1990 to 2011. This equation had the properties that the OECD general government financial deficit to GDP ratio expressed as a percentage equalled a constant of minus 47.03 while each one percentage point rise in the government spending ratio was associated with an increase of 1.22 percentage points in the government borrowing to GDP ratio. This relationship had a high degree of explanatory power. In particular, the R-bar-squared was 93.0 per cent and the standard error was 0.58 per cent, although the value of the Durbin Watson test was only 0.62. The implication is that states can balance their budgets at a spending ratio of 47 per cent of GDP but after that each additional one percentage point of spending created 1.22 percentage points of borrowing.

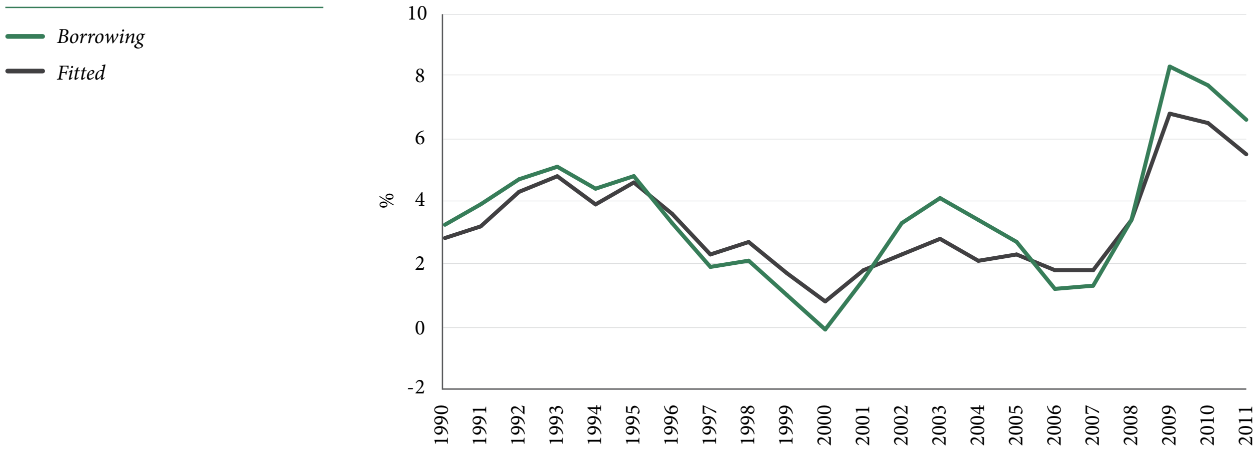
Such static relationships often lead to incorrect estimates of the long run effects though, because adjustment is rarely instantaneous. As a result, it was helpful to estimate a dynamic error-correction model that initially allowed for lags of up to two years on the variables concerned. The resulting final equation had the long run properties that the general government borrowing ratio equalled a constant of almost exactly minus 38.0 per cent and increased on a one-for-one basis with the government spending ratio. This equation explained 95.3 per cent of the annual changes in the government borrowing ratio over the years 1992 to 2011, had a standard error of 0.34 per cent, and a more satisfactory Durbin-Watson statistic of 1.64. The short-term dynamic terms included a one-period lag of the change in the borrowing ratio and the change in the government spending ratio with a coefficient of 1.17. A statistical test of whether the long-run coefficient on the spending ratio differed from unity had an insignificant 't' value of 0.78, justifying the idea of a one-for-one relationship.

That estimate is for the weighted average of the OECD as a whole. While some countries have maintained higher tax ratios, they tend to be smaller countries particularly in Scandinavia, with exceptional circumstances such as a high political tolerance for regressive rather than redistributive taxes among their relatively

52. It is possible to estimate a similar equation for pure tax receipts, excluding other government income. This gave a constant of 42.50 and a coefficient of minus 0.19 on the government spending ratio, with an R-bar-squared of 0.272, a standard error of 0.50 percentage points and DW statistic of 0.36, using annual data for 1990 to 2011. These are very similar results after allowing for the different constants, which reflect the fact that pure taxes represent a smaller share of GDP.

homogenous populations. And those small outliers are offset on the other side by low tax economies such as Korea, Switzerland, Australia and Slovakia.

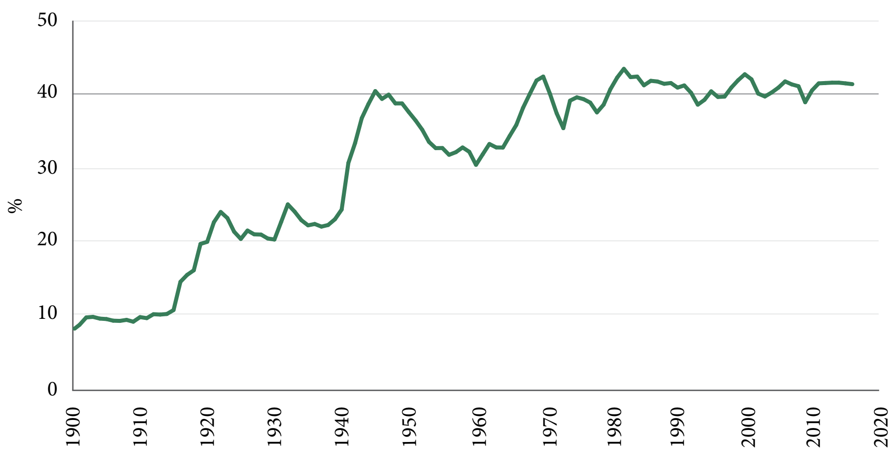
Figure 3.1: Ratio of OECD area general government borrowing to GDP and long run steady state solution from error correction model 1990 to 2011



The old HM Treasury rule-of-thumb, that the sustainable taxable capacity of the British economy was around 40 per cent of market price GDP, may still be approximately accurate

The economic interpretation of those findings is that once the share of government spending in GDP exceeds 38 per cent, all further increases in the government spending ratio become fully reflected in increased borrowing. This suggests the old HM Treasury rule-of-thumb, that the sustainable taxable capacity of the British economy was around 40 per cent of market price GDP, may still be approximately accurate (see Figure 3.2 though this uses non-oil GDP at factor cost). Future research should try to obtain a longer back run of data for the OECD area as a whole and to combine the annual observations for the thirty individual OECD countries in a panel data study to see if they are consistent with the aggregate OECD relationship.

Figure 3.2: Ratio of UK non-oil tax receipts to UK non-oil GDP at factor cost, 1900–2010, with implied March 2012 Budget forecasts for 2012 to 2016



3.1.1.2. Higher taxes lead to the migration of economic activity to lower tax jurisdictions

High taxes can cause people and businesses to move. Individuals, families and firms may choose to move out of a high tax jurisdiction to a lower one. The effects of this can be significant. There is a loss of tax revenue to the exchequer; a loss of productive input into the economy; a loss of spending power. Furthermore, if a business decides to migrate there will be a loss of other jobs, which will exacerbate each of these effects in turn. A good CEO and Board should always be considering moving abroad, whatever the circumstances. If they do not, then they are doing a disservice to their shareholders, as they should be looking to maximise their returns. But high marginal taxes will weigh decisions more heavily in favour of migration.

An OECD report in 2008 found that at the time there were 3.2 million British-born people living abroad, of whom more than 1.1 million were highly-skilled university graduates. Furthermore, over three quarters of these professionals had settled outside of the UK for more than a decade. The same report showed that no other country analysed had lost as many of its skilled citizens. Professor David Coleman of St John's College, Oxford, told the *Daily Telegraph* that the brain drain was "to do with quality of life, laws and bureaucracy, tax and all the rest of it".[53]

This issue is especially relevant to the debate over the top rate of Income Tax. Commentators argue that the additional rate of Income Tax could cause a flight of businesses, entrepreneurs and other individuals to other countries. There are anecdotal stories about long waiting lists for places at English-speaking Swiss schools and other signs that significant emigration is resulting from Britain's high taxes. Inward investment can also be hit: recently the social networking site Twitter decided to locate its international operations in Dublin instead of the UK, and an important reason cited was Ireland's more favourable corporate tax system.[54]

Globalisation means that migration is not necessarily a matter of individuals upping sticks and moving. Capital is now global, and this means that entrepreneurs and businesses have a range of choices of where to invest that capital that they may not have had in past decades. A high tax environment will cause investors to choose to invest elsewhere, meaning less job and wealth creation. Globalisation is not just about Western consumers buying cheap Chinese products; it is about mobile labour and capital too. Therefore states should respond with tax and regulatory systems that encourage inward investment and job creation. American studies have found this to be true when looking at interstate migration. Essentially, the more mobile the factors being taxed – high earners and capital, for example – the bigger the response will be.[55]

Ryanair, the Ireland-based low cost airline, is a case in point. The company recently announced a new investment to expand its fleet of aircraft from 270 to 305. This will see the creation of 1,000 new jobs in 2012 for pilots, cabin crew, engineers and in other roles such as sales and marketing. But the jobs are going to be based in mainland Europe, rather than Ireland. Ryanair said that the Irish Air Travel Tax was a significant factor in its decision. Given that Ireland has low overall rates of Corporation Tax, the effects of punitive tax regimes for particular sectors are likely to be felt more acutely in Britain.

53. Winnett, R. Biggest brain drain from the UK in 50 years, *Daily Telegraph*, 21 February 2008
54. Blackden, R. Twitter joins Ireland's Silicon Valley, *Daily Telegraph*, 26 September 2011
55. Laffer, A., Moore, S. & Williams, J. *Rich States, Poor States 4th edition*, American Legislative Exchange Council, 2011, pg. xiv

A tax on success

UK celebrities who have moved abroad to more favourable tax jurisdictions:

- Sir Michael Caine
- Sir Michael "Mick" Jagger
- Phil Collins
- Jenson Button
- Lewis Hamilton
- Sir Sean Connery
- David Bowie
- Rod Stewart

Many of the individual cases that have been reported are significant in their own right. The *Financial Times* reported in 2012 that UK hedge funds were leaving the UK. William Bollinger, considered one of the pioneers of the City of London's hedge fund industry, decided recently to launch a new venture in Singapore, rather than London.[56] In February 2011, Pfizer announced it was closing its research factory in Sandwich because it was no longer competitive. Other large companies also left the UK in 2010: WPP, Shire, Informat, Aberdeen Asset Management, Hendersons Ireland, Charter, Regus, Brit Insurance, Wolsely, McDonalds (European HQ), UBM, Kraft Foods, Gallaher, Experian, Catlin, and Hiscox. In late 2011, an aluminium smelting plant at Lynemouth in the North East of England announced that it was closing because of the Government's decision to introduce carbon-floor pricing – or a new green tax. 515 jobs were lost as a result.[57] Demand for aluminium will not alter as a result, and economic activity will simply move elsewhere because of high taxes.

Electronics firm Raspberry PI have chosen to produce their products in Taiwan and China rather than the UK. The organisation – a charity that makes credit card-sized computers aimed at helping children learn to write their own programs – said that the tax system in the UK makes it far too expensive for an electronics company to assemble its products in Britain.[58]

There are countless other real-life examples of companies relocating or making initial location decisions based on tax rates. For example, an article in *The Economist* discussed the increasing levels of migration to Texas, a low tax state, from other areas of the United States:[59]

> *Migration statistics reveal that people are moving in droves to Texas. Why? Jobs and no state income taxes. High earning New Yorkers and Californians can take home between nine per cent and 11 per cent more of their income by moving to Texas.*

High corporate tax rates elsewhere can mean more investment in the UK. For example, American rates of corporation tax are currently at 35 per cent, one of the highest rates in the world. This means that corporate tax revenues are actually falling and the effective rate paid by large US public companies fell to its lowest in a decade in the fourth quarter of 2011. More and more revenue is being generated outside of the country, including in the UK. The Chief Financial Officer of Intercontinental Exchange noted in the *Financial Times*:[60]

56. Jones, S. Hedge fund pioneer back for Asia venture, *Financial Times*, 16 February 2012
57. Wachman, R. Rio Tinto blames carbon tax for 515 job losses, *The Guardian*, 16 November 2011
58. Reported on their website here: http://lowtax.es/HOd3bg
59. The Economist, Free Exchange blog *Texas, here we come*, 16 June 2010
60. Demos, T. US corporation tax rates hit 10-year low, *Financial Times*, 4 March 2012

Our focus is on generating the highest after-tax returns for our investors. All else equal, given current tax rates and future expectations, that biases us towards investments in London.

The academic literature on the specific link between taxation and interstate migration is relatively sparse. Most of the literature recognises taxation as a significant reason among others. There is also a wealth of studies on the investment decisions of firms and entrepreneurs and the tax environment. But this is an area that will receive a lot more academic attention as globalisation makes the movement of capital and workers across borders far more common.

Indeed, a 2010 study claimed to uncover, for the first time, "compelling evidence of a link between taxation and migration".[61] The authors looked at European footballers and the clubs that they played for since 1980. The study constructed a panel data set of tax rates, the movement of footballers across Europe, club performances and player careers, finding that "the overall location elasticity with respect to the net-of-tax rate is positive and large".[62] Their study also looks at micro-level results in particular countries. Spain famously introduced 'Beckham's Law' (named after David Beckham, who was one of the first and most notorious players to take advantage of it when he moved from Manchester United to Real Madrid). It meant non-residents were taxed at a flat rate of 24 per cent instead of the top marginal rate of 43 per cent (at 2008 rates).

Consequently, Spain saw its share of foreign players increase and the standard of the clubs increase as well. The Italian league, notoriously strong in the late 1980s and 1990s, saw its pool of top foreign talent shrink and with it the top clubs' competitiveness in European competition. When Beckham's Law was introduced, Arsene Wenger, the manager of Arsenal Football Club, said that "with the new taxation system […] the domination of the Premier League will go, that is for sure".[63] Indeed, Spanish clubs have been dominant since the latter half of the last decade, managing to attract top foreign talent.

This effect has been felt in the traditionally smaller European leagues too. Denmark introduced tax breaks for foreign players in 1992, while Belgium introduced similar schemes in 2002. Both saw an increase in higher-quality foreign players moving to play in these leagues.

Kleven et al. also produced a cohort-based analysis of tax reform in Greek football. This analyses the movement of Greek players to and from the Greek league, rather than the inward migration of foreign players. A tax cap was removed in 1993 which meant that marginal rates increased for high earners. Higher-quality Greek players – at a peak playing age – moved abroad more often than those Greek players in their prime before the tax changes. The cap was reinstated, which lowered tax rates, and again more high-quality Greek players stayed in the domestic league.

Most of the literature on the relationship between economic migration and taxation focuses on when it occurs within a jurisdiction, or interstate migration. This is more straightforward to model than tax-induced cross-country migration.

The seminal work on the migration of economic activity between competing local entities was carried out by Charles Tiebout, who wrote *A Pure Theory of Local Expenditures* in 1956. He developed a model showing that individuals will move

---

61. Kleven, H., Landais, C. & and Saez, E. *Taxation and international migration of superstars: evidence from the European football market*, NBER Working Paper No. 16545, 2010, pg. 39
62. *Ibid.* pg. 1
63. *Ibid.* pg. 4

to different jurisdictions based on what services they are offered and at what price (the tax rate). It was based on the following assumptions:

- Consumer-voters are fully mobile and will move to that community where their preference patterns, which are set, are best satisfied
- Consumer-voters are assumed to have full knowledge of differences among revenue and expenditure patterns and to react to these differences
- There are a large number of communities in which the consumer-voters may choose to live
- Restrictions due to employment opportunities are not considered
- The public services supplied exhibit no external economies or diseconomies between communities
- Average cost of providing public goods as a function of population is U-shaped, i.e. there exists a cost minimising population size
- Communities with population sizes below (above) the cost minimising size seek to expand (contract)

Tiebout does not argue that these assumptions necessarily reflect reality. Rather, they underpin a model of local government expenditures that yields the same optimal allocation that a private market would. These assumptions clearly do not hold exactly: consumer-voters are not perfectly mobile, for example, as there are costs to moving including Stamp Duty, but starting from a model of competitive local government, it is then possible to study effectively the causes and consequences of dysfunctions in that market.

McDonald responded to that by arguing governments tend to look more and more like each other over time, and therefore people do not vote with their feet because they have no incentive to move.[64] That may be truer of local governments within countries, although there are still substantial differences between countries.

On the whole though, the broader academic literature tends to suggest that high taxes do contribute to migration. Vedder analysed net domestic migration numbers in America from 1990 to 1999 and found that low tax states had a net inward migration of 2.8 million people, while high tax states had a net outward migration of 2.2 million.[65] Pema analyses interstate data from the US and finds that the more high-skilled the labour, the more likely individuals are to relocate between jurisdictions. The author finds advanced-degree holders appear twice as responsive to local taxes as college graduates, who in turn are between seven to nine times more responsive than individuals with high school degrees (including those who have started but not finished degrees). At the other end of the scale, people with less than a high school degree are three times more responsive to the local tax environment when compared to high school graduates, favouring a high tax environment due to welfare-induced migration.[66] Ehrenberg and Smith also find that younger and more educated people are more mobile.[67]

The more high-skilled the labour, the more likely individuals are to relocate between jurisdictions

There is also evidence that a local authority setting progressive tax rates to redistribute income will suffer greater emigration. Individuals can avoid higher taxes by migrating to jurisdictions that offer more favourable tax conditions. Gross wages adjust rapidly to higher or lower taxes. This adjustment, according to Feldstein and Wrobel, implies that a more progressive tax system raises the cost to firms of hiring

64. McDonald, B. *Staying put: A rebuttal to Tiebout*, NBES Annual Conference, 2010
65. Vedder, R. *Taxation and Migration*, The Taxpayers Network, 2003
66. Pema, E. *Do state taxes affect migration of human capital?* Naval Postgraduate School, 2005
67. Ehrenberg, R. G. & Smith, R. S. *Modern Labor Economics: Theory and Public Policy*, 1988

more highly skilled employees and reduces the cost of less skilled labour. A more progressive tax system means that firms will hire fewer highly skilled employees, instead hiring more less-skilled employees.[68] On a national level, adjusting the tax system to redistribute more income could make it increasingly hard to attract capital and talent as wages adjust and capital and labour are more flexible and mobile.

An important paper on tax harmonisation and tax competition by Kirchgassner and Pommerehne showed that tax competition in Switzerland influences the populations of the cantons, particularly those with high incomes.[69] While it shows that taxes do affect the migration of economic activity, the paper also finds evidence that tax competition does not lead to a collapse in the public goods supply, nor makes redistribution impossible, if so desired. This paper provides evidence that individuals respond to tax incentives and will move to jurisdictions with a more favourable tax environment, but that this tax competition does not lead to a complete race to the bottom.

Even studies which do not find a particularly strong relationship tend to concede that it does have an effect on migration decisions. A recent paper looked at New Jersey's "millionaire tax" and found that there was not a strong 'responsiveness'. The levels of migration to other States away from New Jersey did not alter massively. But they did increase, albeit concentrated among those of retirement age living off investments rather than wages, and those who work (and pay tax) entirely in-state.[70]

The consensus in the literature – based on Tiebout's model – is that perfectly mobile households will relocate in response to fiscal conditions. There is good reason to think that does apply in practice with those deciding whether or not to remain in the UK.

As long as it remains within a liberal, free-trade framework, competition between governments is as good for individuals as competition between firms is for consumers. It keeps down tax rates, especially on labour and capital, which is good for growth and job creation; states need to produce better services at the cheapest possible cost. And if governments become too irritating or incompetent, it allows an exit strategy. Many who claim to want greater competition in the domestic economy – for example, in banking – are on the other hand fearful of competition for people between states, decrying it as a race to the bottom. Yet monopolies are always bad, in every sphere of human endeavour, breeding complacency, curtailing innovation and undermining progress.

Britain is losing out to other jurisdictions in the race for people. Even though there is very little office space, housing or vacancies in schools in Switzerland – the Swiss are reluctant to expand – there has been a relatively large influx of London financiers to that country, especially from hedge funds and energy and commodity trading firms.

The number of bankers leaving for Switzerland will vary from year to year for a number of reasons, including wider economic conditions and other tax changes. Many of those moving may not be British citizens, as those who have already moved to come to London are likely to have the fewest ties preventing them moving again. However, the number of bankers who are British citizens moving there has been steady at around 300 to 400 in recent years. It was highest in 2008, when the first

68. Feldstein, M. and Wrobel, M., Can state taxes redistribute income? *Journal of Public Economics*, 68, 1998

69. Kirchgasser, G. and Pommerehne, W. Tax harmonization and tax competition in the European Union: Lessons from Switzerland, *Journal of Public Economics*, 60, 1996

70. Young, C. & Varner, C. Millionaire migration and state taxation of top income: Evidence from a natural experiment, *National Tax Journal*, 64 (2), June 2011

rise from the 40p top marginal rate was announced.[71] Consulting firm Kinetic Partners LLP told Bloomberg how it had helped 23 hedge funds move from London to Switzerland in 18 months even before the introduction of the additional tax rate, and that up to 20 per cent of the industry was then likely to leave over the following two years after the announcement of the new top rate.[72]

The Swiss Funds Association has estimated that 20–25 UK hedge funds set up offices in Switzerland over the course of 2010 and early 2011. Switzerland has also witnessed an inflow of Russian oil traders, including Rosneft and Bashneft; several other teams have recently left London for Geneva or Zurich. TNK-BP is opening a trading arm in Geneva; it will be based a short walk away from the third, fourth and fifth largest trading firms in the world. This is a blow for London, which for the first time since the late 1980s is losing its lead in the trading of physical crude and oil products.

Britain loses out in competition for world markets thanks to high taxes as well. There are serious concerns about the failure of Britain's export sector to take advantage of falls in the value of sterling. Liam Fox MP wrote for the *Financial Times* in February 2012 that:[73]

> *Despite a 25 per cent devaluation of sterling, UK exports to Asia in the last three years have grown at a slower rate than those from Greece and Spain.*

That failure may be the result of tax policy. The supply of tradable goods will tend to move from high-tax to low-tax economies over time for quite straightforward reasons: taxes will normally have more of an impact in markets where there are substitutes. For example, a tax on motor fuel will have more of an impact on reducing the amount people use their cars if there is a good public transport network as an alternative. In just the same way, manufacturers supplying global markets have to compete with foreign alternatives, in a way that service businesses like restaurants supplying local markets do not. All of the restaurant's competitors should pay the same taxes.

A relatively high tax burden acts like a discriminatory tax on the exports and import substitution of the country concerned. If all other production costs are the same, then buyers in world markets will always source from the low-tax economy and there will be zero demand for the products of the high-tax one. If there are no welfare benefits, so that the labour market clears, the former employees in the internationally trading sector of the high-tax economy will seek employment in non-traded domestic services. For example, they will shift from car production to shoe cleaning or hairdressing, where real earnings are generally far lower. If welfare benefits are available, the displaced workers from the internationally-open sectors are likely to end up on the dole instead, particularly if the replacement ratio is excessively generous because the government has not allowed for a drop in the market clearing real wage.

One of the main problems facing Western economies with large government sectors is that globalisation – and the development of South-East Asian economies where the state only spends between 20 per cent and 25 per cent of national income – has greatly speeded up and exacerbated this hollowing out effect, leading

71. Channel 4 News *No banker exodus after 50p tax rate hike*, 20 March 2012
72. Lynn, M. Bankers Will Follow Hedge Funds to Switzerland, *Bloomberg*, 12 October 2009
73. Fox, L. The pressing case to cut both taxes and spending, *Financial Times*, 21 February 2012

to the accelerated de-industrialisation that his hit regions such as the North East of England and West Midlands so hard.

In the Foreword to the Government's *Plan for Growth*, Chancellor of the Exchequer George Osborne and Business Secretary Vince Cable wrote that "our economy must become more balanced".[74] It is unlikely that the UK economy can be rebalanced in favour of a larger manufacturing sector while the tax and spending burdens are as high as they are at present.

It is unlikely that the UK economy can be rebalanced in favour of a larger manufacturing sector while the tax and spending burdens are as large as they are at present

Given that recorded productivity growth tends to be faster in manufacturing and internationally-traded services than elsewhere, this switch of labour resources away from the internationally-trading sectors is one reason why open economies with large public sectors grow slowly. Britain has too few private-sector producers who can respond flexibly to the price signal of a more competitive exchange rate.

The debate about economic migration in the UK now is too simplistic. But every time an individual or business chooses to leave the UK because of tax then they take economic activity with them. Or each time they decide not to move here because of tax, and go elsewhere, they deprive the UK of economic activity. A 2010 survey by HMRC showed that one in five UK companies has considered leaving the UK for tax reasons.[75] If taxes remain complex and burdensome that share is likely to grow. Even if they do stay here, if taxes leave them unable to compete on world markets, the result could be much the same..

3.1.2. Under a range of philosophical perspectives, taxes become unethical beyond a certain level

The following sections take particular perspectives for granted, looking at the case for and against higher taxes and spending under different philosophical approaches. The consistent result is that there are limits to the proper level of spending at the point beyond which taxes seriously impede economic efficiency and generate limited social returns.

3.1.2.1. With a utilitarian perspective, there should be an upper limit on the level of tax

For a utilitarian, the most important goals in the economic sphere are to ensure that goods and services are available to allow everyone to have a decent life, and to ensure that resources are distributed sufficiently widely for all or most people to have that opportunity.[76]

There is a certain tension. More tax-based redistribution will help to achieve the second goal, wider distribution, but the adverse effects of increased rates of taxation on investment and on incentives will make it harder to achieve the first goal, adequate total resources. We need to recognise that the first goal is prior. If it is not achieved, then the second goal cannot be achieved. If we do not achieve the first goal, we can still achieve redistribution, but it will be redistribution of a smaller total, making it harder to allow everyone to have a decent life. That would be pointless. The absolute level of provision matters a very great deal, even though it is not the only thing that matters. Redistribution is only part of the means to allowing

74. HM Treasury *Plan for Growth*, March 2011
75. Malam, S. et al., *Large Business Customer Survey*, TNS-BRMB report for HMRC, 2010, pg. 42
76. A true utilitarian would only care about aggregate utility, not about its distribution. But we are here discussing the distribution of resources, not of utility, and given that modest resources in the hands of each of many people may be expected to generate more total utility than the same total resources in the hands of a few, the utilitarian objective is far more likely to be achieved by a wide distribution of resources than by a narrow concentration of them.

everyone to have a decent life, and it can undermine the other part of the means, which is economic growth.

Utilitarians must therefore strike a balance. They should do so in a way that takes full account of the economic evidence on tax levels and growth (Section 3.4; Section 4.1.2). In particular, it is essential to realise that, in the long term, growth rates are overwhelmingly important. A certain amount of economic growth, not followed by contraction, represents an addition to wealth generation every year thereafter. And the cumulative effects of even modest differences in growth rates are startling, showing how much more wealth can be made available to help people on lower incomes. For example, one per cent annual growth over 20 years increases income by 22 per cent, while two per cent annual growth increases it by 49 per cent, and three per cent annual growth by 81 per cent. Over 40 years, the figures are 49 per cent, 121 per cent and 226 per cent respectively.

Our conclusion is that the utilitarian should favour enough taxation to satisfy the legitimate objectives of taxation to a reasonable extent. When we consider what is needed for a decent life, which could include providing a reasonable level of education and healthcare to everyone. The imperative not to hold back economic growth would feed back and help to determine what would be a reasonable level of provision. When such choices arise, one complicating issue is that of how we should balance the interests of current and future generations. That debate can be partly put into quantified terms by debating the appropriate social rate of time discount.

Furthermore, the utilitarian should favour providing services in the most efficient way possible, whether that be direct state provision, private provision at taxpayers' expense or something else. If the objective is to ensure decent lives, we should not waste resources.

The favoured level of taxation is certainly less than is implied by the current level of state spending in the UK. It is hard to determine the precise level of state spending that would maximise welfare (the utilitarian's objective), but it seems to be below 35 per cent of GDP (Section 3.2.1). And even that would be a good deal more than the level that would maximise economic growth.

We can also note that imposing only a modest level of taxation, rather than a high level, promotes other sources of utility. If the level of taxation is kept down, that increases the level of personal freedom to use one's own resources as one wishes. People not only like the feeling of running their own lives, they are also, on the whole, the best judges of what matters to them. If they take their own decisions, the decisions are more likely to be the ones that will really promote their utility than decisions taken by another person would be. (This is of course not guaranteed. Some people do take foolish decisions about their own lives.) Tax is relevant here too, because it takes away from people decisions on how to use some of their financial resources. Even if public spending is in accordance with their wishes, it is still someone else's decision, reducing the extent to which people run their own lives. The new discipline of happiness economics is also finding that autonomy matters to people's well-being.[77]

Keeping the level of tax down also promotes the feeling of living in a cohesive society: people do contribute something to other people's utility, but not so much as to lead to the resentment that can arise if people think that others are sponging off them. It is worth noting that there is a widespread view that we should not be

77. See for example Chirkov, V. I., Ryan, R. M. & Sheldon, K. M. (Eds.), *Human autonomy in cross-cultural contexts: Perspectives on the psychology of agency, freedom, and well-being*, 2010

overly generous to benefit claimants, suggesting that it is not difficult to generate resentment by being very generous.[78]

3.1.2.2. A deontological perspective offers no decisive guidance on the level of tax

One commonly mentioned duty is the duty to respect other people's property rights. This could be the basis of an argument against all taxation. The argument would be that taxation was the forcible transfer of property away from taxpayers, and that this was morally on a par with theft.[79]

On the other hand, the duty to respect other people's property rights could be the basis of an argument for paying for any social resources that one used, even if one did not ask for them to be provided. This argument is perfectly plausible when one could choose which provider of a service to use. A tax system might, for example, allow tax reductions to people who bought private medical insurance or private education for their children, on condition that they did not use taxpayer-funded hospitals or schools.

Such opt-outs would be practical for some substantial areas of public spending, but they would not be universally practical. We therefore need to consider the argument in relation to spending that potentially benefits everyone, but opt-outs from which are not practical, or even if practical, are not likely to be offered in the foreseeable future. The argument that tax should be paid would be an argument against free-riding, rather than an argument against theft. One could construct a deontological argument against free-riding. A Kantian might say that one could not coherently will that all should engage in free-riding, because then there would be nothing for anyone to ride. It would follow that one should not act on a maxim that one should oneself free-ride. On the other hand, one could coherently will that all should abstain from free-riding. It would follow that this would be an acceptable maxim on which to act.

Deontological consideration can therefore work both ways, both opposing tax in general, and favouring tax. The fact that consequences are of no interest to the pure deontologist means that we get no clear guidance on a particular level of taxation, nor can we invoke economics to help us to select a particular level. The question is therefore one of efficiency rather than ethics from a deontological perspective.

3.1.2.3. With a virtue ethics perspective, there should be an upper limit on the level of tax

Many virtues can feature in the arguments of virtue ethicists. The exercise of some of them can be directly affected by the level of taxation.

One virtue is to use one's talents to the full. One may do so regardless of financial incentives, but those incentives can have an influence, with higher rewards encouraging greater effort. To the extent that this happens, high taxation would work against the exercise of this virtue because it would blunt the incentives. There is also a less direct, but equally important, effect to consider. To the extent that high taxation impedes economic growth, it can prevent the creation of significant numbers of jobs in which people could otherwise have exercised their talents.

Another virtue is charity, both in cash and in time. The more net pay people have, the more likely it is that they will feel that charitable donations are affordable. And the more net pay per hour people have, the more likely they will find it affordable to take time away from work to make time for charitable work or other forms of civic

78. O'Brien, N. *Just Deserts? Attitudes to Fairness, Poverty and Welfare Reform*, Policy Exchange, 2011
79. See for example: Rothbard, M. *The Ethics of Liberty*, 1998 (first published 1982), chapter 24

Deciding what we want

Peter and Mary are at school in very similar countries. At the moment, Peter's country provides money to buy whatever teachers in state education request. The schools are well-equipped with the latest technology and buildings are refurbished frequently. In Mary's country, there is stricter control over spending, the technology in schools is adequate, and buildings are only refurbished when they get shabby. The tax burden is therefore lower in Mary's country, and the rate of economic growth is slightly higher. In 20 years time, Mary will be able to earn a higher salary than Peter, because of that difference in growth. Peter could quite rationally wish he were in Mary's country, trading a less costly education system for better prospects later.

Susan and Lisa both work hard and save what they can. That is, they both act virtuously. Susan can afford to save a good deal. Later in life, she wants to help her grandchildren through university. She also develops an interest in travelling round the country to make photographic records of historic buildings that are in decay, for the benefit of future generations. She can afford to do so. Lisa has the same desires, but she has not been able to save as much. She can rely on a limited state pension, but this does not allow her any surplus to help others or to pursue projects like Susan's. Thus Susan achieves more. In that sense, her life is more virtuous.

David and Tom both make no attempt to save, but enjoy their income as they earn it. David has more to spend while he is working, but has a lower income than Tom in retirement. Neither achieves much of significance outside their work, either when working or in retirement.

Thus a policy of low taxes can give more scope than one of high taxes to allow the virtuous to achieve the things that matter to them, even though it may make little difference to the position of those who never wanted to achieve much anyway. But the very fact that a policy of low taxes gives opportunities to achieve, may itself encourage people to achieve things rather than to drift along.

service (for example as school governors or magistrates), alongside their requirement for private leisure time (although this effect does not apply to the very large amount of charitable and community work that is done by the retired and by others who do not have paid work). There is a counter-argument in relation to contributions in time, because a higher net rate of pay per hour may make people value extra time at work more than they otherwise would, but there is no reason to suppose that this effect would be stronger than the effect of making time for service affordable. So whether we are concerned with the virtue of charitable donation of money, or the virtue of participation in charitable or other civic activities, there would again be a case for comparatively low rates of taxation.[80]

Another virtue is independence. It is good to earn what one needs, rather than to depend on subsidies from others. Comparatively low rates of taxation on modest incomes make independence more easily achievable. They reduce the need for the strange but widely prevalent phenomenon of both taxing and paying benefits to

80. It should be noted that the argument here concerns what individuals regard as sensible options for themselves. There is a separate question, not addressed here, as to what they will actually do, and the extent to which that may be affected by the extent and pattern of state spending. There is continuing controversy about the extent to which state spending may crowd out charitable giving.

the same people. They also give people space to save, so that they have their own resources on which to rely in old age, or should accident or illness strike.

It is also part of a good human life to have, and to fulfil, specific commitments to our own projects, to our families and friends, and to our local communities. Doing so requires the retention of control over a substantial proportion of the income that we earn, and the wealth that we possess. High tax rates work against this.

We can conclude that the exercise of several virtues would be promoted by having reasonably low, rather than high, rates of tax. But it is hard to think of virtues, the exercise of which would be encouraged by high rates of tax. High rates of tax do allow generous provision of public services and social security, which may in turn help those who benefit from them to live to the full, unless they are counter-productive by encouraging dependency. But the extent to which high spending can promote good lives is likely to be minimal once one gets beyond a certain level. The benefits of high spending would also have to be set against the damage that would be done to the exercise of virtues by the imposition of high taxes, as discussed here.

3.1.2.4. With a desire to avoid coercion, there should be an upper limit on the level of tax

Not surprisingly, political theory has the resources to contribute extensively to discussions of tax policy. Here, we consider a case against taxation that reflects the coercive nature of tax.

Taxation is coercive, but human beings do not generally appreciate being coerced. Even if people would willingly pay the taxes that the law requires, that requirement, and the threat of enforcement if taxes are not paid voluntarily, make the imposition coercive. It is interesting to speculate how attitudes to this coercion might change if taxes all had to be paid by separate transactions, involving workers and consumers handing over cheques for tax due each year, rather than most tax being collected automatically through such mechanisms as PAYE and the imposition of excise duties and VAT within prices in the shops. There might be much greater resentment than in fact exists.

We can go beyond such general feelings that coercion is suspect by considering an argument that taxation is automatically an infringement of our rights, and examining a counter-argument.

The argument that taxation is an infringement of our rights has most famously been articulated by Robert Nozick.[81] Nozick did not believe that there should be no tax, and hence no state. Instead, he thought that a minimal state would arise naturally, as the most effective way to provide the security of person and property that is needed for ordinary life (to be precise, it would arise naturally among those who chose to subscribe to it, but there would then be a moral case for the extension) of its protection to everyone.) But he did not want to see that state imposed on people. He argued that a distribution of resources was just if it arose from just initial appropriations (for example when people staked claims to land, in a situation in which there was still enough land for others to do the same), and from subsequent chains of transfers that were just (free exchanges or gifts).[82] Any state intervention to impose a different distribution would require continual interference, taking property from people without their consent over and over again, because ongoing free exchanges would soon upset any pattern that the state imposed at a particular point in time.[83] That sort of interference would violate people's rights. The point is

"Taxation of earnings from labor is on a par with forced labor"

Robert Nozick

81. Nozick, R. *Anarchy, State, and Utopia*, 1974
82. *Ibid.* chapter 7, section 1
83. *Ibid.* pg. 160–164

made most strongly in Nozick's claim that "taxation of earnings from labor is on a par with forced labor".[84] If, for example, labour income is taxed at 20 per cent, then one day each week of labour is for the state, not for oneself. And while one could avoid income tax by not working at all, it is not possible to work for oneself without also giving labour to the state.

Such arguments have, of course, been challenged. One line of argument is that considerations of justice, and particularly of equality, are strong enough to outweigh a case against all coercion, although they may still allow a case against the imposition of more than modest tax burdens. A related line of argument is that Nozick should not have relied so heavily on his basic proposition that certain things, such as taking property without consent, cannot be done without infringing rights.[85]

It is hard to adjudicate between Nozick's position and challenges of this nature. It often appears that disagreements reflect basic suppositions that different authors make about where to strike a balance between justice as the absence of coercion, and justice as some form and degree of equality. We can, however, say that Nozick's arguments are powerful ones, and they throw an onus on the advocates of the legitimacy of substantial taxation to make the case for that legitimacy.

One challenge to the way of thinking about these issues upon which Nozick relied can be considered without reaching the impasse of different basic assumptions. This is the challenge that is set out by Liam Murphy and Thomas Nagel.[86]

Murphy and Nagel deny that we should think in terms of a natural distribution of income and wealth, with which a tax-levying state would interfere. Their argument therefore denies that we should see interference by the state of a type that would need the very strong justification that interference with property rights generally needs, although some weaker justification may still be required. It therefore goes further than those who say that Nozick and those who agree with him cannot claim that a distribution of property rights arrived at from an original distribution by free exchanges is just. It says that there is no such distribution.

The argument is based on the argument that in a world without government, there might be no law enforcement, no security of property, no legal code to recognise property rights, no system of enforceable contracts, no stable and universally accepted currency, no scope for a stock market (because there would be no framework of company law, nor enforceable rights to the ownership of equity in companies), no control over negative externalities, no allocation of radio spectrum, and so on. As a result, overall levels of income and wealth would be much lower than they actually are.[87] It is not the case that existing income and wealth could be distributed differently without a tax-levying state. Existing income and wealth would mostly not exist without such a state. This basis has considerable plausibility. Even Nozick set out how a world with no government would develop into one in which there was minimal government.[88]

The argument that is built on this base is that there is no presumptively just pre-tax distribution of income and wealth, against which we can see the result of taxation as interference. The income and wealth very largely exist because of the tax system, or rather, because of what it funds. Our pre-tax incomes, which appear to be

84. *Ibid.* pg. 169
85. *Ibid.* chapter 3
86. Murphy, L. & Nagel, T. *The Myth of Ownership: Taxes and Justice*, 2002
87. Murphy, L. Nagel, T. *The Myth of Ownership*, pg. 32–37
88. Nozick, R. *Anarchy, State, and Utopia*, chapter 5

the amounts that would be ours if taxes were not imposed, are not amounts we could actually have. They are nothing more than book-keeping figures.[89]

So far as it goes, that is sound. We delude ourselves if we imagine that all government could be taken away, and the rest of life remain much as it is now. But the argument is not effective against a slightly different position, and one that does require very strong justification for taxation beyond a minimal level. This is the position which says that there is a presumptively just distribution of income and wealth, the one that would arise if government were limited to minimal functions. We can imagine a government that provides security of persons and property, the enforceability of contracts, commercial law, a currency, and not much else.[90] It is not clear that income and wealth under that regime would, in aggregate, be radically different from what they currently are. It is therefore possible to take the distribution that would exist with a minimal state as presumptively just, and require strong justifications for changes to that distribution that are imposed through taxation.

This rebuttal of the argument only goes so far. It makes it possible to think in terms of a presumptively just distribution, and therefore to require strong justification for deviations from it. The rebuttal does not show that the distribution that there would be under a minimal state would in fact be just, or even presumptively just. There is still scope to argue that justice would require interference with that distribution. But the pressure is put on arguments for the conceptions of justice that would support such interference. Those who would argue for redistribution must out-argue those who can point to the existence of a distribution that one would get with minimal government, a distribution which is, if not natural, at least a plausible starting-point for debates about distribution. Those who would argue for redistribution cannot simply dismiss their opponents by saying that redistribution cannot be seen as interference with a plausible default distribution.

3.1.2.5. Eamonn Butler: The morality of tax

Eamonn Butler *is director of the Adam Smith Institute and has a PhD in Moral Philosophy from the University of St Andrews.*

Everyone knows the moral arguments for taxation. Taxes are necessary to fund large public projects such as roads and bridges; to pay for essential functions such as defence and the justice system; and to produce a more equal society by redistributing income from the rich to the poor.

We hear the moral arguments *against* taxation much more rarely. Yet these unspoken arguments are surprisingly numerous, and surprisingly strong. Tax may be a necessary evil – but it remains an evil.

3.1.2.5.1. Tax is coercive

First, taxation relies on the use of force. Most of us would willingly make some voluntary contribution towards things like policing and poverty relief. But taxes at today's levels can be extracted from us only by the threat that non-payers will be fined or imprisoned. The belief that our taxes might do some good is only a small part of the reason why we pay up. The main reason we pay our taxes is the threat of judicial force.

Plainly, coercion is an evil. We could perhaps justify the use of force against people if it forestalls some even greater evil – arresting an intended terrorist, for

89. Murphy and Nagel, *The Myth of Ownership*, pg. 36

90. We can get an idea of just how radical a retrenchment this would represent by noting that in the UK, under 10 per cent of public spending goes on the Home Office, the Department of Justice, the Foreign Office and the Ministry of Defence (*Budget 2011*, London, HM Treasury, pgs. 47–48). Some spending in other departments would be on minimal functions, but some spending in these departments would be on non-minimal functions.

example. That is simply choosing the lesser of two evils. But it is much harder to justify the evil of force against some people in order to produce good for others – using compulsory purchase orders, say, to facilitate a new airport development. That is because we cannot compare how different people feel about these things: we cannot get into their minds and strike any balance between the grief of those who lose their family homes against the pleasure of air travellers.

So if we propose to use force – including taxation – against people in the name of creating some wider benefit, we need to ensure that our case is really strong. Coercion is a serious business: it imposes an awesome responsibility on the authorities to ensure that the money that is raised through it is spent wisely and effectively. Bureaucracy and waste are not just a loss to the economy – they are a moral outrage.

But the only thing that seems to have been produced by decades of government waste and efficiency campaigns is 'targetitis' and more bureaucracy. Most people believe that they could spend their money far better than the government does, and that waste and bureaucracy are in the very nature of public spending. If so, forcing people to pay for them through taxation is quite immoral.

3.1.2.5.2. Tax eclipses personal morality

Not only is taxation a form of confiscation under threat of force. It is confiscation by people who believe their values and priorities are superior to those whom they force to pay up.

The idea that Whitehall – or a majority in Parliament – knows best is not just contemptibly patronising; it is also a breathtaking moral claim. Even if they do reflect majority opinion, who is to say that their values and ethics are superior to someone else's?

Taxation forces people to pay for things they disagree with, and indeed for things that they may oppose morally, at the deepest personal level. People may have fundamental moral objections to abortion, foreign wars, mixed-sex schools, even bank bailouts – yet they are still forced to finance these things through taxation. Their values may be just as profound as those of the authorities, their feelings as keen, their views just as rigorously constructed. Yet we force them to live with the dismal thought that their money is being used for purposes they consider highly immoral, and that things they regard as evil – perhaps as plain murder – are being done in their name. This should give the tax authorities the utmost discomfort; though there is scant evidence that it does.

3.1.2.5.3. Taxation raises the state over individuals

The fact that taxation limits people's control of their own resources means that it necessarily reduces their freedom. They are not at liberty to use their own earnings, capital and savings as they believe is right for themselves and their families, and as they think is ethically appropriate. This in turn means that an important part of their moral being is extinguished. People can only be considered moral – or immoral – if they actually have control over their own actions, and are free to make moral choices. A person whose choices are usurped by another is not a whole human being, but a mere cypher. Taxation eats into people's moral integrity and makes them, in part, mere agents of the state.

But *institutions* like the state do not have values. Only *individuals* have values. Only individuals choose, act, and hold ethical beliefs. They may well combine on collective projects such as mutual defence or welfare or the creation of large infrastructure projects. But the collectivity, the society or the state is not some super-human being with values and beliefs of its own, to which those of individuals can be legitimately sacrificed: it is simply an integrated arrangement of individuals. Individuals remain the ultimate ethical units. And since no person has any more or less moral worth than another, individuals must be treated as ends, not as means to someone else's ends.

This is why the argument that some people must be forced to pay money for the benefit of others is extremely fraught. The state has no prior moral right to people's property. If it did, there would be no logical stopping point; no level of state expropriation which any of us had any right to resist.

3.1.2.5.4. Taxation undermines personal responsibility

By relieving people of control over their own resources, taxation also – malignly – relieves them of personal responsibility. They may wish, for example, to take care of elderly relatives, or to provide educative activities for their children, or to give themselves training that might enhance their employment prospects. By eating into their income, savings and capital, taxation reduces their ability to do these things – all of them things that would bring benefits to the community as a whole, and not just to the specific family. Although most of us want to see individuals, families and local groups taking more responsibility for their own lives and welfare, high taxes make it more difficult for them to do so.

"By relieving people of control over their own resources, taxation also – malignly – relieves them of personal responsibility"

Indeed, taxes may leave people convinced that they have no outstanding social obligations at all. When our taxes are collected, we are told that they will pay for vital public services such as education, welfare and policing. And since most people greatly underestimate the cost of public services, they may well look at their tax bill and conclude that these services must be in ample supply. That in turn may make them believe that their social obligations have been completely discharged – that they have paid handsomely for others to do the job.

They may well feel, then, that it is up to the teachers to make sure that their children are literate, numerate and well behaved, and that they need take no responsibility in this. They may believe that the welfare state, comprehensive as it is, clears them of any moral duty to help others who might need their help. They may walk on by when they see children being neglected or crime and vandalism being committed, believing that these are the responsibility of the police and social services for which they pay their taxes.

3.1.2.5.5. Taxation crowds out private contributions

People who pay high taxes are also less likely to make financial contributions for the general benefit. In the first place, tax leaves them with less money to devote to charitable giving. Schools, hospitals, libraries, galleries, orchestras, care homes and other welfare charities have all benefited from the bequests of people who understand their importance to society and humanity; but high rates of lifetime or inheritance taxes inevitably leave people with less to give.

And again, when people have the impression that the state will provide, they see less reason to contribute their own support to good causes. When people see public libraries closing, their first thought is to demand that public expenditure priorities should be changed – rather than to dip into their own pockets. Why support medical research, for example, when the government already directs countless grants and subsidies to this very function?

A classic example was the Royal National Lifeboat Institution, which was created independently in 1824, but fell on hard times thirty years later. So in 1854 it accepted £2,000 in government grants. But for every pound the government put in, the RNLI lost thirty shillings (£1.50) in voluntary donations. People could not see why they should support a state-funded institution. So in 1869 the RNLI cut loose again, and has flourished ever since.

3.1.2.5.6. Higher tax societies are less generous

The 1960s US Vice-President Hubert H Humphrey was once voted 'The Most Generous Man in America'. It was not for giving away his own money, but for his keenness to give away other people's through tax and public spending measures. Yet higher public spending is no measure of a country's generosity, morality or philanthropy. Indeed, charitable giving that comes voluntarily, through the goodwill and public spirit of private donors, is far more laudable, and far more superior morally, than support that is extracted from people by force.

America gives almost twice as large a proportion of its earnings (1.67 per cent of GDP) to charity as does the UK (0.73 per cent of GDP). It means the Average American gives $15 a week to charity, the average Briton only the equivalent of $5 a week.[91] At least in part, that must be due to the fact that the US leaves people the space to make their own decisions about what to support. The US government absorbs a smaller share of America's income each year than Britain's does. In addition, the US actively encourages charitable giving, allowing its citizens to deduct all their philanthropic gifts from their taxable income.

This is why low-tax America has long had a deep and generous tradition of private giving. The Scottish-born Andrew Carnegie, who sold his steel company in 1901 for $480 million, used most of that money to fund scientific research and to establish schools, libraries and colleges, particularly in the US, Canada and the UK. Another American immigrant, the Hungarian-born financier George Soros, is reckoned to have given over $7 billion to philanthropic causes so far, including anti-poverty initiatives in Africa, delivering internet infrastructure into Russian universities, and promoting democracy in Eastern Europe. Bill and Melinda Gates intend to give away their entire software fortune on causes such as education, health care and the eradication of malaria. The US actor Paul Newman has given over the whole profit from his popular supermarket sauces, amounting to more than $300 million, to charitable causes.

So it seems that it is not only governments that can spend money on good causes. Indeed, private individuals, voluntary societies and independent charities seem to promote such projects with far greater enthusiasm, imagination and effect. Unfortunately, however, at least some of their vigour is sapped by the burden of higher taxes.

3.1.2.5.7. The self-interest of the authorities

It is not as if the money raised through taxation is spent in accordance with the views and wishes of those it comes from – or even as if it is spent honestly and objectively in the public interest.

We get very little say in where our tax money goes. Elections are normally infrequent. When elections do come, we are not voting on individual spending programmes but on a whole package of measures that could include issues as diverse as immigration, schools, healthcare, welfare, unemployment and prisons. On such infrequent and confused evidence, the politicians who decide where our money is to be spent cannot have any clear idea of what the public's priorities really are, and of the depth of feeling that different people have about those priorities.

---

91. Calculations from GDP figures and Charities Aid Foundation *International Comparisons of Charitable Giving*, November 2006

"People do not suddenly become angels when they are elected into office or start working for a government agency"

But then our legislators and officials have priorities of their own. People do not suddenly become angels when they are elected into office or start working for a government agency. They have their own interests, ambitions and objectives that inevitably colour the decisions they make. Officials may well try to ensure that public money is spent effectively and dispassionately; but they may equally have an eye on protecting their own budgets. Parliamentarians may well claim, and believe, that they are in politics to make things better for everyone; yet they may also incline to take greater care in steering public resources to their own voters and supporters. The real world of government is very distant from the textbook ideal in which representatives and officials weigh up the issues dispassionately, decide them impartially and apply them objectively in the public interest.

3.1.2.5.8. Taxation promotes interest-group politics

Some politicians make no bones about being in politics to promote the interests of their own supporters; but in fact everyone involved in the process of deciding how taxpayers' money is spent inevitably brings to it some smaller or larger measure of their own self-interest. The more taxpayers' money that flows through that decision-making process, the more power is given to politicians and officials to indulge those personal interests.

A great deal of what passes for income redistribution, for example, is actually a form of vote buying, with grants and subsidies being steered to particular groups that are favoured by the ruling party. Interest groups take full advantage of this, lobbying for special legislative favours for their cause or their industry, often in return for party funding or other inducements. Such favours can be extremely lucrative, perhaps involving tax concessions, subsidies or regulations that make life harder for competitors; so it is not surprising that lobbying is such a big industry. But the higher that tax rates are, the bigger are the potential rewards from getting special tax treatment, and the larger the lobbying industry grows. High taxes, as they say, feed big government rather than hungry children.

As the US humourist H L Mencken put it, "elections are advance auctions for stolen goods". Interest groups of all sorts are out for the favours that the politicians of a large state are able to grant them. The only group that seems to be under-represented in this carve-up of taxpayer funds is, unfortunately, taxpayers themselves.

3.1.2.5.9. Inefficiency of tax spending

There is an argument that people can spend their own money better than others can, and that taxpayers too can spend their money more effectively than can politicians and officials. Given that taxes are collected by coercion, this should worry us, since it implies that, to some extent, people are being coerced for no good purpose.

To illustrate the argument, consider four kinds of spending. First is when I spend my own money on buying things for my own use. In this case, I will of course be very concerned to get a good price, but also to get good quality. Second is when I spend my money on buying something for someone else – a present for my aunt, say. Here, I am very concerned about the price, but not so concerned that I get good quality. Third is when I spend someone else's money on myself – as with an expense-account lunch. Here I am keen to get good quality, but hardly concerned about the price at all. Fourth is when I spend someone else's money on someone else. And this is the public sector.

There is, certainly, an argument that charities and voluntary groups are probably more efficient in spending other people's money on services such as healthcare, education and welfare than are governments. That is why various governments, while continuing to fund these services, have given over some or all of their provision to private and voluntary organisations.

One important reason for the difference may be that a private body is better able to treat people as individuals, and to tailor support innovatively around their needs, than is a civil servant who inevitably has to follow a book of rules laid down by some distant central legislator. A charity might conclude, for example, that an unemployed person would be better served by a course in interview technique or self-assertiveness training than by a lifetime of cash benefits. A charity might pay for immediate private treatment of a back problem, rather than let the condition deteriorate until the person is unable to work again. In the state sector, there would either be no provision for such novel approaches, or the funding would have to be coaxed out of someone else's budget.

3.1.2.5.10. Taxation promotes scepticism of government

An interesting point about presents is that the people who receive them tend to underestimate their costs. A very informal newspaper survey of Christmas presents some years ago put the difference at around 14 per cent.

In a similar fashion, surveys suggest that people significantly underestimate the cost of public services. Yet they see the full cost they are paying through taxes plainly enough. There is, also, a wide feeling that public services are poorly targeted and that the public bureaucracy is wasteful and inefficient. These perceived deficiencies may prompt many people to conclude that they are getting poor value from the money they pay in taxes.

The higher their taxes go, therefore, the more are people likely to regard them as unjust confiscation rather than a payment for services. They come to consider themselves more as victims being exploited by those in power, rather than willing collaborators in the provision of essential public functions. On occasion, such alienation has led to taxpayer revolts – such as Britain's Fuel Duty protests of 2000 and California's 1978 Proposition 13 measure to limit property taxes, which prompted more general taxpayer protests throughout the United States. And there is evidence that, when personal taxes rise beyond a level of roughly one-third of income, a silent tax protest starts, with people more likely to avoid or evade tax, or to move their money or themselves to lower-taxed jurisdictions.

Likewise, as the range of functions performed by the government grows ever wider on the back of increased taxation and spending, individual taxpayers each see the government doing more and more things that they regard as marginal, pointless or even downright undesirable. This again makes them feel like exploited victims of the political class rather than willing contributors.

3.1.2.5.11. Higher taxes are morally corrosive

Moreover, as the state takes on increasingly wide and diverse roles, managing it all becomes increasingly difficult for the authorities. The opportunities for making mistakes grow in number, the scale of the potential shortcomings becomes larger, and gaps, inconsistencies and injustices open up. An overstretched state begins to lose authority – which may be corrosive at a moral level too, with citizens becoming increasingly cynical of law and authority.

In addition, the higher that taxes are, the less willing are people to pay them, and the more widespread will avoidance and evasion become. The standard official response to that, of course, is to tighten the rules and increase the penalties of non-compliance – in other words, to *increase coercion*. But this simply breeds even greater resentment, and sets us on a downward ethical spiral. The American comic

Will Rogers once joked that income tax had made more liars out of his countrymen than had golf. In the UK today, even professional suppliers will ask whether you would prefer to settle in cash rather than see VAT added to your bill; and home buyers will offer extravagant amounts for 'fittings' rather than face paying Stamp Duty on the full value of the property. When ordinary people come to believe that taxes are unjustly high, it makes criminals of us all.

As the 19th Century French politician and author, Frédéric Bastiat, pointed out, almost everyone supports the provision of basic services such as defence and the administration of justice. But when people believe that government is plundering, they will inevitably try to avoid or evade the taxes it imposes on them.

3.1.2.5.12. Ethical corrosion in government

The unwillingness of taxpayers to allow themselves to be exploited also prompts politicians to be underhand about how they raise taxes. There is a strong moral argument that the amount of tax we pay should be transparent and obvious – precisely so that we can have an honest debate about whether we are getting good value from the money that is taken from people by force. But that transparency does not suit governments who want to spend more money than the public would willingly pay. And so we have seen the rise of 'stealth' taxes, in which the full burden of the tax is deliberately concealed.

Rather than raise the 'headline' rates of tax, for example, payment thresholds may be adjusted, or simply not raised in line with inflation, in order to bring more people into the higher rate brackets. Reliefs and exemptions may be phased out. Taxes may be imposed on things such as pension contracts, where the increased burden may not become obvious for many years. Duties may be imposed on consumption items, such as fuel, insurance or air travel, where the tax becomes subsumed as part of the price such that its amount is not obvious to the consumers who are paying it. There is a case for calling such stealth taxes dishonest and morally unacceptable.

Envy taxes are a particularly immoral set of impositions. Envy taxes against particular groups – people with high incomes, say, or who choose to spend more of their money on large houses, expensive cars or other extravagances – are, in their origin and by their nature, socially divisive. Nor is it moral, in particular, to impose very high rates of tax on higher earners, when those taxes raise little revenue, increase the incidence of avoidance and evasion, and drive high-fliers and entrepreneurs to seek refuge in other countries rather than create business and employment opportunities for their fellow citizens at home.

There is another way in which higher taxes, and a larger government sector, is morally corrosive. The larger that the government budget grows, the more opportunities that arise for politicians and officials to grant favours to interest groups, supporters and friends. Those opportunities in turn extend the possibility – perhaps the likelihood – of political and bureaucratic corruption, with such favours being granted in return for cash or personal benefits.

3.1.2.5.13. The tax gravy train

In addition, the higher that tax and spending grows, the more people there are who have an interest in keeping it that way. In the North East of England and Wales, public spending is equivalent to more than 60 per cent of GDP. It is no wonder that the (generally more hostile to public spending) Conservatives are hardly represented in these areas. But, whatever the fortunes of particular parties, the figures do suggest that people who live in places that are highly dependent on government spending, or who themselves depend on it, are more likely to vote for more of it, rather than

"The more money that the government is spending, the more of us think that some part of it should come to us, and the more likely we are to lobby for precisely that"

to make some dispassionate judgement about what is beneficial for the nation as a whole.

Indeed, the bigger the government pie, the keener are most of us to get a slice, rather than think about the general prosperity of the nation. The more money that the government is spending, the more of us think that some part of it should come to us, and the more likely we are to lobby for precisely that. This is particularly true when we feel that a large part of the government's spending is being wasted on other people.

3.1.2.5.14. War between social groups

It is not just envy taxes that engender competition and resentment between different social groups that, ideally, we should like to see living in harmony and cooperation. All public spending is to some extent divisive.

In the market place, different people can choose different products. Car buyers, for example, can choose any colour they want, in countless shades. One person's choice does not preclude another's. Things are quite different in politics and government, however. Elections and votes in the legislature decide what *everyone* will have – from the size of the defence force through the frequency of the mail delivery to the quality of the road repairs.

People may have different views on what their tax money should be spent on; but in the political arena there is only one winner. Rather than accommodating diversity in peaceful coexistence, political decisions pitch different people and groups and opinions against each other. The higher the taxes they pay, the more determined people will be that *their* choices should prevail, and the bitterer becomes the political debate. Such factional rivalry undermines the idea and substance of a moral society.

3.1.2.5.15. Perverse incentives

Tax constitutes an extra price that is imposed on things such as income, capital and saving. So it has the perverse effect of discouraging people from earning, from saving up and from accumulating the capital goods that will raise productivity and generate wealth for the whole community. Indeed, taxes on these things have the economically and morally debilitating effect of promoting idleness and indebtedness – which may explain some of our present predicament.

There is a strong moral argument that people who create things should enjoy the fruits of their creativity. It is, after all, their labour and ingenuity that has produced those fruits. And one can argue that people have a right to use their natural talents freely and without others impeding them, as taxation surely does. For purely selfish reasons too, we should want people to be creative and to use their talents, since it is through such creativity and effort that the productivity of humankind increases. But tax stifles that creativity.

Perhaps the greatest moral scandal in taxation is that the poor pay most of it. For a start there are, quite simply, more of them. Around two-thirds of the population live on earnings that are below the national mean, and most of them pay tax on their earnings and savings, plus all of their expenditures that are subject to VAT and excise duties. By far the bulk of our tax revenue, in other words, comes from those who are not well off.

Not only that, but some of the poorest people also quite commonly face by far the highest deduction rates on each additional pound they earn. In many countries, including the UK, welfare benefits are phased out as people's income rises, while income tax and payroll or social taxes start to cut in. The result is that many people are discouraged from moving off social benefits and into a job, since they would lose most or all of the extra income that having a job would bring in. The disincentive effect of benefits being phased out may be hard to do anything about; but the additional disincentive of the taxes that are applied on low earnings are by no means inevitable and as such must surely be morally indefensible. In addition, such perverse incentives encourage a moral malaise among those whose lives they corrupt – a culture of dependency that swamps the natural urge to self-improvement.

Inheritance tax has some of the same effects, discouraging saving and capital accumulation. It is also at odds with human nature – and thus with our basic ethical programming – since the drive to provide for one's friends and family, and in particular one's children, is a strong human instinct. The tax hits families at the very worst time of their lives, namely after bereavement. It encourages people to rearrange their affairs to avoid it; with the unfortunate result that their assets are likely to produce less than they otherwise would, making them and their families worse off. None of that is what we would seek from a just tax.

3.1.2.5.16. Taxes reduce human prosperity

Precisely because of perverse effects on creativity and productivity, high-tax countries grow more slowly than low-tax countries. They export less and create fewer jobs. All of these things are misfortunes for the millions of individuals whose prosperity is directly diminished. But not only that, they also harm anyone who depends on government and charitable support, because a less wealthy public has less to spend on such causes.

Tax havens are often criticised for facilitating money-laundering and crime; but there is a moral case for low-tax jurisdictions too. In the first place, the finance that they attract may be the only viable livelihood in places that are otherwise largely barren: choking off that finance may cause real hardship. And low-tax jurisdictions have another beneficial effect: their existence reduces the ability of governments in other countries to impose unjustly onerous taxes on their own populations, with all of the economic and moral downside this implies.

3.1.2.5.17. Is taxation theft?

Is taxation theft? Some people say so, but the term is loaded and therefore perhaps best avoided in a discussion of the morality of taxation. Unlike theft, taxation at least has the justification that it is usually imposed only by the decision of a majority, after public debate, and for public rather than private purposes.

Nevertheless, if two strong people took money from a third by force and spent it on themselves, we would certainly call it theft. If 51 per cent take money by force from the other 49 per cent and spend it as they think fit, is there really such a big difference?

But such name-calling is hardly necessary. It is evident that high taxes are not moral, or generous, or the hallmark of a humane society. On the contrary, they are coercive, they undermine personal morality and responsibility, they diminish prosperity and crowd out charity, they are divisive and inefficient, they reward power and discourage creativity and they turn both people and governments into cheats. The moral case against them, in other words, is quite strong enough.

***Matt Ridley** is the award-winning author of provocative books on evolution, genetics and society, most recently* The Rational Optimist *which was short-listed for the Samuel Johnson prize for non-fiction and won the 2011 Hayek Prize.*

3.1.2.6. Matt Ridley: Doing your altruism through the tax system

There is in all of us a tension between the individual wish to increase our wealth and the social wish to see greater equality between people. Politically, debates over tax boil down to an argument between those who want to emphasise wealth creation and those who want to emphasise wealth distribution: tax cutters worry about crimping economic growth; tax raisers worry about social cohesion. Yet is it quite that simple? Is wealth creation really so selfish, and is taxation really so altruistic? A journey into the psychological and evolutionary roots of this debate reveals some surprising things.

Anybody who has spent time with businessmen knows that – though profit is their principal motive – they often believe passionately and sincerely that they are doing good by providing goods and services that lighten the burden of their customers' lives. Conversely, anybody who has spent time with politicians and public servants knows that – though public service is their chief motive – they often squabble with surprisingly selfish gusto over how much money they get to control and how proprietorial they feel about it.

It has always seemed odd that we expect to worship to the point of deification those whose careers are devoted to spending other people's money (and then we are cruelly disappointed when they do not turn out to be gods), while we expect to despise those whose careers are devoted to making the money available to be spent (and then are cynical when they do good deeds with their fortunes). The explanation may be that a devotion to wealth distribution is at least partly selfishness dressed up as caring; while wealth creation is at least partly generosity disguised as selfishness. People focus on the motive, not the outcome.

Of course, some public servants do achieve great public benefits while some private capitalists do great harm, but the assumption that the first are virtuous while the second are vicious is misleading, whatever the motivation. Tony Blair sincerely wanted to spend well the money others made, and we admired him for it (initially). Bill Gates, by selling software, sincerely wanted to make money for himself, though in doing so he helped millions of people find good products or good jobs, and generally we resented him for it. (Bill Gates the philanthropist is doing lots of good, too, but arguably no more than he did as a businessman.)

3.1.2.6.1. Work expands to fill the time available

I recently had an exchange with an intelligent friend who challenged my cynical view of much government spending. At one point, I referred to 'public choice theory'. My friend admitted that he had never heard the phrase. A week later, my son showed me the section in his school economics textbook on 'public choice theory'. It completely misrepresented the idea as a form of 'market fundamentalism', wholly missing the point. The notion is almost completely absent from many discussions of government. So here, for my friend and for students, is what I understand public choice theory to say, having read the likes of Mancur Olson, James Buchanan and C. Northcote Parkinson. It boils down to this: the people who spend taxpayers' money are no less (or more) immune to selfish motivation than the people who spend their own money. Examine in detail how government agencies behave and you will find that their actual goals include exactly the same features as everywhere else in the human race: to maximise budgets, seek promotions, look after one's own interests, win market share and to reward cronies. The notion that a bureaucrat becomes a paragon of selfless virtue when he enters his office is simply false, as is the notion that a businessman leaves his generosity behind when he enters his office. Just as you will find kindness in business, so you will find selfishness in government. Yet the implicit assumption of much economic argument is that imperfect markets must be fixed by perfect governments, pitting paragons against devils. Frédéric Bastiat wondered:

> *If the natural tendencies of mankind are so bad that it is not safe to permit people to be free, how is it the tendencies of these organisers are always good? Do not the legislators and their appointed agents also belong to the human race?*

They do. It is worth quoting at length from the original formulation of Parkinson's Law, which is in effect an early version of public choice theory, in *The Economist* in 1955:

> *We must picture a civil servant called A who finds himself overworked. Whether this overwork is real or imaginary is immaterial; but we should observe, in passing, that A's sensation (or illusion) might easily result from his own decreasing energy – a normal symptom of middle-age. For this real or imagined overwork there are, broadly speaking, three possible remedies:*
>
> *(1) He may resign.*
>
> *(2) He may ask to halve the work with a colleague called B.*
>
> *(3) He may demand the assistance of two subordinates, to be called C and D.*
>
> *There is probably no instance in civil service history of A choosing any but the third alternative. By resignation he would lose his pension rights. By having B appointed, on his own level in the hierarchy, he would merely bring in a rival for promotion to W's vacancy when W (at long last) retires. So A would rather have C and D, junior men, below him. They will add to his consequence; and, by dividing the work into two categories, as between C and D, he will have the merit of being the only man who comprehends them both.*
>
> *It is essential to realise, at this point, that C and D are, as it were, inseparable. To appoint C alone would have been impossible. Why? Because C, if by himself, would divide the work with A and so assume almost the equal status which has been refused in the first instance to B; a status the more emphasised if C is A's only possible successor. Subordinates must thus number two or more, each being kept in order by fear of the other's promotion. When C complains in turn of being overworked (as he certainly will) A will, with the concurrence of C, advise the appointment of two assistants to help C. But he can then avert internal friction only by advising the appointment of two more assistants to help D, whose position is much the same. With this recruitment of E, F, G and H, the promotion of A is now practically certain …*
>
> *Seven officials are now doing what one did before. This is where Factor II comes into operation. For these seven make so much work for each other that all are fully occupied and A is actually working harder than ever. An incoming document may well come before each of them in turn. Official E decides that it falls within the province of F, who places a draft reply before C, who amends it drastically before consulting D, who asks G to deal with it. But G goes on leave at this point, handing the file over to H, who drafts a minute, which is signed by D and returned to C, who revises his draft accordingly and lays the new version before A.*
>
> *What does A do? He would have every excuse for signing the thing unread, for he has many other matters on his mind. Knowing now that he is to succeed W next year, he has to decide whether C or D should succeed to his own office.*

He had to agree to G going on leave, although not yet strictly entitled to it. He is worried whether H should not have gone instead, for reasons of health. He has looked pale recently – partly but not solely because of his domestic troubles. Then there is the business of F's special increment of salary for the period of the conference, and E's application for transfer to the Ministry of Pensions. A has heard that D is in love with a married typist and that G and F are no longer on speaking terms – no one seems to know why. So A might be tempted to sign C's draft and have done with it.

But A is a conscientious man. Beset as he is with problems created by his colleagues for themselves and for him – created by the mere fact of these officials' existence – he is not the man to shirk his duty. He reads through the draft with care, deletes the fussy paragraphs added by C and H and restores the thing back to the form preferred in the first instance by the able (if quarrelsome) F. He corrects the English – none of these young men can write grammatically – and finally produces the same reply he would have written if officials C to H had never been born. Far more people have taken far longer to produce the same result. No one has been idle. All have done their best. And it is late in the evening before A finally quits his office and begins the return journey to Ealing. The last of the office lights are being turned off in the gathering dusk which marks the end of another day's administrative toil. Among the last to leave, A reflects, with bowed shoulders and a wry smile, that late hours, like grey hairs, are among the penalties of success.

This is the essence of public choice theory. Whereas private extravagance is eventually punished by bankruptcy, public extravagance is rewarded by budget increases. Observe the way people who get their hands on public budgets, from Rameses to Mubarak, from Peter the Great to Stalin, from the Ming to Mao, have behaved since time immemorial: they have plundered treasuries for their own comforts, diverted funds to their own supporters and always claimed that they do so for the good of those they govern.

"Whereas private extravagance is eventually punished by bankruptcy, public extravagance is rewarded by budget increases"

Today, we are fortunate to live in a democracy where politicians are constrained by the rule of law and not given to arbitrary confiscation to support their clans. Er, up to a point. It would be hard to persuade a time traveller from say Boston in 1775, or Paris in 1789, that a modern citizen of a democracy on middling income is not subject to arbitrary confiscation, or that his rulers do not favour their virtual clans. Indeed, the pork-barrel tendency of democratic government to reward vocal minorities by passing many small costs to indifferent majorities is all too familiar a modern problem.

Taxation means that Smith is forcing Jones to hand money to Bloggs under threat of imprisonment. That is treating Jones as Smith's slave. That we willingly embrace such slavery is not altogether surprising. Even in a modern democracy, it is rational for politicians and bureaucrats to increase spending on their pet projects, because it costs them nothing and gains them the gratitude of the recipients. It is rational of the special interests to lobby for more spending because the benefit is concentrated and the cost diffuse. It is even rational for taxpayers to let it happen because the cost is small, but the cost of defeating a particular spending proposal is high. Thus an outcome may result that is bad for society and not wished by a majority – a bridge to nowhere, paid for by a painful and commerce-stifling excise. Public choice theory shows that increases in taxation may result from rational self-interest, even though dressed up as altruism.

3.1.2.6.2. Getting rich by making the poor less poor

Yet to many people, it is the raising of taxes, not the spending of them, that marks you out as an egalitarian with a social conscience. That is to say, the cause of social cohesion is served by redressing imbalances in wealth rather than by spending the proceeds of tax on good causes. In its most naïve form, this philosophy expresses a zero-sum view: that there is only a certain amount of money and if somebody has more of it, somebody else must have less. Zero-sum thinking permeates many of our discussions, from the mercantilist perspective on trade to the Marxist perspective on labour. We just do not find it easy to think in terms of emergent value, of the magicking into existence of prosperity that is greater than the sum of its parts. Yet human prosperity is possible entirely because of the discovery of non-zero-sum outcomes, such as the division of labour or the consequences of new technology. It seems we stumbled upon these by accident while continuing to think that the rich got rich because the poor got poor.

Of course, the rich can get rich by making the poor poor. In the past this was often the dominant method of enrichment. Predation – by theft or tax – was a tried, trusted and even honourable way to grow wealthy. Ask Croesus or Caesar, or even Cicero who milked the provinces he governed only a little less enthusiastically than the senators he prosecuted. Ask Richard the Lionheart and Winston Churchill, both of whom are revered for careers that were funded chiefly by forms of compulsory extortion.

But there is another way of getting rich, the Steve Jobs/Sam Walton/Stelios Haji-Ioannou way – by making something so good or so cheap that lots of people want to buy it: by making the poor richer. By contrast with the reverence accorded to Winston Churchill, consider the vilification heaped upon Cornelius Vanderbilt, the man for whom the phrase "robber baron" was coined by the *New York Times*. Vanderbilt was indeed filthy rich, but he got that way not by drawing a salary upon the taxpayer, but by repeatedly cutting the costs of transport for ordinary people. He began at the age of 16, with $100 borrowed from his parents, by running a sailing ferry from New York to Staten Island, charging far less than rivals. He then undercut the New Jersey state-protected monopoly steamboat line, running his boat the Bellona with the slogan "New Jersey must be free" flying from the masthead. He operated a series of steamboat ferries to Philadelphia and up the Hudson, charging one-quarter of rival fares. Finally, he turned to running railways more cheaply than his rivals. He delivered to consumers an enormous benefit that would otherwise have eluded them – affordable transport. Here is what *Harper's Weekly* had to say about his steam ships in 1859:

"Vanderbilt was indeed filthy rich, but he got that way not by drawing a salary upon the taxpayer, but by repeatedly cutting the costs of transport for ordinary people"

> *The results in every case of the establishment of opposition lines by Vanderbilt has been the permanent reduction of fares. Wherever he 'laid on' an opposition line, the fares were instantly reduced, and however the contest terminated, whether he bought out his opponents, as he often did, or they bought him out, the fares were never again raised to the old standard. This great boon – cheap travel – this community owes mainly to Cornelius Vanderbilt.*

Vanderbilt was no saint, and the benefit he delivered to consumers was at the expense of harsh conditions and low wages for the producers who worked for him, at least by modern standards. None the less, both the workers and the customers volunteered their time or money because they thought it the best option available. Vanderbilt did not get rich by making the poor poor.

So here is a question: is it better for the poor to take a Vanderbilt's money off him in tax, or to leave it with him so he can start a new cheap steamboat line to undercut yet another monopoly?

3.1.2.6.3. The egalitarian stone age

The writer Michael Shermer believes that you can trace the egalitarian ethos to the old stone age.[92] When all human beings lived in small bands of hunter-gatherers, as we all did for hundreds of thousands of years until just the Neolithic yesterday, a dislike of inequality had reproductive value. The luck that brought a hunter a big kill – and with it lots of sexual opportunities – was often transient. So a lucky hunter knew that he must share his kill or earn the resentment of his fellow hunters. Besides, flaunting your success and intimidating your inferiors has probably been unwise in our species ever since the invention of throwing weapons, which enabled Davids to defeat Goliaths as they never can among cattle or chimpanzees (Damon Runyan called guns "old equalisers").[93]

To this day there is a great willingness to share hunted, but not gathered, food in hunter-gatherer bands such as the Hadza of Tanzania or the Ach'e of Paraguay. Actually, "willingness" states it too strongly. The anthropologist Nick Blurton Jones described the division of a Hadza kill as "tolerated theft":[94] a phrase that describes modern taxation rather neatly.

The successful hunter knows better than to resist the theft, and he still garners some rewards – in terms of gratitude, prestige and sexual affairs – for his success. Among hunter-gatherers, even the tiniest inequality translated into more babies on average. The man who killed the most game, or killed the most enemies, got the most sexual opportunities. That's the startlingly simple calculus that we still walk around with in the back of our heads. There's been a lot of water under the cultural bridge since then, of course, but it is not obvious that it changed the instinct. It was still the same in early agricultural societies: the man with the most corn or cattle had the most wives or concubines. And it is still true today: even in an age of working women, sexual continence and gender equality, the man with the most money still gets more sexual opportunities than the man with the least money. Ask them.

So no wonder we dislike inequality. No wonder we want tax to take that money off a Vanderbilt before he grabs all the best women. In the end, it is not necessarily because we think he stole it, though there are still a plenty of zero-sum Marxists out there, and it's not because we think the government is better at spending it, though there are still plenty of demand-managing Keynesians out there; and it's not even because we think tax is a decent redistribution system – who can really think that when confronted with all the middle-class benefits that flow from the taxpayer? No, it's at least partly plain old sexual jealousy at the root.

3.1.2.6.4. Spot the billionaire

Don't get me wrong: I am not criticising jealousy of wealth, just analysing it. The intelligentsia's virulent dislike of the non-zero magic that creates wealth has been growing for some decades now, and it coincides neatly with the intelligentsia's slow slide down the relative income league. There was a time when professors travelled

92. Shermer, M. *The Mind of the Market*, 2007
93. Bingham, P. & Souza, J. *Death from a Distance and the Birth of a Human Universe*, Booksurge Publishing, 2009
94. Blurton Jones, N. G. A selfish origin for human food sharing: tolerated theft, *Ethology and Sociobiology* 5: 1–3, 1984

first class and ate in the best restaurants and flirted with the best women. Now they watch philistine bankers turning left as they enter the plane.

("How can they bear," wonders Deirdre McCloskey of her academic colleagues in what she calls the clerisy, "to hear yet another diatribe against the evil of profit, the curse of materialism, the insincerity of advertising, the scandal of excessive consumption, the irreligiousness of commercial dealing, the corruptions of corporations, the ruination of the environment, the inevitable poverty consequent upon a system of market capitalism, the horrors of piano lessons and learning French and settling down to a quality job?")[95]

The sexual jealousy explanation works mainly among men. What about women? Why would a woman prefer wealth distribution to wealth creation? Again, I think there is a decent explanation in evolutionary psychology. Women and men want to show they care. Human society is suffused with kindness and is correspondingly vulnerable to being taken advantage of by free-riding selfishness. So we are psychologically alert to signs of selfishness in others, to hints that Og does not share his kills, and we stand ready to ostracise Og to protect the social contract. This combination of co-operation with punishment of non-co-operators is known as the theory of strong reciprocity.[96] Support for taxation is a rather clear expression of commitment to social welfare, whereas an obsession with wealth creation at the expense of wealth distribution is almost the definition of not caring in today's culture.

Yet, strangely, the poorer the society, the more people tolerate wealth inequality. In an African state where some go genuinely hungry, the plutocrat in his limo is probably less resented and more admired than he would be in a Western society where the poor at least have taxpayer-provided housing, education and healthcare. The economist Don Boudreaux recounts an intriguing episode:[97]

> *At [a] seminar a George Mason University graduate student presented his research on economic development in the Philippines. In the audience were college professors, graduate students, and a bona fide American billionaire. At some point during the student's presentation I realised that had I not been told that the billionaire (let's call him Mr. Bucks) was, in fact, a billionaire, I would have had no inkling that a person of such enormous wealth sat in the room.*
>
> *It's not that Mr. Bucks was shabby or unkempt. On the contrary, he wore a nice suit and a nice watch, and had a nice haircut. The reason he was not distinguishable as a billionaire had nothing to do with his own appearance; it had everything to do with the appearance of the other 25 or so people in the room. Everyone was as well-dressed and groomed as he was.*
>
> *Take the graduate student making the presentation. His suit, his watch, and his haircut were also nice. In fact, just looking at both men indicated no difference at all in the quality of their dress, jewellery, or grooming.*

Boudreaux's point is that when it comes to the basic needs of life – decent clothing, food, cleanliness, communication technologies – there has never been greater equality. There is plenty of inequality in a modern, Western society, but it all comes in the luxuries, not the necessities. The modestly poor do not get the jets, jewels and Jacuzzis that the very rich get, but they do not actually go hungry, cold, unsheltered, unwashed, unlit, unentertained or unclothed. In 1800 it took six hours of work on

95. McCloskey, D. *The Bourgeois Virtues*, 2006, pg. 57

96. Fehr, E., Fischbacher, U. & Gachter, S. Strong reciprocity, human co-operation and the enforcement of social norms, *Human Nature* 13:1–25, 2002

97. Boudreaux, D. J. Can You Spot the Billionaire, *The Freeman*, 54, 1, January 2004

“Artificial light was an unimaginable luxury. Today it takes less than half a second”

the average wage to earn the price of a tallow candle that could burn for an hour. Artificial light was an unimaginable luxury. Today it takes less than half a second. To be deprived of artificial light is an unimaginable deprivation.

This equality in necessities was simply not true at any time in history until quite recently. (And it is still not true in, say, the Democratic Republic of the Congo, today.) In the 18th Century, Mr Bucks would have stood out like a sore thumb – plumper, taller, cleaner, more groomed, better dressed, better read, better lit, better warmed. Inequality was once about basics; now it is about luxuries. So why do people mind about inequality as much or more than ever? Why, now that even the poor have mobile phones, do people want taxes paid at all? It is a paradox that the rich were lightly taxed when the poor were truly wretched; and are heavily taxed now that the poor are merely relatively deprived.

3.1.2.6.5. Extravagance with others’ money

There is something wrong with the notion behind Abraham Maslow’s hierarchy of needs[98] – in which people are only supposed to devote their energy to luxuries once they have satisfied their basic needs. As the evolutionary psychologist Geoffrey Miller has argued,[99] human beings are selected by sexual selection to be show-offs. That is to say, long before they have even satisfied their most basic needs, they are prepared to devote resources to advertising their fitness as potential mates, parents, friends or leaders in competition with others.

This sexual selection argument explains the otherwise puzzling category of positional goods – things that are valued because others do not have them. The economist Robert Frank did an experiment with a class of students.[100] He asked them if they would rather (a) live in a neighbourhood with 4,000-sq-ft houses when others lived in neighbourhoods with 3,000-sq-ft houses; or (b) live in a neighbourhood with 6,000-sq-ft houses when others lived in neighbourhoods with 8,000-sq-ft houses. Despite the fact that all the houses are fairly large, most preferred (a).

They wanted to be in the relatively superior neighbourhood with access to the better schools and neighbours. However, he then asked them if they would rather (a) work where the probability of dying on the job was two in 10,000 where others’ was 1 in 10,000; or (b) work where the probability of dying on the job was four in 10,000 where others’ was eight in 10,000. Of course, they preferred (a). The task of the policy deviser is sometimes to convert the first kind of dilemma into the second, to get people to think in terms of absolute sufficiency rather than relative treadmill. One way, Frank suggests, to rein in excessive and wasteful competition for relative status in winner-takes-all professions such as finance, is a progressive consumption tax. That is to say, soak the rich when they spend, not when they save and invest. Buy a jet and you have to pay for roads and schools. This punishes extravagance and rewards thrift.

A public-choice version of sexual selection for positional goods may also explain the paradox that taxes have got heavier as needs have got less urgent. Politicians run for election promising to spend ‘money’ doing good, whether through defence or welfare, art or pensions. They are essentially showing off at others’ expense. Sure, they dress it up with “market failure” and “public good” arguments that only public spending can fill a gap, but these rarely hold water. As privatisation repeatedly demonstrates, the government often provides services that the private sector

98. Maslow, A.H. A theory of Human Motivation, *Psychological Review*, 50:370–96, 1943
99. Miller, G. *Spent: sex, evolution and the secrets of consumerism*, William Heinemann, 2009
100. Frank, R. *The Darwin Economy: Liberty, competition and the common good*, Princeton, pg. 68, 2011

could more efficiently supply. As Herbert Spencer said, when arguing against the assumption that only the state can provide money:[101]

> *Had the baking and sale of bread been hitherto carried on by government agents, probably the supply of bread by private enterprise would scarcely be conceived possible, much less advantageous.*

Just as we must admit that it is human (or animal) nature to be extravagant, so it is human nature to be extravagant with other people's money. Yet generally, the myth persists that there is something unselfish about spending other people's money. Why is it that we think there is something noble in handing over your income as tax to be spent by others? Why do we think this expresses social cohesion? When Warren Buffett says that he thinks the rich should pay more of their income in tax – based on an observation discussed in Section 5.1.4, nothing is stopping him from setting an example. Instead, he wisely decides to give more to charity.[102] Between 2002 and 2009, a total of just £7,349.90 was sent to the Treasury as voluntary contributions by living people.[103]

3.1.2.6.6. Why not redistribution instead?

If the point of tax were just to get the rich to give to the poor, redressing inequality, instead of to provide other people's money for public servants to spend, then it could easily be achieved. The total UK tax revenue is close to £600 billion and the population is close to 60 million, of whom say 10 million are genuinely poor by a broad definition. If even 25 per cent of the tax revenue were given straight to the poor, then they would get £15,000 a year each, or £60,000 for a family of four. Taxation does not take money from the rich to give to the poor so much as take money from the merchant or the worker and give it to the bureaucrat in the long-discredited belief that the bureaucrat can spend it better than they would – and better than would the pauper to whom it is aimed. To quote the economist Steve Landsburg: "It's an odd sort of compassion that forces people to buy things they don't want .... For God's sake, why not at least **ask** them if they'd rather have the cash?"[104]

"The notion that taxation is an expression of compassion sits oddly alongside its compulsory nature"

The notion that taxation is an expression of compassion sits oddly alongside its compulsory nature. As Don Boudreaux puts it:[105]

> *Insofar as [welfare] programs are enacted and survive because of political support they receive from their beneficiaries, they are creatures not of compassion but of greed: 'give me what you've got because I want it and I'm willing to vote to ensure that the officials in charge of prisons and the police will use those instruments to take from you what I want for myself.' Does anyone doubt that at least some of the support for such programs comes, not from generous people wishing to give, but instead from greedy people itching to take?*

In any case, if the purpose of taxation is to support spending that creates social cohesion, it is not at all clear that it has succeeded. Whereas sweet commerce demonstrably encourages peace and civic virtue wherever it has been tried (the

101. Spencer, H. *Social Statics*, 1851, pg. 402
102. Buffett, W. E. Stop Coddling the Super-Rich, *New York Times*, 14 August 2011
103. Worstall, T. French letter shock: Tax us more, demand rich people, *The Register*, 25 August 2011
104. Landsburg, S. E. Compassion Play, *The Big Questions Blog*, 19 September 2011
105. Boudreaux, D. J. Two Sides to Those Political 'Transactions', *Café Hayek*, 16 September 2011

Birmingham of Joseph Chamberlain, the Hong Kong of John Cowperthwaite), government programmes mostly produce discontent and misery (the Birmingham of Gordon Brown, the North Korea of Kim Jong Il). In the words of Deirdre McCloskey:[106]

> *Anyone who after the twentieth century still thinks that thoroughgoing socialism, nationalism, imperialism, mobilisation, central planning, regulation, zoning, price controls, tax policy, labor unions, business cartels, government spending, intrusive policing, adventurism in foreign policy, faith in entangling religion and politics, or most of the other thoroughgoing nineteenth-century proposals for governmental action are still neat, harmless ideas for improving our lives is not paying attention.*

3.1.2.6.7. Trust versus tax

There is a further problem with doing your altruism through the tax system. Except when dealing with close kin, especially children, human beings evolved to be conditional rather than unconditional altruists.[107] That is to say, we are prepared to be nice to strangers, but warily and only if they show some reciprocal generosity or appreciation. The smile is a trick human beings use to elicit nice behaviour. The same is true in many social species: reciprocity lubricates trust. But human beings go one step further. Through the magic of exchange they do immensely kind things for strangers while also benefiting themselves. As Adam Smith observed:[108]

> *Man has almost constant occasion for the help of his brethren, and it is in vain for him to expect it from their benevolence only. He will be more likely to prevail if he can interest their self-love in his favour, and show them that it is for their own advantage to do for him what he requires of them.*

In other words, free markets allow you to cooperate with people whose values you don't share (a remark attributed to Milton Friedman). What makes society work, what glues us all together, is that we have a trick for turning strangers into honorary friends. We build trust through exchange. As one historian remarked of the development of credit in the Italian commercial renaissance: there was a 'trust explosion'.[109]

"Free markets allow you to cooperate with people whose values you don't share"

"Having a reputation for fair dealing is a profoundly practical virtue," said Alan Greenspan. "We call it 'good will' in business and add it to our balance sheets. Trust is at the root of any economic system based on mutually beneficial exchange."[110] And here lies the problem with a system of tax and spend. How does it encourage trust? In paying his taxes the taxpayer is offered no opportunity to build trust with the tax collector, let alone with the ultimate recipient of his generosity. Paying honestly and fully and punctually does not elicit reciprocal generosity, not even in the form of a forgiving attitude next time you file late. All it achieves is an avoidance of punishment. The experience of paying taxes is not like the experience of paying money into a charity, where you are thanked and offered opportunities to participate. The taxman is an anonymous bully who cares not one jot what you think of him. What a strange way to build a compassionate society.

106. McCloskey, D. *The Bourgeois Virtues*, 2006, pg. 50
107. Zak, P. (ed) *The Moral Market*, 2008
108. Smith, A. *The Wealth of Nations*, 1776, pg. 11
109. Padgett, J. cited in Clippinger, J.H. *A Crowd of One*, 2007
110. Greenspan, A. Commencement address, Harvard University, Cambridge, Massachusetts, 10 June 1999

3.1.2.7. Graeme Leach: Judeo-Christian ethics and tax

Graeme Leach *is the Chief Economist and Director of Policy at the Institute of Directors.*

According to Christian scripture, government was and is ordained by God (Romans 13:1), but the Biblical model for the state is small and decentralised. A limited role for the state naturally leads to a limited burden of taxation under the Biblical model. In the view of this author, if the principles of tithing (see below) are applied to taxation, four key features emerge:

- Taxation should be proportional rather than progressive.
- Taxation should be capped at a low level, with low marginal rates.
- Taxation should be universal.
- Low marginal tax rates are the beginning, not the end, of giving. Additional voluntary altruism should also be made.

The Bible supports decentralised private ownership of resources and clearly warns about the dangers of centralised political and economic power (1 Samuel 8: 15–17). The prophet Samuel warned that in taking a king the Israelites would have to pay a tithe to God and a tax to the king. Samuel implied that a 20 per cent tax burden (10 per cent tithe and 10 per cent tax) was too high. It should also be noted that only landowners paid the tithe. The Levites paid no tithe because they received no land inheritance.

Scripture teaches that because humans are steeped in sin, the state is required to administer justice, to protect against aggression and to provide for public works. In other words, the role appears to be limited to defence, law and order and some infrastructure. There might also be a very limited involvement in health and education matters, financed from any surplus from the tithe.

However, the Biblical model is also clear that Christians are to pay taxes, regardless of whether the state operates within a Biblical framework, because government is ordained by God (Romans 13:6, Matthew 22:21).

When Jesus said that Christians should render unto Caesar he was not endorsing high taxation. Instead, he was stating an obligation to obey the civil authorities, even when the burden was onerous. This should be interpreted as a practical instruction – not paying would lead to dire consequences with the Romans – and obligation, rather than a statement on the desirability of high taxation *per se*. Clearly there was deeper spiritual meaning to his response also, relating to giving our all to God.

It is useful to interpret a Biblical view of taxation under two principles, equity and efficiency:

3.1.2.7.1. Equity

Scripture clearly teaches God's heart for the poor, but it does not teach a large redistributionist welfare state. Tax and spend redistribution of income is not endorsed in the Bible. The core Biblical principle is that charity is more virtuous than redistribution through taxation, because it is based on love and not coercion. In the Biblical model the welfare state is internalised to the family, extended family and church. Also, the architecture of the economic system (ownership structure and property rights), most notably in the restoration of land under Jubilee, included an in-built resistance to extreme poverty or wealth.

In the Biblical model welfare policy is handled through individual responsibility – an individual responsibility for the poor to work and an individual responsibility for the wealthy to give. A wide range of poverty alleviation mechanisms existed (interest free loans, bonded service, debt cancellation, gleaning laws and the role of kinsman redeemer) and they all required personal effort (the grain must be gleaned, *"The concept of the tithe is also equitable in that it is proportional, requiring the same percentage contribution regardless of rich or poor"*

the loan repaid etc.), most notably in the Apostle Paul's statement that if a man will not work he shall not eat (2 Thessalonians 3:10). Those with wealth were exhorted to give generously (Deuteronomy 15: 7–8, 10).

Under the Biblical model the ideal was voluntary action stimulated by the 'motive clauses' found in Biblical law. In contrast, state ownership of welfare could be said to have created a 'bad Samaritan' culture with people content to pass by on the other side, ignoring their neighbour's needs, simply because welfare is seen as the responsibility of government alone.

The concept of the tithe is also equitable in that it is proportional, requiring the same percentage contribution regardless of rich or poor. From a Biblical perspective progressive taxation is not equitable.

One final comment under equity relates to property rights. It might be argued that God endowed humans with certain inalienable rights, including personal freedom, and that taxation breaches those rights. Property rights are breached because taxation is forcefully extracted and personal rights are overridden when people are forced to work for the state – the amount of taxation as a proportion of income translated into time.

3.1.2.7.2. Efficiency

Efficiency applies the principle of good stewardship to God's resources, which comprise the earth and all that is in it. In a modern context, the proportional nature of the tithe reduced the distortionary impact on the economic system.

There are many potential elements to efficiency and good stewardship but four key assertions can be made. First, higher taxes can impose an increasing deadweight burden on the economy. Second, as government grows relative to the market sector, diminishing returns to the growth of government will occur. Third, the political process is much less dynamic than markets. Fourth, as government grows it tends to become more heavily involved in redistribution and regulatory activism, both of which encourage wasteful rent-seeking. Consequently good stewardship requires a recognition of the damaging impact of high levels of public spending and taxation.

The idealised Biblical model faces significant challenges. The 21st Century UK is not an Old Testament theocracy. Moreover there are significant transitional issues that arise even if one did attempt to apply Biblical principles to current fiscal policy. The most obvious being the risk that in a secular society, after a century of state provided welfare, any withdrawal of government provision might not trigger an expansion of philanthropy and personal giving.

3.1.2.8. Bilal Sambur: Islam and the immorality of high taxation

Professor Bilal Sambur, *Yıldırım Beyazıt University, Ankara.*

Benjamin Franklin expressed the certainty of tax in our lives by saying: "In this world nothing can be said to be certain, except death and taxes." Governments claim that they have to tax us in order to pay the army, police, and bureaucrats; to build infrastructure; to operate schools and hospitals; for a number of other purposes. Taxation is the most important source of revenues for modern states. Although states claim that taxation is their right, people still debate the morality and justification of taxation.

We do not pay taxes voluntarily. We are forced to pay taxes. There are some hard questions: how can we minimise the loss of economic welfare due to taxation and how can we minimise the burden of taxation on society? Taxation transfers our wealth from households and businesses to government. But this transfer is not a simple transfer of wealth. It also creates serious problems in regard of human liberty, morality and dignity. Does the government have a moral right to levy and collect taxes from its citizens?

Governments have imposed many types of taxes on human society. In most developed countries, individuals pay income taxes when they earn money, consumption taxes when they spend it, property taxes when they own a home or land, and so on. People are not happy about these taxes and often complain at the prospect of higher taxes.

Taxation affects our behaviour, choices, businesses, savings and spending. Taxation both limits and restricts our economic freedom. We have to limit our economic activities – such as spending, consuming and running a business – according to the amount taken in taxes. Companies fix their investment plans in the light of the tax system and those taxes often make it less efficient. It forces businesses to make choices based on what will ease their tax burden rather than on what will make them most productive. Taxes have limited our economic freedom and diminished our wealth and ability to invest.

The real burden of the government is its expenditure. In order to finance its spending, government taxes us. In other words, the burden of government, which is spending, becomes our yoke, which is high taxation. Government must limit its spending, instead of taxing us at high rates, so that our yoke can be a bit more bearable. If government does not limit its spending, high taxation will remain a constant source of suffering in our lives.

3.1.2.8.1. God, not State, as The Ultimate Owner

In Islam, God has been considered as the real and actual Owner of everything. The Qur'an says: "Whatever is in the heavens and the earth belongs to God". (The Qur'an, 2:284) But God makes the desire for private property as the natural dimension of our nature. It is natural for us to have the wealth of this world. According to the Qur'an, "He has created for you whatever that is in the earth." (The Qur'an, 2:29) Islam relativises the ownership of everything and considers only God as the Absolute Owner.

"Nothing shall be legitimate to a Muslim, which belongs to a fellow Muslim, unless it was given freely and willingly"

Islam recognises private property and discourages the excessive accumulation of wealth by a minority group in society. In his farewell pilgrimage, the Prophet of Islam said that "O People, just as you regard this month, this day, this city as Sacred, so regard the life and property of every Muslim as a sacred trust. Return the goods entrusted to you to their rightful owners." Economic freedom and individual labour is highly valued. The state is not the owner of what the individual has. The Prophet said so explicitly in his farewell pilgrimage: "Nothing shall be legitimate to a Muslim, which belongs to a fellow Muslim, unless it was given freely and willingly."

In order to protect human dignity and liberty, the government's power to tax must be limited. The cost of maintaining an over-sized political establishment is heavy taxation, which is unbearable. Human beings are endowed with natural rights by their very existence. Human rights are an indispensable part of being human and private property is a natural human right. No authority, including the state, should violate this right. What an individual earns only belongs to them. Through taxes, the state says to people that what they own is not their own.

Direct or indirect taxation is an infringement on private property. The government does not care about the right of the citizen to their property. Income, inheritance and other taxes are the denial of private property. The government says to the citizen: "Your earnings do not belong to you; I have a right to own what you own, and my rights come before your rights. I will leave some of your property to you, because I recognise your need, not your right. You should not forget that I am the only authority, which decides the amount of property you can own." In this approach, the state comes before the individual. People have no right to object to high rates of tax. The state is the only authority and determines the amount which must be paid as tax.

There must be justice, which reflects the will of the Ultimate Owner, behind every economic activity and policy, including taxes. The state cannot claim absolute ownership of our private property. If the state makes such a claim, that is aggression against humanity as well as God. Excessive and unjust taxes could be considered as representative policies, in which the state plays the role of God. The state is only allowed to receive a limited amount of tax, it is not allowed to tax individuals to any extent or in any way. The state is the greatest centre of power. The might of the state does not make the state the author of our rights. The tax system can destroy our right to private property and human dignity. The state has no right to own us or to own our property, because we are the owner of ourselves and our property.

3.1.2.8.2. Care and Compassion as the Natural Aspects of Human Individual

An individual human cannot live as a selfish, isolated creature. They must care about other humans. Compassion and care makes someone a real human being. Someone without compassion and care cannot be considered a true human individual. The Prophet of Islam makes care and compassion a natural part of being a human as well as being a Muslim. According to the Prophet, helping the needy people is our human responsibility: "The one who goes to sleep satisfied while he knows that his neighbour next to him is hungry does not believe in me." It is the duty of every individual to help one's neighbour in a free society. But in a socialist order, individuals do not care about each other, because the only owner of property is the state. Needy people expect help from the state, not from individuals.

Compassion and care is not only an individual responsibility but also a social responsibility. Individual and social responsibilities are united in the following statement of the Prophet: "Any community, whosoever they are, if a person among them became hungry, they will be removed from the protection of God the Blessed, the Supreme." Without human qualities, namely care and compassion, there is merely a crowd, not a society. Compassion and care are essential to a true society.

Care and compassion must be manifested through voluntary charitable activities. Voluntary charitable acts have been called *sadaqah* or *infaq*. The Qur'an commands Muslims to help others voluntarily. There are more verses dealing with voluntary charity than obligatory dues. Everyone is morally obliged to help others according to their means and resources.

> *… The pious (are) those who … spend (in charity) from whatever We have given to them.* (The Qur'an, 2:3)

> *The pious people (are) those who spend (benevolently) in good and bad days.* (The Qur'an, 3:134)

Wealth and prosperity are valued in Islam, because people can contribute to human society through these means. True charity is the fruit of prosperity. If we had no right to own our private property, we would have no right to give. The denial of private property means the denial of charity. The Prophet says that "The best charity (*sadaqah*) is that given out of richness."

Each individual person must use their income to support themselves, their families, their relatives and society. The road starts with the individual and moves to other people. The Prophet defines the road map of human charity as follows:

Start with yourself when giving charity. If there remains any excess, then to your family. If there remains any excess, then to your relatives. If there remains any excess, then do like this, give to those in front of you and those to your right and those to your left.

People must satisfy their needs first and then support others. The Qur'an encourages people to spend the excess of their incomes for the benefits of society: "They ask you what they should give: say, 'Give what you can spare.'"(The Qur'an, 2:219).

Income, which is the fruit of human labour and skills, is very important in Islam. No authority has the right to steal our income from us. It is totally up to us to use our income the way we want to. Through our incomes, we should satisfy our needs and help the needy sections of society. People are encouraged to donate their excess wealth to help other people. There is no income tax in Islam.

In order to help other people through voluntary charitable activities, individual people must be economically self-sufficient, not dependent on the state. The Prophet and the Qur'an do not ask people to pay tax to the state, but rather give their excess wealth as a charitable donation to other people. The state cannot tax people in the name of social justice. It is the task of individuals to realise social justice in society. It is not the task of a nanny government to feed the hungry, care for the sick, build schools, look after the elderly people and so on. It is our job and responsibility as humans.

People produce goods in order to satisfy their desires, needs, and ideals. No one is working in order to pay taxes. Our income belongs to us, not to the state. The income, investments and savings of individuals must be protected against the higher taxation of government.

3.1.2.8.3. Islam promotes *Zakat* (almsgiving), not Taxation

There is neither the concept of state, nor a theory of taxation in the Qur'an. The Qur'an does not say anything about paying taxes to the state. There is no such thing as Islamic tax. There is no Islamic foundation for sales taxes on goods and services. Instead, Islam encourages people to help others voluntarily and work very hard. There is no way to mystify or sanctify taxation, because there is nothing sacred about taxation. It is only a policy of the state, which can be immoral, oppressive and inhuman. Imposing taxes on an individual's property without his or her consent is *haram* (forbidden) in Islam. The Qur'an writes:

And do not consume one another's wealth unjustly or send it [in bribery] to the rulers in order that [they might aid] you [to] consume a portion of the wealth of the people in sin, while you know [it is unlawful].
(The Qur'an, 2:188)

Although Islam does not promote a particular type of taxation, it requires *zakat* (almsgiving), which is the third pillar of Islam. *Zakat* is not a state tax but an individual responsibility towards another individual. *Zakat* is an act of worship, which purifies individual and social life spiritually as well as materially.

Reducing *zakat* to a form of tax is the corruption of religion. *Zakat* and tax cannot be identified with each other. They are two totally different things. *Zakat* is a type of worship, which is imposed on believers by God. On the other hand, tax is an obligation imposed on citizens by the state. *Zakat* is essentially a matter between God and individuals, but tax has been primarily a matter between citizens and the state authorities.

"The aim of zakat *is not to satisfy the needs of the state, but the needs of people"*

Taxation is required in order to cover government expenses. For a long time, governments have imposed taxes to raise revenue only to cover the cost of administration and defence, and in the case of despotic monarchs for the personal benefit of the ruler. Hajjaj-ı Dalim (Hajjaj the Oppressor) is a major symbolic figure in Muslim history renowned for his oppressive tax policies. But today, taxes are no longer levied for defence and administration only, but also for the purpose of furthering social and economic policies of the state. People pay their *zakat* voluntarily, but people pay their taxes compulsorily. Tax can be spent for any purpose, but *zakat* cannot. *Zakat* is meant to be spent for particular objectives, which are mainly provision for the poor; to free debtors from their debt; to free people in bondage; to support travellers; and for the good of the people. The state and *zakat* must be separated from each other. Unfortunately, many rulers have collected *zakat* from people as a tax in history. Making *zakat* a form of taxation could create disastrous consequences for the freedom and prosperity of human society.

The aim of *zakat* is not to satisfy the needs of the state, but the needs of people. Spending one's money for the sake of God is not a tax, but an act of worship and responsibility. The Qur'an says:

> *Alms are only for the poor and needy, and those who collect them, and those whose hearts are to be reconciled and to free the slaves and the debtors, and for the cause of God, and (for) the wayfarers; a duty imposed by God. God is knower, wise" (The Qur'an, 9:60). The Qur'an does not say anything about the right of the state or Caesar. It does not ask us to give state its due, but asks us to support the needy. The Quranic reference is said to be "and render to kindred their due rights, as (also) to those in want…* (17:26)

Furthermore, the Qur'an also prescribes what the charitable donations should be spent on:

> *They ask thee what they should spend in charity. Say: whatever ye spend that is good, is for parents and kindred and orphans and those in want and for wayfarers. And whatever ye do that is good – Allah knoweth it well.*
> (The Qur'an, 2:215)

Islam protects the rights of the poor through *zakat*. Although Islam does not make the state responsible for needy people, it makes every wealthy person responsible for the poor. This is the virtue of *zakat*.

People must know how to help. Islam does not show the state how to help, but commands the wealthy to help others through *zakat* and charity. Islam encourages personal responsibility; it rejects collective responsibility. People must help the needy people in a personal way, rather than simply remaining passive and allowing the state to take their money and give it to the needy in an impersonal way. If we transfer our responsibility for caring and charity to the state, we will end up with a society of irresponsible, uneducated and cruel people. Peace, order, prosperity, liberty and welfare existing in human society are mostly a product of the voluntary activity of individual charity.

Making the state caring and compassionate reduces the field of individual responsibility and virtue while it enlarges the area of irresponsibility and cruelty. Islam asks for people to be free from want. Islam encourages people to make profits, but does not ask people to pay their profits as taxes to state. Taxes make people the beggars of the state. Depending on government to satisfy all our needs elevates the state to the status of the omnipotent deity. The government has nothing of its own to give, for it is not a producer of wealth. We should not forget this basic reality: a government that can give us everything we need, can take everything we have away.

Islam protects individual property and everybody is responsible for themselves. The Qur'an says that "no bearer of burden shall bear the burden of another" (The Qur'an, 53:58). Islam also prohibits overspending (*isrâf*) which is forbidden, even in charity (The Qur'an, 17:29). So we could conclude that high and unjust taxes are contrary to the spirit of Islam.

3.1.2.8.4. Taxation as the source of injustice and immorality

The state has no right to impose direct or indirect taxes such as sales taxes, court fees, fees on petitions, sale or registration of a property, buildings and so on. Imposing oppressive taxes is an unjust act, which diminishes human liberty and dignity. The power of the state must be limited in the area of taxation. Any ruler, who imposes unjust taxes, has been rejected by Islam. The Prophet of Islam says that "He, who imposes *maks* (custom duty) would not enter paradise."

Higher taxes can be an unbearable burden for the poor and the rich. High taxes can make life harder for everyone. Taking private property through high taxes is inhuman as well as unIslamic. If the state claims that those taxes are the only way to finances its expenditure, this is a demonstration of its economic failure and corruption.

Higher taxation is the original source of corruption. Justice Oliver Wendell Holmes forgets an important fact when he says: "I like paying taxes. With them I buy civilization". Tax revenues are too often diverted from the state treasury into the bank accounts of rulers and bureaucrats. They spend the money supporting their own interests, not genuine public services. Many politicians have promised lower taxes in order to get people's votes, but after they have been elected they forget those promises. Those taxes are the source of their power. Tax and corruption are frequently connected.

Rulers who collect unjustified taxes have committed a great injustice, because they have infringed upon property rights. People can and must keep the fruits of their labour, which is the requirement of morality. We need the freedom to keep what we earn. In order to protect our freedom, we need lower taxes.

Although there is no moral and human foundation for taxation, we could consider tax a necessary evil alongside the state. Taxes should be collected only in order to cover the vital expenses of the state. The aim of tax is not to prevent the increase of wealth or increase the revenues of state. The only aim is to fulfil the required tasks of state, such as security, the protection of our borders and enforcing justice. A limited level of taxation could be justified on the basis of practical needs and necessity. People then have the right to know where their taxes have been spent. Higher taxes beyond the absolute needs of the state are unjust, immoral and inhuman.

3.1.2.8.5. Taxation: Wealth Redistribution or Theft?

Taxation cannot be considered business revenue, since government is not a business. Taxation is not a payment made for services rendered by voluntary agreement. People have been forced to pay taxes. Mostly, we are paying taxes not for government services, but the money is used to redistribute income or buy votes.

Frédéric Bastiat describes the legalised form of theft as follows: "See if the law takes from some persons what belongs to them, and gives it to other persons to whom it does not belong. See if the law benefits one citizen at the expense of another by doing what the citizen himself cannot do without committing a crime." There is no morality in taking someone's wealth and giving it to another. Such redistribution of wealth is about controlling society, not about helping others. It creates two classes of people: tax payers and tax consumers. Tax is a necessary evil which should be limited to financing the required expenditures of state. It is not the job of the state to distribute wealth in society through taxes.

3.1.2.8.6. Taxation as the Source of Poverty

The states of poverty or wealth are themselves neither virtues nor vices. But Islam asks people to work more and create more wealth in order to free themselves from begging, weakness and destitution. Higher taxes do not liberate people from poverty nor create more wealth. Instead, they leave people poorer. People who pay high taxes find it harder to pay for their own homes, education and businesses. The pain and suffering created by excessive taxes must not be ignored.

3.2. There is a limited set of legitimate objectives for government

There is a certain limited set of objectives for government, and limits on the extent to which they can be pursued and enhance social welfare. Those limits are considered in this section.

Research suggests that extra spending ceases to contribute to increasing welfare beyond 35 per cent of national income. That should be seen as the maximum justifiable level of public spending (Section 3.2.1).

Some claim that the findings of happiness economics provide a scientific template for an ambitious new role for government: promoting happiness. However the early empirical findings that were the basis of that claim seem to be weaker than they initially appeared and happiness economics has not changed the proper role of government (Section 3.2.2).

We then look at the legitimacy of using taxes to support action in a number of broad areas: essential services (Section 3.2.3); other services (Section 3.2.4); supporting those in need (Section 3.2.5); and promoting opportunity (Section 3.2.6).

3.2.1. The maximum justifiable level of public spending is 35 per cent of national income

The French economist Paul Leroy-Beaulieu wrote in 1888 that tax revenue of five to six per cent of GDP could be considered "moderate"; revenue of eight to 10 per cent of GDP would be "normal"; and revenue beyond 12 per cent of GDP would be "exorbitant", and would undermine economic growth in a country.[111] There is a modern literature on the optimal size of government that tries to understand both the size of government that maximises welfare in the short term and that maximises economic growth to improve prosperity over the longer term.

Different taxes and different types of public spending have different consequences for welfare and economic growth. As a result there is no single optimal share of public spending in national income. If taxes and spending were more efficient, that could justify a higher share of national income, whereas particularly inefficient taxes and spending could mean that it was optimal to tax and spend less. As a general rule, however, this definition explains the optimal level of public spending as a share of national income:[112]

---

111. Cited in Tanzi, V. *The Economic role of the state in the 21st century*, Cato Institute, 2005
112. Smith, D. B. *Living with Leviathan: Public Spending Taxes and Economic Performance*, Institute of Economic Affairs, 2006

The social welfare maximising point can be defined as the share of national output at which the discounted net present value of the diminishing marginal social utility derived from extra government spending equals the rising opportunity cost in terms of the net present value of the foregone economic output, and also personal liberty, of the need to pay for it.

The fact that this definition is couched in net present value terms means that it can cope with issues such as inter-generational equity or environmentalist concerns about the long term future of the planet provided the appropriate rate of societal time discount is employed, a real rate of around 2.5 per cent to 3.5 per cent.

Tanzi and Schucknecht produced an estimate based on the United Nations Human Development Index to see at what point in increasing public spending as a share of national income no further increases in social welfare became discernible. Their results suggest that, even if you accept the current set of objectives the state is expected to achieve, general government does not need to spend more than 35 per cent of national income.[113]

Davies found the optimal size of government to maximise the Human Development Index was 30 per cent

Davies produced a similar study and found a smaller optimal size of government. He used panel data for 154 countries and found the optimal size of government to maximise the Human Development Index was 30 per cent (measured as consumption and investment spending combined). That was made up of consumption spending at 17 per cent of national income and investment spending of 13 per cent of national income.

There are limitations to that kind of study though. Tanzi notes that:[114]

Some of the countries with the highest HDI scores and with high levels of public spending, such as Norway, Canada, Sweden, Belgium, the Netherlands, and Finland, have in recent years significantly reduced their public spending while retaining their high HDI index […] Thus, there is life after public spending reduction. These countries have shown that public spending can be significantly reduced without causing the large fall in public welfare that many expect. A scatter diagram […] shows that there is no identifiable relationship between levels of public spending and HDI. This is confirmed by the absence of any correlation between the two variables.

The Human Development Index was not designed for this purpose and may not properly capture differences in living standards between countries, particularly among relatively well-off countries like Britain.

For example, beyond a certain level the contribution of health spending to life expectancy diminishes rapidly. Additional spending is no longer focused on conditions that can kill people earlier in life, where it will make a substantial different to life expectancy, but instead on end of life care for the elderly. That may mean countries where health care is rationed less, and provided more in response to demand from consumers who spend a lot on treatment that improves their quality of life (or marginally extends it at the end) but makes little difference to aggregate life expectancy, appear to have inefficient healthcare sectors. Life expectancy will also be seriously affected by lifestyle decisions that will contaminate any assessment of the role of public spending. In the same way, the Education Index looks at the adult

113. In their initial research Tanzi and Schuknecht used a figure of 30 per cent but more recent papers, many of which have been published by the London think tank Politeia, have quoted a 30 per cent to 35 per cent range. Professor Tanzi has recently updated this work in Part 4 of Tanzi, V. *Government versus Markets: the Changing Economic Role of the State*, 2011.

114. Tanzi, V. *The Economic role of the state in the 21st century*, Cato Institute, 2005, pg. 622

literacy rate and the amount of time spent in school. In developed countries those are probably more a measure of social dysfunction and inputs than public sector output and its effects on aggregate welfare.

Those studies may also measure the short term results of higher spending but not the long term cost in terms of diminished economic growth. While some of the costs of higher spending may be reflected in the Index, such as a reduced ability to buy private health or education or an immediate reduction in incomes from reduced labour supply, the dynamic economic harms over time may not be.

For a more complete understanding of the optimal size of government, we also need to consider the effects on economic growth (Section 3.4). There have been a large number of studies looking at the optimal size of government to maximise economic growth, some of them summarised in Table 3.1.

Table 3.1: Studies of the growth-maximising size of Government

Author	Title (year)	Country	Optimal size of Government	Notes
Branson, J. & Lovell, C.	A growth maximising tax structure for New Zealand (2001)	New Zealand	22.5%	Annual growth rates in New Zealand since 1945 have varied from 18 per cent to -8 per cent. Meanwhile the tax burden has grown from 23 per cent to 35 per cent. At the optimal rate, real growth would have increased by 17 per cent.
Chao, J. & Grubel, H.	Optimal Levels of Spending and Taxation in Canada (1998)	Canada	34% (Government spending)	In 1996, public spending in Canada was 48 per cent of GDP. Reducing spending to the optimal level would have meant growth levels of 3.7 per cent, rather than three per cent.
Chobanov, D. & Mladenova, A.	What is the optimum size of Government? (2009)	Sample of OECD countries	25%	The authors also examined the relationship between the optimal size of consumption and the general government consumption on final goods and services for a set of 81 countries. In that case, they estimated that the optimal size of government consumption is 10.4 per cent of GDP.
Facchini, F. & Melki, M.	Optimal government size and economic growth in France (1871–2008): An explanation by the state and market failures (2011)	France between 1871–2008	30% (Government spending)	This extensive study found that the optimal level was reached in 1940. In the period 1999–2009, it was around 53 per cent. The authors note that other studies on France have indicated an optimal size of around 40 per cent, but they dismiss these as having analysed too short a time period.
Forte, F. & Magazzino, C.	Optimal size of government and economic growth in EU-27 (2010)	EU–27 countries	37% (Government spending)	This paper combines the models set out by Barro, Armey, Rahn and Scully to use a BARS curve. The peak of the BARS curve – where economic growth is maximised – is at 37 per cent in this model. The actual level was 47 per cent, hindering economic growth.
Herath, S.	The size of government and economic growth: an empirical study of Sri Lanka (2010)	Sri Lanka	27% (Government spending)	This paper uses Armey's quadratic curve and finds that it applies to developing economies, as well as developed economies.
Karras, G.	On the optimal Government size in Europe: theory and empirical evidence (1997)	European countries	16 % average (+/-3%) (Government spending)	The study also found that evidence that the marginal productivity of government services is negatively related to government size. In other words, the public sector is more productive when small.

Author	Title (year)	Country	Optimal size of Government	Notes
Karras, G.	The optimal Government size: further international evidence on the productivity of Government services (1996)	Various	23% average (Government spending)	The average of 23 per cent ranges from 14–33 per cent. In Africa, the rate is 20 per cent; in North America, 16 per cent; in South America, 33 per cent; in Asia, 25 per cent; and in Europe, 18 per cent.
Keho, Y.	Estimating the growth-maximising tax rate for Cote d'Ivoire: Evidence and implications (2010)	Ivory Coast	21.1% to 22.3% (revenue/GDP)	In this case, the author finds that the current tax revenue/GDP ratio is actually too low in the Ivory Coast, and that revenues should be increased to the optimal rate.
Mutascu, M. & Milos, M.	Optimal size of Government spending: The case of European Union member states (2009)	EU–15	30% (Government spending)	This could have led to a maximum rate of GDP growth of 3.96 per cent a year on average for the EU15 countries, which is higher than the average two to three per cent achieved. The average level of expenditure was 46 per cent, so to get to the optimal level this would have had to be reduced by 16 per cent.
Mutascu, M. & Milos, M.	Optimal size of Government spending: The case of European Union member states (2009)	EU–12	27% (Government spending)	This optimal rate could have led to growth of 7.7 per cent, with a reduction in spending of just over 13 per cent.
Rahmayanti, R. & Horn, T.	Expenditure efficiency and the optimal size of Government in developing countries (2011)	Developing countries	15% (Government spending)	The sample consists of 63 countries, but a score could not be determined for 16 of them, as the model required a sufficient efficiency score.
Schoeman, N. & van Heerden, Y.	Finding the optimum level of taxes in South Africa: a balanced budget approach (2009)	South Africa	18.5% (revenue/GDP)	The author finds that the optimal rate of taxation in South Africa is actually much lower than it has been in reality for two decades.
Scully, G.	What is the optimal size of Government in the United States? (1994)	United States	21.5% to 22.9% (revenue/GDP)	Taxes as a share of GDP have not been in this range since 1949. Growth calculations based on the model suggest that American families would have had twice as much real income.
Scully, G.	Optimal taxation, economic growth and income inequality in the United States (2008)	United States	19.3% (revenue/GDP)	At the mean tax rate, a growth rate of 3.4 per cent was expected. However, shifting down to the optimal level increased the growth rate to nearly seven per cent.

Again there are limitations with those studies as well, though. Kahn argues that:[115]

On the measurement front, [research should go] beyond the size of the government budget to include such factors as regulations, price controls, and trade restrictions. Regarding methodology, it has argued for approaches that take into account "simultaneity" (the problem of disentangling cause-and-effect) and the multidimensional nature of the problem, and which look for lasting effects on the level, rather than the growth rate, of economic activity. Surveying the literature, and looking directly at broader measures of government size, while the evidence does not allow us to determine what the optimal size of government is, it does clearly indicate that, for the most part, the governments we observe are too large – at least from the point of view of maximising GDP per capita.

115. Kahn, J. A. *Can We Determine the Optimal Size of Government?* Cato Institute, 14 September 2011

For the purposes of the 2020 Tax Commission, the right conclusion is that there appears to be a maximum justifiable level of spending at 35 per cent of national income – the current Institute of Directors recommendation for the medium term target – but that lower levels of spending are likely to substantially improve economic growth and prosperity over time. Those short and long term priorities could be balanced with a 33 per cent of national income target, which was also the mean level chosen by respondents to polling cited in Section 3.5.1. As a result that is the 2020 Tax Commission's medium term target, and the amount that its proposals will aim to raise.

3.2.2. High and redistributive taxes cannot be used to promote happiness

Happiness economics is founded around the finding in surveys that happiness does not increase in developed economies with average income, but does increase for individuals with their relative income. For example, Lord Layard has argued that:[116]

> *Survey evidence suggests that there has been no increase in happiness since the 1950s, despite vast increases in income*

Proponents of happiness economics claim that this means too much emphasis is placed on aggregate economic growth and that more attention should be paid to how policy can deliver increased happiness. Among other things, they argue this justifies higher taxes:[117]

> *None of this would matter if income fell like manna from trees. But income is earned by the sacrifice of time with your family and friends. If much of the extra income (say 60 pence in the pound) brings no overall increase in happiness, we should reduce the incentive to acquire it. It would therefore be efficient to have a marginal tax rate of say 60 pence in the pound – corresponding to the 60 pence worth of pollution caused by the extra pound that is earned.*
>
> *This is the first dramatic policy implication of adopting a happiness-based approach to public policy, and should form an important part of a social democratic agenda that is based on the new social science. Up to now we have apologised for taxation. The standard economic analysis says that taxation reduces work effort, which is true. But it also says that this is inefficient, which our previous analysis shows is false. Indeed taxation is one of the most important institutions we have for preserving a sensible balance between work and leisure. We should be proud of it and stand up for it.*

Politicians making decisions can and will already take into account objectives other than economic growth, as voters take a range of factors into account when they cast their vote

Politicians making decisions can and will already take into account objectives other than economic growth, as voters take a range of factors into account when they cast their vote. There are a number of problems with basing policy on findings from happiness surveys though: weaknesses in the evidence underlying happiness economics; strong assumptions about the policy implications; and the question of whether happiness – understood this way – is really the right objective for government policy.

The same surveys show that happiness does not correlate with other likely variables either, including income inequality, public spending, crime rates, longevity,

116. Layard, R. Towards A Happier Society, *New Statesman*, 24 February 2003, http://lowtax.es/yMnSLw
117. *Ibid.*

and even clinical depression.[118] So either a broad range of social policies, successful in achieving their immediate objectives, do not improve our happiness either, or the measures themselves aren't reliable.

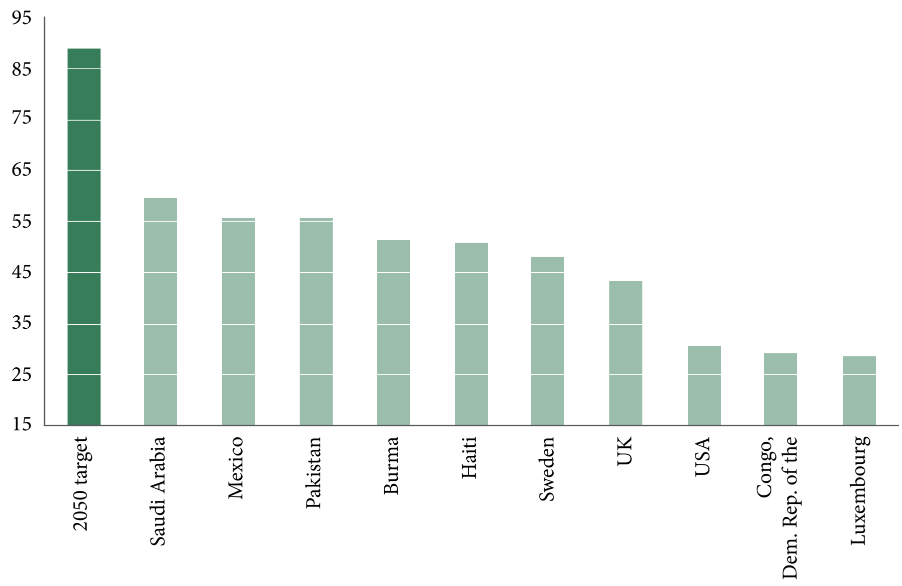
Many happiness surveys use a three point scale – asking whether respondents are "not happy", "fairly happy", or "very happy" or something similar.[119] That measure is not continuous, since moving between categories requires a substantial change in opinion and therefore often only very substantial changes in public happiness produce a difference that is statistically significant.

There is also an upper limit to how happy someone can register themselves, whereas there is no equivalent upper limit on other variables such as how someone's income can grow. And the surveys are a highly relative measure, not an absolute one. Even those surveys which use more graduated scales – which therefore offer more precise data – are subject to those problems.

Ormerod reports that more "subtle recent work is in fact suggesting that there is a clear and positive connection between life satisfaction and income, and that there appears to be no cut-off point for this", citing work by Kahneman and Deaton.[120]

The results produced by indices of different countries which use happiness surveys to assess their economic performance produce very implausible results. For example, the New Economics Foundation has produced two editions of the *Happy Planet Index* by combining a measure of happiness with a measure of resource intensity. They say that countries which score well "show that achieving, long, happy lives without over-stretching the planet's resources is possible." But Saudi Arabia (13th), Mexico (23rd), Burma (39th) and Haiti (42nd) are way ahead of Sweden (53rd), the United Kingdom (74th) and the United States (114th).[121] Again that does not inspire confidence in the underlying measure of wellbeing.

Figure 3.3: Happy Planet Index score, selected countries



118. Johns, H. & Ormerod, P. *Happiness, Economics and Public Policy*, Institute of Economic Affairs, 2007 http://lowtax.es/HUWU4p
119. *Ibid.*
120. Ormerod, P. *The Folly of Wellbeing in Public Policy in Booth*, P. (ed) … and the Pursuit of Happiness: Wellbeing and the Role of Government, Institute of Economic Affairs, January 2012
121. Abdallah, S., Thompson, S., Michaelson, J., Marks, N. & Steuer, N. *The Happy Planet Index 2.0: Why good lives don't have to cost the Earth*, June 2009, HPI results table

It is reasonable to argue that promoting economic growth should not be the sole focus of policy. But in reality it never has been, and politicians will hopefully respond to voters who have a range of priorities. Johns and Ormerod wrote in a study for the IEA that the "much more securely grounded" longitudinal panel data on happiness finds that "stable family life, being married, good health, having religious faith, feelings of living in a cohesive community where people can be trusted, and good governance contribute to happiness." That would lead to a set of policy proposals very different to those recommended by Lord Layard, which might prioritise the family and social cohesion (Section 4.3.5).[122]

With the difficulties measuring happiness, radical shifts in policy on the basis of the surveys would clearly be a mistake. It would be impossible to properly understand what works or assess the results. Dubious schemes could be supported with significant amounts of money, which it will be easy to justify taking on the grounds that money does not make people happy.

Of course, happiness is not just a matter of what you are paid. But money is the raw material that allows us to make all sorts of choices, including those that make us happy. If someone wants a home to build a stable family life then a higher income will make that easier. Others might be happier with the experience of a foreign holiday, or if they are able to support religious or other charitable causes. Low taxes allow people to use their own money to pursue their own happiness.

Calls for politicians to embrace an ever wider duty to promote our wellbeing are vulnerable to the critique contained in Aldous Huxley's *Brave New World*. It might be possible for people to be extremely satisfied with their condition if they are inculcated with low expectations and treated with recreational drugs (like the fictional soma in the book). Other choices might produce a life that is less superficially happy but in some sense more meaningful. With a narrower set of objectives – such as building a stable, prosperous and liberal society – politicians do not neglect our broader wellbeing. They simply leave the question of what constitutes a good life to the individual.

3.2.3. It is legitimate to spend a limited amount to support essential services

It is relatively easy to justify spending to provide national defence, a police force and criminal and civil justice systems. It is true that we could live in isolation, or live with foreign invasion or with crime, or resolve disputes by force. But life in those circumstances would be a great deal more miserable than life under a system in which crime is controlled (although sadly not eliminated), and disputes can reliably be resolved peacefully.

This obvious argument for providing these things is a utilitarian one. Most of us are better off in a law-governed society than in a lawless one. Our lot is also greatly improved by living in a society where property rights can be sustained and where contracts can confidently be made, in the knowledge that they can be enforced. Such conditions allow businesses and trade to develop, to a far greater extent than would be possible without those guarantees. They also give consumers confidence when agreeing to buy from suppliers. Not only does it become reasonably safe to pay deposits in advance of work being completed or large goods being made to order, it also enables consumers to obtain compensation if they have legitimate cause for complaint.

122. Johns, H. & Ormerod, P. Happiness, *Economics and Public Policy*, Institute of Economic Affairs, 2007 http://lowtax.es/HUWU4p

It is, however, worth noting that other ethical arguments point in the same direction. The deontologist will readily agree that respect for property, the keeping of promises, and observance of the law are generally sound maxims. As Kant would note, they are maxims that one can obey easily, and which should be universal. Given that not everyone can be relied upon to observe them voluntarily, but practically everyone would want everyone else to observe them, there is a good case for having a system of laws to ensure enforcement. The virtue ethicist will be keen that people should have the opportunity to use their talents to the full. Most of us can only do so in a peaceful society, and in a society in which property is respected and agreements are kept.[123]

While these arguments show that it is perfectly legitimate to use taxation in order to achieve the objectives, it does not follow that everything in this general area should be provided out of taxation, or that there should be no efforts to limit the burden of providing these services on taxpayers. One might, for example, expect those who got involved in civil disputes to bear the full costs of resolving those disputes, or expect convicted criminals to pay as much as possible of the costs of the police and criminal justice system.

3.2.4. It is legitimate to spend a limited amount to support other services, but less so as the marginal benefits diminish as spending rises

Roads and other infrastructure, schools, hospitals and a social security system are all things that modern states provide out of taxation.

There is a utilitarian case for the provision of all of these things, at some level, to the extent that they are not provided privately. They can greatly enhance welfare. And the enhancement to welfare that is produced by an initial slice of provision, such as primary education and the prompt treatment of medical conditions that are easily treatable and best treated early, would be very likely to be enough to justify the coercion that is involved in taxation. As one moved on to more and more generous provision, the benefits per extra pound spent would be likely to fall, and the rising burden of taxation would make the coercion involved more and more objectionable, ultimately to the point where further taxation could not be justified as discussed in Section 3.2.1. Thus a utilitarian approach to the consideration of specific items of spending would be entirely consistent with the notion of a welfare-maximising overall level of spending, set at somewhat below the most generous possible level of spending.

A virtue ethicist could make a similar argument for state provision of services that allow people to use their talents to the full. Again, the return from provision would be high enough to justify taxation and spending to make basic provision, but the case for further taxation and spending would get progressively harder to make as one moved on to more generous provision.

One specific type of provision for which utilitarians in particular might argue is the provision of public goods, that is, goods which are available to all, in the sense that there is no practical way of excluding people, whether or not they meet some condition such as payment, and which are such that one person's enjoyment of the good does not diminish other people's enjoyment of it. The classic example is national defence. Such goods are likely to be under-provided in a purely market system, because providers could not enforce payment for them and would therefore

123. This point does not apply to everyone. Creative artists sometime do their best work under adverse conditions, including civil strife or even war, but most of us are not like that, and the gain from the elimination of strife far outweighs any loss of works of art that might have been created.

make inadequate returns. There is therefore a case for taxation in order to provide such goods at the level that will maximise overall welfare, rather than at the level that the market would naturally provide.

3.2.5. It is legitimate to spend a limited amount to support those in need, but not with an overly generous welfare system that creates dependence

Even in a rich country, some people would, without external help, live in unacceptably poor conditions. Taxation is one way to provide that help. It may be the only way to ensure that help is reliably provided to all who need it, because charitable donations, while important, may be routed to specific classes of beneficiary whom the donors consider to be the deserving poor. But how strong are the arguments that we should ensure that help is provided to all who need it?

The utilitarian argument for helping the poor is clear. The utilitarian objective is to increase overall utility. The utility of the poor can be increased by improving their lot. The cost of generating an extra unit of utility among the poor is such that if one takes that amount from the rich, they lose less than one unit of utility. Therefore, the utilitarian would say, this is a perfectly good reason to impose taxation. It does not, however, follow that an arbitrarily high level of taxation should be imposed for this purpose. As tax burdens rise, other losses are imposed, and there comes a point where total utility is not increased by further transfers to the poor. Most obviously, economic growth may be lost, and large-scale provision will require transfers from people on moderate incomes, not just people on high incomes.

Deontologists can recognise a duty to care for the poor. Kant certainly did.[124] His thoughts on that duty were, however, about the duties of individuals, not about a taxpayer-funded welfare state. He did also consider taxpayer-funded welfare, but his argument for it is obscure and not wholly convincing.[125]

Virtue ethicists can point out that it is virtuous to care for those less fortunate than oneself, and can therefore accept that provision for the poor is a good reason for imposing taxation. But like utilitarians, virtue ethicists would set limits to the extent to which this should be done, and would do so on the basis of the same ethical system that they saw as justifying some transfers. Excessive transfers would limit the opportunities to live a full life of those who paid. They would also encourage dependence and idleness among the recipients.

Suppose that we accept such arguments, and decide that the poor should be helped through taxation. We then have to consider the role of charity, as an alternative means of help. We need to look at the positions of the individual contributors, the individual recipients and the population as a whole.

Let us start with the individual contributors. A utilitarian is likely not to care whether the poor are helped through charity or through taxation, except to the extent that there are second-round effects, such as adverse economic consequences of high taxes. What matters is that the poor are helped. A deontologist may positively favour charity over taxation. Kant argued that the truly moral action had to be motivated by a sense of duty, not by consideration of the consequences for oneself or for others.[126] It is possible to pay taxes out of a sense of duty, and to make charitable donations because it makes one feel good (a desirable consequence for oneself). But it is more likely that tax will be paid out of fear of being penalised for non-payment,

124. Kant, I. *Groundwork of the Metaphysics of Morals*, pg. 423; Metaphysics of Morals, pgs. 452–454.
125. Kant, I. *Metaphysics of Morals*, pgs. 325–326. A study of the limitations of the scope to build on Kant's argument is given in Penner, J. The State Duty to Support the Poor in Kant's Doctrine of Right, British Journal of Politics and International Relations, 12, 1, February 2010, pgs. 88–110.
126. Kant, I. *Groundwork of the Metaphysics of Morals*, pg. 390

and that a charitable donation will be made out of a sense that it is the right thing to do. (This is not to deny that charitable donations can be made for many other reasons, including the feeling of pleasure from making them or the admiration that known generous donors may attract.) Finally, a virtue ethicist might well prefer to see voluntary charitable donations. The ground for this preference would not be the same. It would be that it is more virtuous to give voluntarily than to hand over money because of the threat of penalties.

The first priority of individual recipients is likely to be to get help. To that extent, the source of the help may not matter. But recipients may quite legitimately care about how they are helped. They may feel ashamed at receiving charity. To the extent that this is so, it would be better if they received statutory benefits, to which they were legally entitled. It would be better both on utilitarian grounds, because removing any sense of shame would improve their quality of life, and from the point of view of virtue ethics, because there is virtue in accommodating people's sensitivities.

Great reliance on charitable contributions might also have adverse effects at the level of society as a whole. Charitable contributions depend on individual choice, and one might have concerns about a society in which some contributed a lot, while others on comparable incomes contributed little or nothing, even though the large contributors were happy to make their contributions. The distribution of benefit might be very uneven, with those who were generally seen as the undeserving poor receiving very little provision. And such a lack of provision might have serious consequences for the rest of society. For example, if ex-prisoners lack the support to pay for essentials and to find work, they may re-offend, imposing costs both on the victims of crime and on society as a whole, through the cost of the police, court and prison systems. On the other hand, there is a case for making some distinction between the deserving and the undeserving. Any who are really undeserving, the deliberate architects of their own misfortune, have no moral claim on the rest of us. Knowledge that those who are seen to have squandered their income rather than saved money to provide for things like long-term care may get short shrift, should create incentives to provide for oneself, and not to assume that others will provide. Utilitarians would approve because such incentives would lead to the better management of resources, with an eye to one's future needs as well as one's current wants. Virtue ethicists would approve because the incentives would encourage the virtue of independence.

Beyond a certain point, generous benefits become a burden that reduce both the welfare of those who pay for them, and the virtue of those who come to depend on them

Finally, none of the ethical theories gives us any precise idea of where to draw the boundary between needs and wants. Furthermore, none of them guides us as to whether to be greatly exercised about relative poverty (such as income of less than half median income), or whether we should only address absolute poverty (such as a lack of housing or of food). Such questions can be regarded as empirical ones, which we can best answer by surveying attitudes.

We can conclude that while it is legitimate to use tax to alleviate poverty, there is considerable scope for argument about the extent to which this should be done. And there are clear ethical arguments against an over-generous welfare system. Beyond a certain point, it becomes a burden that reduces both the welfare of those who pay for it, and the virtue of those who come to depend on it.

3.2.6. It is legitimate to spend a limited amount to promote opportunity

It is good to live a fulfilled life. Some people happen to have all the resources they need for that anyway, but most of us need education, healthcare and a reasonable income, many are brought up in families without adequate income to pay the full cost of education, and many do not have the income to pay the full cost of healthcare.

A system of taxation and government spending can provide all of these things, effectively by taking part of the cost of the supply of goods and services to poorer people, and transferring that part of the cost to richer people – although taxpayer-funded provision is by no means guaranteed to ensure a high standard of provision, or a uniform standard across the country. A system of taxation and spending achieves redistribution by making the same opportunities for education and health-care available to all, but charging some people more than others. It also ensures that these services will be available to all, and requires all to pay the price appropriate to their income, regardless of people's own spending preferences or their actual use of the services in question.

A utilitarian could accept this objective. A sense of fulfilment, and the possession of the practical ability to lead the life of one's choice, are both sources of utility. Not only are healthcare and education valuable in themselves, and for the opportunities that they create, but the utilitarian has a special reason to value education: it enables us to form our preferences under better conditions than would otherwise be the case. An educated person is aware of more options than an uneducated one, and can weigh up their advantages and disadvantages more effectively. A utilitarian would, however, set limits to the use of tax revenues in this way. A substantial tax burden would both damage economic growth and limit the opportunities of those who had to pay, including those on moderate incomes because there simply are not enough people on high incomes to pay a substantial total burden. Furthermore, what is to be paid for out of taxes is generally determined by elected governments, not by each of us individually. That lack of individual choice would limit the extent to which fulfilled lives were achieved, because an important aspect of fulfilment is self-determination, rather than following a plan that has been laid down by others.

You have to use your opportunities yourself

Daniel and Vincent both start a degree course in physics in the same year. Daniel works long hours, has a very limited social life, and spends his vacations gaining work experience. As a result, he gets a good degree. He is taken on by a law firm specialising in patents, where he has a successful career, becoming a partner in his thirties. Vincent spends a lot of time on sport, travelling during his holidays, and gets only a mediocre degree. He has difficulty finding work, but eventually finds an office job in which he does not use his knowledge of physics at all.

Can Vincent argue that Daniel should be taxed heavily, so as to provide generous public housing, subsidies for public transport and the like, that would reduce Vincent's need to spend his own limited income on necessities? It would seem not. Vincent faced the same choices as Daniel. He chose different options, and he must live with the consequences.

This does not mean that provision should not be made for those who would be in real poverty without public spending. But it is hard to see why those who can earn a reasonable living for themselves should be subsidised by those who made choices that led them to be better off.

A virtue ethicist could also support the objective. It is a virtue to make the best use of one's talents, and having the resources to develop and apply those talents is therefore conducive to virtue. A virtue ethicist would, however, want to set limits to the extent of taxpayer-funded provision. Not only is it a virtue to develop and to apply one's talents, it is also a virtue to achieve things under one's own steam, or with the voluntary co-operation of others. An achievement that substantially reflects the mandated contributions of others is less of an achievement.

We may also note that a whole new line of thought on the topic of justice, the capabilities approach, takes opportunity to be of primary importance. What matters is the freedom to do the things for which one has the intrinsic capacity. Thus we are intrinsically capable of thought, and emotional relationships, and control over our environment. We ought therefore to be given the external equipment to engage in such activities, equipment such as education and personal freedom, so that we can engage in them to the extent that we choose.[127]

Only a deontologist need have nothing much to say, either positive or negative, about this objective. It would be possible to argue for duties that would imply that the objective should be pursued, but that would take us beyond the normal scope of deontological argument.

It does therefore appear to be legitimate to use taxation to promote opportunity, but only within fairly strict limits.

Equality of opportunity is an objective that is quite different from the equality of outcome discussed in Section 4.3.6. The idea of equality of opportunity is that no-one should be excluded from advancement, or from particular positions, by factors outside his or her control. But if someone chooses options that impede his or her advancement, that is down to him or her, and not something for which the rest of us should be expected to compensate. Equality of opportunity can therefore easily be combined with inequality of outcome.

Equality of opportunity is not something that might be promoted by the tax system alone, of course. There are other policies that could be far more important. But the tax system does have some potential roles.

The first role is to promote opportunity, in particular by ensuring the availability of education, regardless of financial means, so that anyone with the necessary natural abilities and inclination to hard work can do well, and has a reasonable chance of entering the profession of his or her choice. This can be subsumed within the objective of promoting opportunity. There is no need to consider it separately under the heading of equality of opportunity. Indeed, the mere promotion of opportunity through education is likely to have the side-effect of increasing equality of opportunity. This is because help to all brings bigger benefits to the disadvantaged than to the advantaged: the same investment can be expected to make a bigger difference to those who start from a lower base. And if opportunities increase for all, as when economic growth permits greater provision for education, both taxpayer funded and privately funded, that should surely be welcomed, even if the new distribution of opportunities is less equal than the old one.

We should, however, note that if opportunities to enter the most demanding professions are indeed to be made available to all, quite high spending is likely to be required. That must lead us to stop and consider just how much ethical and political justification there is for pursuing the conferral of opportunity to the greatest possible extent. We should also note that perfect equality of opportunity is an impossible goal: we could only hope to move in that direction, not to get all the way. And we may reasonably hesitate to offer taxpayer subsidies for services that primarily benefit

127. Good starting-points for an exploration of the capabilities approach are Nussbaum, M. C. *Women and Human Development: The Capabilities Approach*, 2000; Sen, A. *The Idea of Justice*, 2010

the individual rather than society, and that are, unlike healthcare, not necessary for a reasonable life.[128]

The second role is to ensure that opportunity is indeed equal. Taxation could be used to pay for generous spending on education and training, in order to compensate people for not having the advantages that other people enjoy through having been born into families where culture and ambition are the norm. Taxation could also be used to fund payments of cash to people at certain points in their lives, which they could then spend on training, or on setting up their own businesses.

Even if equality of outcome is to be dismissed as a legitimate objective of taxation, as we shall dismiss it in Section 4.3.6, it does not follow that this aim of equality of opportunity is to be dismissed. The crucial difference is this. Equality of outcome includes at least a reasonable degree of equality of personal income and wealth (it may not require perfect equality of income and wealth: some may be adequately compensated in outcomes for getting less money by, for example, greater job satisfaction or more leisure time). But the total amount of income, and the total amount of wealth, are not fixed. It is possible to make the poor richer, without making the rich poorer. It makes sense to take this option, given that, as we shall see, there are no strong arguments for equality of outcome in itself. Opportunity in itself can be addressed in the same way. It is possible to use the fruits of technological progress and of economic growth to provide better education for some, without worsening provision for others. But if the "equality" aspect of equality of opportunity is to be significant, it must relate to competitions which some cannot win without others losing.

There are two reasons for wanting an opportunity to compete with others on equal terms, and one is of rather narrower application than the other. The reason of comparatively narrow application is that one may wish to exercise one's talents in a particular way, in areas where there are far more people who wish to do so than places for them. The reason of wider application is that one may wish to be higher up the pecking order than others.

The former reason is of limited application because there is no inevitability about the number of positions in many walks of life. Economic growth can bring new businesses and new opportunities. The number of taxpayer-funded opportunities in areas of work that are normally taxpayer-funded, such as education, medicine and academic research, is of course limited, but economic growth can bring forth new privately-funded positions in such fields, and where there is a natural limit, that can reflect some desirable fact. For example, it is a good thing if the general level of health is such that few doctors are needed. The latter reason can be of wide application because whenever there is a scale of status, some will be high up it and some will be low down it.

Given that there is a reason of wide application, we must consider the ethical and political arguments for ensuring equality of opportunity in the sense of being fairly placed in competition, and whether those arguments are strong enough to justify the substantial taxation and spending that achievement of such equality may entail. (High taxation and spending may not be the only way to achieve equality of opportunity. The use of tests for access to positions that do not favour those who have had advantages earlier in life may be an alternative.)

128. The obvious example is education, where individual returns to tertiary education are markedly greater than the social returns. For a survey and discussion, see European Commission, *Efficiency and effectiveness of public expenditure on tertiary education in the EU*, European Economy Occasional Papers 70, 2010, pgs. 24–28

Ethical theory, unaided by political theory, has little to say here. Utilitarians want to see good, competent people in influential positions. Where they come from matters little. There are two main utilitarian arguments for equality of opportunity. One is the fact that without it, resentment may build up among those who feel excluded from opportunities, and that resentment will itself be a source of loss of utility. The other is the fact that if people are excluded from competition for posts by force of circumstance, the most talented people may easily be overlooked, so that important jobs are not done as well as they could be done. The virtue ethicist will be keen that people should use their talents, but if only a certain proportion of the population can occupy influential positions, it is inevitable that only a certain number of people will be able to exercise talents that are specific to that kind of position. The deontologist is unlikely to have much to say, because his primary concern is with how individuals should act, rather than with how society as a whole should be organised. He would, however, be likely to say that anyone who selected people for positions should consider candidates on their merits, and should not be biased.

Stronger views on equality of opportunity come from political thought. In particular, John Rawls argued that one of the principles we would choose, if we were designing a society without knowing who we would be within it, would be the principle that social and economic inequalities were to be arranged so that they were "attached to offices and positions open to all under conditions of fair equality of opportunity".[129] His view that we would agree to such a principle is perfectly plausible, although we can of course challenge the view that imagining what we would want, if we were in a position of ignorance as to who we would be, is the right way to settle such questions. But we should consider how far such a principle could plausibly go.

Rawls' formulation is quite general. His concern is with both social and economic inequalities. It could cover not only competition for well-paid jobs, but also competition for jobs with good working conditions. And it could cover both jobs in the public sector and jobs in the private sector. This is where the debate is to be had. If we agree that there is something in principle desirable about fair competition, over what range is it important to ensure it through state intervention?

One can make a strong case in respect of appointments to taxpayer-funded positions. There are three main reasons for this. First, if we are required to pay for positions, we should be in a position to compete for them. Second, we should get the best people doing the jobs for which we have to pay, and the absence of market pressures to hire the best people means that some other regulatory mechanism is needed. Third, if the friends of those in political power could have privileged access to plum positions, corruption would be rife. The case is distinctly weaker for jobs in the private sector, where we are not required to pay, there are market pressures and, while corruption exists, it is primarily a cost for those who have chosen to be shareholders, employees or customers of the enterprises concerned.

Then we must ask how much should be done. Anti-discrimination laws and strict rules on the public advertisement of jobs in the public sector should go a long way towards achieving the goal, and they already exist in the UK. Measures that impose higher direct costs, such as the provision of extra education for those who have been disadvantaged by their upbringing, might be considered, but such measures would benefit applicants for jobs in the private sector just as much as they would benefit applicants for jobs in the public sector. If we consider the full equalisation of opportunity in the private sector to have limited value, then the expenditure

129. Rawls, J. *A Theory of Justice*, revised edition, 1999, pg. 266. All references are to this edition.

Putting the case for spending on education and the like in terms of equality of opportunity, rather than simply in terms of opportunity, does not greatly strengthen the case for spending

involved would, on average, produce less of an improvement per pound spent than it would have if the value attached to equal opportunity in the competition for public-sector jobs applied universally. The conclusion to draw is that while there is merit in increasing opportunity through education, the case that may be made for higher spending on education based specifically on equality of opportunity is quite weak.

That may serve as a conclusion for this section as a whole. The promotion of opportunity is worthwhile, although resources are limited and we cannot go as far as we might like in that direction. But putting the case for spending on education and the like in terms of equality of opportunity, rather than simply in terms of opportunity, does not greatly strengthen the case for spending.

3.3. You spend your money better than government will

The simplest result of higher taxes is that there is less money for people to spend themselves, buying goods and services in the market. A critical justification for low taxes is that people will tend to get better value spending their own money (Section 3.3.1).

In a 2004 interview, Milton Friedman captured the issue when he described four ways of spending money:[130]

> *There are four ways to spend money. You can spend your own money on yourself. When you do that, why you really watch out for what you're doing, and you try to get the most for your money. Then you can spend your own money on somebody else. For example, I buy a birthday present for someone. Well then, I'm not so careful about the content of the present, but I'm very careful about the cost. Then, I can spend somebody else's money on myself. And if I spend somebody else's money on myself, then I'm going to have a good lunch! Finally, I can spend somebody else's money on somebody else. And if I spend somebody else's money on somebody else, I'm not concerned about how much it costs, and I'm not concerned about what I get. And that's government. And that's close to 40 per cent of our national income.*

There are substantial challenges in obtaining the information needed to allocate resources without the price system. Politicians and bureaucrats are employed to manage the process of spending taxpayers' money to provide public goods. However, whether they are doing this effectively can be hard for individuals – as voters and taxpayers – to assess, as they have more incentive to acquire information about their decisions in markets, and as Pennington notes, "an individual's decision to obtain information about the quality of policies on offer is not decisive in determining what they receive".[131] The danger this section looks at is that they may not be working entirely or even mostly in the interests of those taxpayers, not because they are particularly immoral or irresponsible but because they are independent actors with their own sets of interests (Section 3.3.2), and because rent seeking special interests are able to subvert their work (Section 3.3.3). That leads to lower productivity and reduces economic growth.

By contrast, with lower taxes people can do more to support their own families and their own causes (Section 3.3.4).

130. Ross, R. Friedman's Four Ways, *American Spectator*, 5 October 2011
131. Pennington, M. *Robust Political Economy*, 2011, pg. 40

3.3.1. Value for money tends to be higher in the market sector than the public sector, and higher within the public sector when it is a smaller share of national income

The result of rent seeking and the inefficiencies of delivering public services through a bureaucracy is that the cost of delivering a given good or service tends to be higher in the public sector. Mueller provides a table setting out a range of estimates of the difference. He cautions though, that in some sectors regulation of the private sector will reduce its advantage over the public sector, and therefore argues that "the most revealing comparisons" "may be the ones at the very end of the table between privately and state-owned companies operating in non-regulated sectors like manufacturing and mining."[132]

Table 3.2: Mueller review of public and private sector cost estimates

Activity: author	Unit/organisational form	Findings
Airlines		
Davies (1971, 1977, 1981)	Australia/sole private domestic vs. its lone public counterpart	Efficiency indices of private 12–100 per cent higher
Forsyth and Hocking (1980)	Australia's one private and one publicly owned airline (1964–76)	Similar performance
Banks		
Davies (1981)	Australia/ one public vs. one private bank	Sign and magnitude in all indices of productivity, response to risk, and profitability favour private banks
Davies and Brucato (1987)		Government owned banks hold less risky assets and are less profitable than private banks
Bus and transit service		
Oelert (1976)	Municipal vs. private bus service in selected West German cities	Cost public bus service 160 per cent higher per km than private equivalents
Bails (1979)	School buses in six U.S. states (1976–7)	Costs are lower in school districts which contract with private sector than for state-owned systems
McGuire and Van Cott (1984)	School buses in 275 districts in Indiana	Privately owned bus services have 12 per cent lower costs than state owned
Pashigian (1976)	Transit systems in 117 U.S. cities (1971)	Publicly owned systems have lower profit margins and revenue per vehicle
Cleaning services		
Bundesrechnungshof (1972)	Public production vs. private contracting out in West German post office	Public service 40–60 per cent more costly
Hamburger Senat (1974), Fischer-Menshausen (1975)	Public production vs. private contracting out in West German public building	Public service 50 per cent more costly than private alternative
Debt collection		
Bennett and Johnson (1980a)	U. S. General Accounting Office study/ federal government supplied service vs. privately contracted-for equivalents	Government 200 per cent more costly per dollar of debts pursued
Electric utilities		
Meyer (1975)	Sample of 60–90 U.S. utilities/public vs. private firms	Very weak indication of higher costs of private production

132. Mueller, D. C. *Public Choice III*, 2003, pg. 373

Activity: author	Unit/organisational form	Findings
Moore (1970)	Sample of U.S. utilities/27 municipal vs. 49 private firms	Overcapitalisation greater in public firms; total operating costs of public production higher
Spann (1977b)	Four major U.S. cities/public (San Antonio, Los Angeles) vs. private (San Diego, Dallas) firms	Private firm adjusted for scale as efficient and probably more so with respect to operating cost and investment (per 1,000 kWh)
Wallace and Junk (1970)	By region in U.S./public vs. private firms	Operating costs 40–75 per cent higher in public mode; investment (per kWh) 40 per cent more in public mode
Atkinson and Halvorsen (1986)	U.S. electric utilities (1970)	Privately and publicly owned are equally efficient
DiLorenzo and Robinson (1982)	U.S. electric utilities	Privately and publicly owned are equally efficient
Peltzman (1971)	135 U.S. electric utilities (1966)	Privately owned are more efficient
Pescatrice and Trapani (1980)	56 electric utilities in the U.S. (1965, 1970)	Publicly owned have 24–33 per cent lower costs
Fire protection		
Ahlbrandt (1973)	Scottsdale, Arizona (private contract) vs. Seattle area (municipal) fire departments	Municipal fire departments 39–88 per cent higher cost per capita
Forestry		
Bundesregierung Deutschland (1976)	Public vs. private forest harvesting in West Germany (1965–75)	Operating revenues 45 DM per hectare higher in private forests
Pfister (1976)	Private vs. public forests in state of Baden-Württemberg	Labour input twice as high per unit of output in public compared with private firms
Hospitals and nursing homes		
Clarkson (1972)	Sample of U.S. hospitals/ private non-profit vs. for profit	"Red tape" more prevalent in non-profits; greater variation in input ratios in non-profits; both suggest higher cost of non-profit outputs
Lindsay (1976)	U.S. Veterans Administration vs. proprietary hospitals	Cost per patient day less in V.A. hospital unadjusted for type of care and quality; less "serious" cases and longer patient stays in V.A.; preference for minority group professionals compared with proprietary hospitals
Rushing (1974)	Sample of 91 short-stay hospitals in U.S. mid-South region/private non-profits vs. for-profit	Substitution among inputs and outputs more sluggish in non-profit hospitals
Wilson and Jadlow (1982)	1,200 U.S. hospitals producing nuclear medicine/ government vs. proprietary hospitals	Deviation of proprietary hospitals from perfect efficiency index less than public hospitals
Becker and Sloan (1985)	1979 data on 2,231 U.S. hospitals	Costs and profitability similar in private for profit, private non-profit, and publicly owned hospitals
Frech (1985)	U.S. nursing homes	Private profit-seeking have 5–29 per cent lower costs than non-profit homes; 34–41 per cent lower costs than state-owned homes
Tuckman and Change (1988)	Nursing homes in Tennessee	No significant cost differences between for-profit and non-profit homes
Housing		
Muth (1973)	Construction costs in U.S. cities, private vs. public agencies	Public agencies 20 per cent more costly per constant quality housing unit

Activity: author	Unit/organisational form	Findings
Rechnungshof Rheinland-Pfalz (1972)	Public vs. private cost of supplying large public building projects in the West German state of Rheinland-Pfalz	Public agencies 20 per cent more costly than private contracting
Schneider and Schuppener (1971)	Public vs. private firm construction costs in West Germany	Public firms significantly more expensive suppliers
Insurance sales and servicing		
Finsinger (1981)	5 public vs. 77 private liability and life firms in West Germany	Same rate of return and no obvious cost differences between organisational forms
Kennedy and Mehr (1977)	Public car insurance in Manitoba vs. private insurance in Alberta	Quality and services of private insurances higher than those of the public one
Finsinger, Hammond and Tapp (1985)	96 German life insurance companies, 83 German automobile insurance companies (1979)	Public enterprises have lower costs than private stock companies
Frech (1976)	78 health insurance companies	Profit seeking companies have 15 per cent lower costs than non-profit
Ocean tanker repair and maintenance		
Bennett and Johnson (1980a)	U.S. General Accounting Office/ Navy vs. commercial tankers and oilers	U.S. Navy from 230 to 5,100 per cent higher costs
Railroads		
Caves and Christensen (1980)	Canadian National (public) vs. Canadian Pacific (private) railroads	No productivity differences recently, but CN less efficient before 1965, the highly-regulated period
Refuse collection		
Collins and Downes (1977)	53 cities and municipalities in the St. Louis County area, Missouri/public vs. private contracting-out modes	No significant cost differences
Columbia University Graduate School of Business Studies: Savas (1974, 1977a, 1977b, 1980), Stevens and Savas (1978)	Many sorts of U.S. cities/municipal vs. private monopoly, franchise vs. private non-franchise firms	Public supply 40–60 per cent more expensive than private, but monopoly franchise only five per cent higher than private non-franchised collectors
Petrovic and Jaffee (1977)	83 cities in Midwestern U.S./public vs. private contracting-out modes	Cost of city collection is 15 per cent higher than the price of private contract collectors
Hirsch (1965)	24 cities and municipalities in the St. Louis city-county area, Missouri/public vs. private firms	No significant cost differences
Kemper and Quigley (1976)	101 Conneticut cities/private monopoly contract vs. private non-franchise vs. municipal firms	Municipal collections costs 14–43 per cent higher than contract, but private non-franchise 25–36 per cent higher than municipal collection
Kitchen (1976)	48 Canadian cities/munipal vs. private firms	Municipal suppliers more costly than proprietary firms
Savas (1977c)	50 private vs. 30 municipal firms in Minneapolis	No significant cost differences
Pier, Vernon, and Wicks (1974)	26 cities in Montana/municipal vs. private firms	Municipal suppliers more efficient
Pommerehne (1976)	102 Swiss municipalities/public vs. private firms	Public firms 15 per cent higher unit costs
Spann (1977b)	Survey of various U.S. cities/municipal vs. private firms	Public firms 45 per cent more costly
Bennett and Johnson (1979)	29 private firms vs. one public trash collection authority in Fairfax County, Virginia	Private firms more efficient

Activity: author	Unit/organisational form	Findings
Edwards and Stevens (1978)	77 U.S. cities (1975)	Prices 41 per cent lower when cities contract with private firms
Stevens (1978)	340 public and private U.S. collectors (1974–5)	Labour productivity lower in public monopolies than private ones
Saving and loans		
Nicols (1967)	California Savings and Loans/cooperative or mutual vs. stock companies	Mutuals have 13–30 per cent higher operating costs
Schools		
Chubb and Moe (1990)	Test scores for over 7,000 U. S. high school students (1982, 1984)	Students in private schools outperform students in public schools
Slaughterhouses		
Pausch (1976)	Private vs. public firms in five major West German cities	Public firms significantly more costly because of overcapacity and overstaffing
Water utilities		
Crain and Zardkoohi (1978)	112 U.S. firms/municipal vs. private suppliers; case study of two firms that each switched organisational form	Public firms 40 per cent less productive with 65 per cent higher capital-labour ratios than private equivalents; public firm that became private experienced an output per employee increase of 25 per cent; private firm that became public experienced an output per employee decline of 40 per cent
Mann and Mikesell (1976)	U.S. firms/municipal vs. private suppliers	Replicates Meyer's (1975) electricity model, but adjusts for input prices; found public modes more expensive by 20 per cent
Morgan (1977)	143 firms in six U.S. states/municipal vs. private suppliers	Costs 15 per cent higher for public firms
Feigenbaum and Teeples (1983)	57 private and 262 public water companies in U.S. (1970)	Two types of firm perform the same
Weather forecasting		
Bennett and Johnson (1980a)	U.S. General Accounting Office study/U.S. Weather Bureau vs. private contracted-for service	Government service 50 per cent more costly
Industrial companies in private sector		
Boardman and Vining (1989)	500 largest non-U.S. corporations in the world (1983): 419 private, 58 state-owned, 23 mixed ownership	Mixed and state-owned companies have lower profitability and productivity than private companies
Funkhouser and MacAvoy (1979)	100 Indonesian companies (1971)	Profit rates 14–15 per cent lower for publicly owned companies; prices the same; costs higher
Majumdar (1998)	Used data envelopment analysis to measure the relative efficiency of a large sample of Indian companies (1973–89)	State-owned companies have average efficiency scores of 64–66, where 1.0 is most efficient. Mixed ownership companies have mean scores of 91, privately owned average 975
Picot and Kaulmann (1989)	Sample of large companies drawn from 6 countries and 15 industries (1975–84)	Privately owned firms have higher profitability and productivity than state-owned companies
Gugler (1998)	94 Austrian companies (1975–94)	Privately owned firms have higher profitability and productivity than state-owned companies
Vining and Boardman (1992)	370 large Canadian companies	Privately owned companies are significantly more profitable and efficient than state-owned; mixed ownership companies fall in-between

As Mueller notes:

> *All six studies at the end of [the table] found that the privately owned companies significantly outperformed the state-owned companies in the same sectors. Even partial ownership by the state substantially reduced performance. If companies that face competition can become so inefficient, what should we expect from bureaucracies that supply hard-to-measure outputs and face little or no competition?*

In a position paper for the TaxPayers' Alliance, Patrick Barbour wrote that a "recent Work Foundation study shows that the average output per person doubled when monopoly status and political management were removed" from the formerly nationalised industries in Britain. The most extreme improvement came at British Coal. The workforce was one quarter of its 1979 size in 1994, but mined ten per cent more coal.[133]

Table 3.3: Increases in productivity after privatisation

Company or industry	Increase in output per person pre and post de-nationalisation, 1979–1994 (%)
British Coal	341
BT	180
Cable & Wireless	123
BAA	115
British Steel	104
Electricity	100
Rolls Royce	100
British Gas	73
British Airways	14

Measuring productivity growth in the public sector is extremely difficult, and Black for example argues that evidence in the NHS is not as clear as many commentators have suggested,[134] though the Office for National Statistics contests his criticisms. Their best available estimate suggests that "productivity generally declined by 3.0 per cent from 2001 to 2008 with the exception of a brief pick-up in 2005 and 2006."[135] Amyas Morse, head of the National Audit Office, reported that over the last ten years "there has been significant real growth in the resources going into the NHS, most of it funding higher staff pay and increases in headcount. The evidence shows that productivity in the same period has gone down, particularly in hospitals."[136]

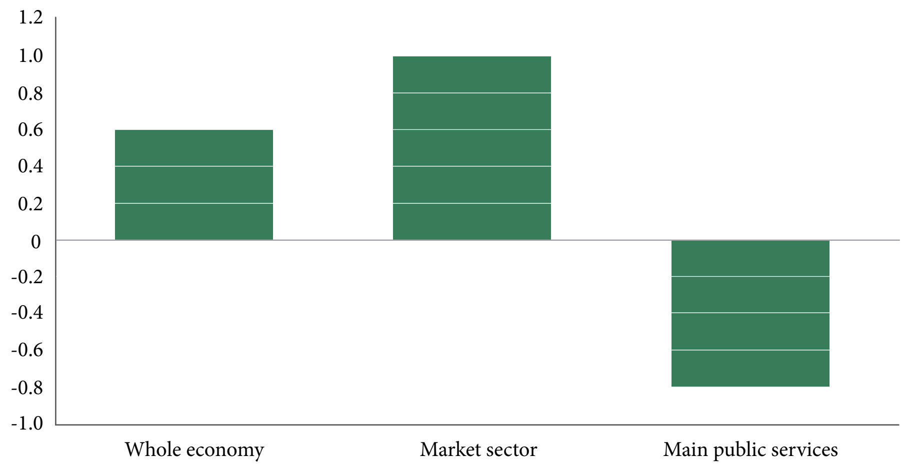
After the Office for National Statistics released an overall estimate of public sector productivity performance in 2009, the Centre for Economics and Business Research estimated that if, instead of falling by 3.4 per cent, the public sector had matched the 27.9 per cent increase in market sector productivity over the period

133. Barbour, P. *Better Government*, The TaxPayers' Alliance, January 2007
134. Black, N. Declining health-care productivity in England: the making of a myth, *The Lancet*, 13 February 2012
135. Peñaloza, M-C., Hardie, M., Wild, R. & Mills, K. *Public Service Output, Inputs and Productivity: Healthcare*, Office for National Statistics, UK Centre for the Measurement of Government Activity, 2010
136. National Audit Office *Management of NHS hospital productivity*, 17 December 2010

1997 to 2007, it would have saved £58.4 billion.[137] They argued that "in other words, not far short of half our income tax is paying for public sector inefficiency".

There are some differences in the various productivity statistics produced by the Office for National Statistics for the public and private sectors. It argues that the best comparison is multi-factor productivity for the market sector and main public service sectors, though there are still limitations over the quality of measurement.[138]

Figure 3.4: Multi-factor productivity growth by sector, 1995–2008



Falling productivity in a growing public sector means that overall productivity is reduced. That means less economic growth and leaves most people worse off. Ideally the public sector needs to be both smaller and more productive, using the resources provided through taxes more efficiently.

Public sector efficiency has been measured in research for the European Central Bank by Afonso, Schuknecht and Tanzi.[139] Their results suggest that Britain could cut spending by 16 per cent and produce the same results if it matched the performance of the developed countries with the most efficient public sectors. If that is applied to 2011–12 spending of £710 billion, it implies a potential saving of £113.6 billion. And if their results for different countries are compared with average public spending as a share of national income over the ten years 2000 to 2010, then it suggests that a larger public sector is associated with less efficient public spending.

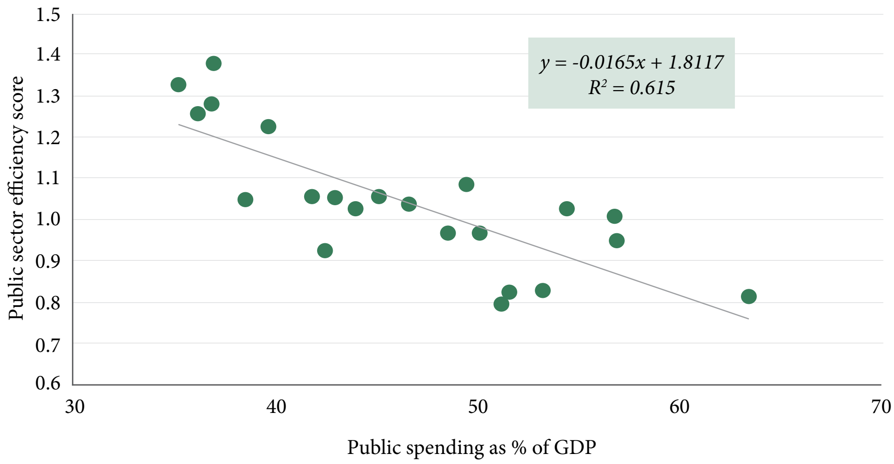
Lower spending and taxes would not just mean taxpayers would be able to spend more money in the more efficient market sector themselves, they would also get better value from the remaining public spending. That will mean higher productivity and greater prosperity.

137. Centre for Economics and Business Research *The UK's public sector productivity shortfall is costing taxpayers £58.4 billion a year*, 23 August 2009

138. Long, K. & Franklin, M. Multi-factor productivity: estimates for 1994 to 2008 in Office for National Statistics *Economic and Labour Market Review*, September 2010

139. Afonso, A., Schuknecht, L. & Tanzi, V. *Public sector efficiency: an international comparison*, European Central Bank Working Paper No. 242, July 2003

Figure 3.5: Public sector efficiency and public spending as a share of national income



3.3.2. Money taken in taxes is often captured by rent seeking special interests

If firms can gain the advantages of a monopoly by lobbying or even bribing politicians and officials, they can increase their surplus at the expense of their customers. To give a modern example, companies operating wind farms or installing solar panels can lobby for subsidies and mandates that transfer money from consumers by increasing domestic and industrial energy bills.[140] That process will both create the deadweight loss created by a monopoly and be wasteful itself: not just because the firm is using its resources to lobby rather than produce goods and services, but because other firms may do so too in response and officials may also be distracted from more productive work.[141]

For example, lobbying by rent seeking firms is thought to be responsible for protections that breach the principle of free trade. The theoretical literature suggests that there will be higher tariffs with products where demand is relatively inelastic – as the welfare loss will be less – and in industries with well organised interest groups. Goldberg and Maggi found support for those predictions by looking at industries in the United States. They compared the level of nontariff trade barriers with whether an industry's campaign contributions were over $100 million in 1981–2.[142] Lopez and Pagoulatos found that the more an industry's political action committees (PACs) gave to support politicians' election campaigns, the larger their rents from tariff protection.[143] Other studies have looked at the source of politicians' PAC contributions and found that those with contributions from unions or textile industries, for example, are more likely to support protective legislation.[144]

140. Sinclair, M. *Let Them Eat Carbon*, August 2011
141. Buchanan, J. M. Rent Seeking and Profit Seeking in Buchanan, J. M., Tollison, R. D. & Tullock, G. *Toward a Theory of the Rent-Seeking Society*, 1980
142. Goldberg, P. K. & Maggi, G. Protection for Sale: An Empirical Investigation, *American Economic Review*, 89, 5, December, 1999
143. Lopez, R. A. & Pagoulatos, E. Rent Seeking at the Welfare Cost of Trade Barriers, *Public Choice*, 79, April 1994
144. Baldwin, R. E. *The Political Economy of U.S. Import Policy*, 1985; Tosini, S. C. & Tower, E. The Textile Bill of 1985: The Determinants of Congressional Voting Patterns, *Public Choice*, 54, 1, 1987

As a result of the logic of collective action, countries with more active special interest groups tend to grow more slowly

Lopez and Pagoulatos also found, along with a number of other studies, that more concentrated industries were more likely to obtain protection.[145] The inverse is also true: in industries with more concentrated customers there was less protection.[146] That fits with Olson's argument in *The Logic of Collective Action* that more concentrated special interests are better able to organise and lobby, at the expense of the latent majority's interests.[147] Olson's logic even helps to explain why farmers in developed countries, where agriculture tends to be concentrated in a relatively small number of large businesses, tend to get more subsidies than those in developed countries.[148]

As a result of the logic of collective action, countries with more active special interest groups tend to grow more slowly. Coates, Heckelman and Wilson look at a number of countries over time and find that societies with more special interest groups accumulate less capital and see less growth in productivity and incomes.[149] Horgos and Zimmerman produced time-series evidence for Germany and also found that interest group activity "leads to a decline in the growth rate and a rise in the inflation rate."[150]

Olson's argument is significant for fiscal policy because it may lead to excessive public spending. To give a hypothetical example: if the government can tax £1 billion over a year and distribute it to a thousand people then that will make each of those thousand people a millionaire, whereas it will cost around £40 for each family in Britain. It will be easy to mobilise that thousand people to fight for their million pounds each but the taxpaying majority may not feel it is worth the effort to coordinate a response just to save £40 a year.

As a result, rent seeking does not only take place through regulation. As Mueller puts it the "entire federal budget can be viewed as a gigantic rent up for grabs for those who can exert the most political muscle."[151] He cites an example from Aranson and Ordeshook who look at how even a public good like a new road may have distributional effects that affect the decision over whether or not to provide it:[152]

> *A larger view of production would embrace the idea that some contractor must build a road to the exclusion of other contractors. Some concrete manufacturer receives a subcontract while other manufacturers do not. Some bureaucrats must receive the wages for planning and overseeing construction, while another bureaucrat (or his agency) or even private sector taxpayers do not. And, those who speculate correctly on land in one area gain a windfall*

145. Pincus, J. Pressure Groups and the Pattern of Tariffs, *Journal of Political Economy*, 83, August 1975; Marvel, H. P. & Ray, E. J. The Kennedy Round: Evidence on the Regulation of International Trade in the United States, *American Economic Review*, 73, March 1983; Godek, P. E. Industry Structure and Redistribution through Trade Restrictions, *Journal of Law and Economics*, 28, 1985; Trefler, D. Trade Liberalization and the Theory of Endogenous Protection: An Econometric Study of U.S. Import Policy, *Journal of Political Economy*, 101, February 1993

146. Pincus, J. Pressure Groups and the Pattern of Tariffs, *Journal of Political Economy*, 83, August 1975; Trefler, D. Trade Liberalization and the Theory of Endogenous Protection: An Econometric Study of U.S. Import Policy, *Journal of Political Economy*, 101, February 1993

147. Olson, M. *The Logic of Collective Action*, 1965

148. Balisacan, A. M. & Roumasset, J. A. Public Choice of Economic Policy: The Growth of Agricultural Protection, *Weltwirtschaftliches Archiv, Review of World Economics*, 123, 1987

149. Coates, D., Heckelman, J. C. & Wilson, B. Special-interest groups and growth, *Public Choice*, 147, 2011

150. Horgos, D. & Zimmermann, K. W. Interest groups and economic performance: some new evidence, *Public Choice*, 138, 2009

151. Mueller, D. C. *Public Choice III*, 2003

152. Aranson, P. H. & Ordeshook, P. C. Regulation, Redistribution, and Public Choice, *Public Choice*, 37, 1, 1981

> *over those who speculate incorrectly elsewhere. In sum, a federally funded interstate highway system in production can be much like a private good; its supply is limited and subject to exclusion.*

As a result, those seeking government contracts spend more on campaign contributions. Zardkoohi found that the amount of campaign contributions a firm makes is positively and significantly related to the percentages of federal and state government outputs purchased by the firm's industry, and whether or not it is subject to industry-specific regulation.[153]

Rent seeking is very important, and estimates suggest that the welfare losses are substantial. Estimates of the total loss have ranged from seven per cent of national income in India in 1964 to 50 per cent of national income in the United States in 1985.[154]

Estimates of the money spent directly and successfully pursuing those rents are much lower but that is only part of the total spent seeking rents. Everything from advertising to the work of corporate lawyers is often concerned with either establishing rents or capturing existing ones by fighting for market share in protected industries. Phillips produced an estimate of the total spent on a very broad range of activities that are potentially intended to seek rents, and found that they summed to over 50 per cent of GDP – as high as the largest estimate of the scale of the rents to be captured.[155]

More recently Angelopoulous, Philippopoulos and Vassilatos have found that reducing rent seeking in European economies can produce substantial welfare gains and that "an increase in any of the tax rates […] leads individuals to substitute from productive work to rent seeking".[156]

3.3.3. Money taken in taxes is often captured by the bureaucracy

Niskanen listed a number of potential goals for a bureaucrat: "salary, perquisites of the office, public reputation, power, patronage, output of the bureau, ease of making changes, and ease in managing the bureau" and argues that all but the last two are likely to rise with the size of an organisation's budget. For that reason he argues that bureaucrats are "budget-maximising", beyond where marginal public benefits equal marginal costs, if necessary by straying outside their allotted domain.[157] That ability to successfully maximise their budget depends on three advantages: the organisation's status as a monopoly supplier; those within the organisation alone knowing its true cost schedule; and the ability to set the agenda by making take it or leave it budget proposals. If they do not have those advantages, their ability to maximise their budgets will be weakened. The final result depends on the outcome of a bargaining game between an agency with more information and often a monopoly status and a sponsoring government which controls the purse strings.

---

153. Zardkoohi, A. On the Political Participation of the Firm in the Election Process, *Southern Economic Journal*, 51, January 1985

154. Krueger, A. O. The Political Economy of the Rent-Seeking Society, *American Economic Review*, 64, June 1974; Laband, D. N. & Sophocleus, J. P. The Social Cost of Rent Seeking: First Estimates, *Public Choice*, 58, 1988; Other estimates are provided in Mueller, D. C. *Public Choice III*, 2003

155. Phillips, J. D. Estimating the Economic Surplus in Baran, P. A. & Sweezy, P. M. (eds) *Monopoly Capital*, 1966

156. Angelopoulos, K., Philippopoulos, A. & Vassilatos, V. The social cost of rent seeking in Europe, *European Journal of Political Economy*, 25, 2009

157. Niskanen, W. A. *Bureaucracy and Representative Government*, 1971

There are other potential objectives – for example Weatherby suggested maximising staff numbers.[158] Or they may be slack-maximising or risk-avoiding. The final result will still be pushing for higher spending than is optimal.

There is no reason to assume that bureaucrats are benevolent and disinterested, unlike other economic actors. Empirical research supports the idea that bureaucracies behave as these theories suggest. For example, Romer and Rosenthal found that Oregon schools used their ability to offer a take it or leave it budget to increase their spending.[159]

Brennan and Buchanan's Leviathan model suggests that the only real limits on the growth of government are constitutional rules

Things could be even worse. Niskanen at least envisages a competition between a bureaucracy looking to maximise its budget and the government looking to restrain spending. Brennan and Buchanan's Leviathan model sees the sponsor – parliament and the government – fusing with the bureaucracy to produce a monolithic monopoly state that maximises the size of the public sector.[160] It is not effectively constrained by political competition, thanks to a combination of rational ignorance on the part of voters and collusion among elected officials. Their view is that the only real limits on the growth of government are constitutional rules.

That leads to a number of particular conclusions. For example, under this view of government it would be best to institute rules that do not allow special tax concessions favouring narrow interest groups, as that limits the ability of the government to increase revenue through tax price discrimination. There is some evidence that this is effective. New Hampshire has a constitution that requires proportional tax rates and a political structure which makes that hard to change. As a result, it has very low taxes which result in much higher population growth than neighbouring states.[161] Nelson also found that states which tax personal income had significantly larger government sectors and, along with a number of other studies (Section 8.1.1), that decentralisation led to smaller government. The relative size of the government sector varied inversely with the number of local government units. Intergovernmental competition is another way people can limit government in Brennan and Buchanan's model, but it can be undermined by grants between governments that allow them to collude.[162] That is again backed up by empirical studies which suggest intergovernmental grants encourage growth in the public sector.[163]

Other studies do suggest the bureaucracy is less powerful, and government is better constrained. The congressional dominance model suggests that, through the creation of committees of interested legislators[164] and the "power of the purse", politicians are able to control bureaucracies and win re-election by supplying legislation to the constituents who can re-elect them and the interest groups that fund their campaigns. There is empirical support for this theory in the extent to which membership of US Congressional committees tends to be associated with

158. Weatherby, J. L. A Note on Administrative Behaviour and Public Policy, *Public Choice*, 11, 1971
159. Romer, T. & Rosenthal, H. Median Voters or Budget Maximizers: Evidence from School Expenditure Referenda, *Economic Inquiry*, 20, October 1982
160. Brennan, G. & Buchanan, J. M. *The Power to Tax: Analytical Foundations of a Fiscal Constitution*, 1980
161. Campbell, C. D. New Hampshire's Tax-Base Limits: An Example of the Leviathan Model, *Public Choice*, 78, February 1994
162. Brennan, G. & Buchanan, J. M. *The Power to Tax: Analytical Foundations of a Fiscal Constitution*, 1980
163. Grossman, P. J. Fiscal decentralization and government size: An extension, *Public Choice*, 62, 1989
164. Weingast, B. R. & Marshall, W. The Industrial Organization of Congress; or, Why Legislatures, Like Firms, are not Organized as Markets, *Journal of Political Economy*, 96, 1988

greater federal spending in a congressman's district.[165] With constituents who favour smaller government, politicians on oversight committees can also use those roles to rein in budget-maximising bureaucrats. Another congressional dominance model suggests politicians can rein in bureaucrats by defining administrative rules that make it easier for outside interests to challenge those bureaucrats.[166] That power is limited by the uncertainty of legislators and their necessary inconsistency over time.

The final result of all these problems is not just an expensive government but also an ineffective one. In Britain the most famous expression of those problems is Parkinson's Law (3.1.2.6.1).

Oversized and overly complex governments can respond very poorly in a crisis. Sobel and Leeson looked at the failure of the US Federal Emergency Management Agency to respond effectively after Hurricane Katrina and concluded that a layered bureaucracy produced a "tragedy of the anti-commons" as there were simply too many decisions makers, each with their own set of incentives, delaying action. The results were so extreme that they led to "slightly inaccurate but amusing media accounts of how the Royal Canadian Mounted Police beat the U.S. government into New Orleans." At the same time, the process was also undermined by politicians and officials manipulating the process to win votes and "glory seeking".[167]

There is substantial evidence that, even leaving aside the wider economic harms created by higher taxes, money is simply spent better if it is left in taxpayers' pockets instead of going through bureaucracies that have their own interests.

3.3.4. People tend to donate more to charity in countries with lower taxes

Recent data suggests there is a relationship between the level of taxation and charitable giving.[168] For instance, out of the OECD countries, the US has a relatively low tax to GDP ratio (25 per cent) and scores top place in the World Giving Index. 65 per cent of Americans gave money to favoured causes in 2010 and 43 per cent volunteered time. Ireland's tax to GDP ratio was 28 per cent, and it was placed second in the World Giving Index: 75 per cent of Irish people gave money while 38 per cent volunteered time.

Countries that have higher tax to GDP ratios tend to score lower on the World Giving Index. For instance, Sweden was placed 40th, and it had a tax to GDP ratio of 46 per cent. France and Italy both taxed at 43 per cent of GDP and were placed 80th and 104th respectively on the World Giving Index.

---

165. Ferejohn, J. A. *Pork Barrel Politics: Rivers and Harbors Legislation, 1947–1968*, 1974; Goss, C. F. Military Committee Membership and Defense-Related Benefits in the House of Representatives, Western Political Quarterly, 25, 1972; Strom, G. Congressional Policy Making: A Test of a Theory, *Journal of Politics*, 37, 1975; Arnold, R. D. *Congress and the Bureaucracy: A Theory of Influence*, 1979; Holcombe, R. G. & Zardkoohi, A. The Determinants of Federal Grants, *Southern Economic Journal*, 48, October 1981; Rich, M. J. Distributive Politics and the Allocation of Federal Grants, *American Political Science Review*, 83, 1989; Cohen, L. R. & Noll, R. G. *The Technology Pork Barrel*, Brookings Institution, 1991; Alvarez, R. & Saving, J. L. Congressional Committees and the Political Economy of Federal Outlays, *Public Choice*, 92, July 1997; Kroszner, R. S. & Stratmann, T. Interest-Group Competition and the Organization of Congress: Theory and Evidence from Financial Services' Political Action Committees, *American Economic Review*, 88, December 1998

166. McCubbins, M. D., Noll, R. G. & Weingast, B. R. Structure and Process, Politics, and Policy: Administrative Procedures as Instruments of Political Control, *Journal of Law, Economics and Organization*, 3, 1987; McCubbins, M. D., Noll, R. G. & Weingast, B. R. Structure and Process, Politics and Policy: Administrative Arrangements and the Political Control of Agencies, *Virginia Law Review*, 75, 1989

167. Sobel, R. S. & Leeson, P. T. Government's response to Hurricane Katrina: A public choice analysis, *Public Choice*, 127, 2006

168. Figures from OECD *Revenue Statistics*, Comparative Tables; Charities Aid Foundation *World Giving Index 2011*, Tables 1–14

The UK actually scores highly, being placed fifth on the list and – at 79 per cent – with the highest proportion of people donating money to charity. Tax as a share of GDP in 2010 was 35 per cent, which was lower than many other European economies that also saw fewer people donating to charity. There are some outliers, such as Turkey that had a tax/GDP ratio of 26 – one of the lowest in the OECD – but scored 136th on the list. Conversely, Denmark was placed 15th on the list despite tax receipts of 48 per cent of GDP. This makes intuitive sense as residents of countries with higher incomes are also likely to have higher disposable incomes that will enable them to give more to charity.

Earlier research also suggests that higher spending and taxes reduces charitable giving. Garrett and Rhine found that:[169]

> *Government growth itself, ignoring the destination of government spending, may reduce private charitable contributions. Private contributions may decrease because of reduced disposable income that results from higher taxes used to fuel future government growth.*

Other studies have shown that government redistribution can crowd out private contributions to charity. Warr found that private donations to charity fall by a dollar for every dollar of incremental fiscal redistribution.[170] Direct government grants to charity also reduce charitable giving, with Andreoni and Payne finding that charitable organisations significantly reduce fund-raising efforts when they receive state funding.[171]

Lower taxes are not just likely to mean that people spend more money supporting themselves and their families; they are also likely to increase charitable donations to support others.

3.4. Economies with larger market sectors grow faster

There is a long history of macroeconomic studies which have found that economies where public spending is a lower share of national income tend to see stronger economic growth. That includes the early cross-section studies (Section 3.4.1); modern panel data studies (Section 3.4.2); and the results of econometric modelling (Section 3.4.3).

Government spending can theoretically reduce prosperity by discouraging working and investment and the critical theoretical question is whether or not it affects just the level or the level *and* growth of income. That is the difference between the results from the neo-classical and post-neo-classical endogenous growth theory models of the economy (Section 3.4.4).

3.4.1. Early cross-section studies showed that economies with larger market sectors grew faster

The relatively strong performance of most Western economies in the 1950s and 1960s – and the fact that public spending ratios had fallen with cuts in defence

169. Garrett, T. & Rhine, R. *Government growth and private contributions to charity*, Federal Reserve Bank of St. Louis Working Paper Series, 2007, pg. 16
170. Warr, P. Pareto optimal redistribution and private charity, *Journal of Public Economics*, Number 19, 1982
171. Andreoni, J. & Payne, AA. *Is crowding out entirely due to fundraising? Evidence from a panel of charities*, National Bureau of Economic Research, 2010

spending after World War II and the early 1950s Korean War – meant that many people had become too relaxed about the economic harm done by high spending and taxes by the early 1960s.

Growing problems resulting from the excessive expansion of government spending were already apparent by the late 1960s, however. Britain, for example, had to devalue sterling in 1967 and seek an International Monetary Fund (IMF) bailout in 1969. In the US, the combination of President Johnson's Great Society welfare programmes and the costs of fighting the Vietnam War were also leading to rising inflation and undermining the US dollar's role as a reserve currency. Things got much worse in the first half of the 1970s, when it was becoming increasingly apparent that the Keynesian intellectual apparatus was breaking down. In particular, inflation expectations had become un-tethered, the sustainable growth rate had slowed markedly, and structural joblessness was rising. This situation encouraged a small number of economists to switch their attention from the then conventional Keynesian approach to look at the long term determinants of economic growth, as distinct from the factors that predominated at business cycle frequencies.

One example is an early paper by Smith that related the average growth rate of a sample of developed countries over the decade to 1972 to two measures of the share of government spending in national output – one including transfer payments, one excluding it – and the fall in the percentage of the labour force in agriculture.[172] The current relevance is that many of the subsequent studies summarised in Table 3.4 have produced similar results, suggesting that the underlying effects are robust. Among the findings from the early studies that have repeatedly cropped up in the literature are the following:

- There is a statistically significant negative impact of government spending on growth.
- Direct public provision of goods and services is more damaging to economic growth than welfare payments. The government is a poor supplier of goods and services compared to the private sector.
- Growth reflects many factors other than the ratio of public spending to national income. It is important to avoid naive mono-causal explanations.[173]
- An increase in the ratio of public spending to national income crowds out private-sector capital formation almost on a one-for-one basis. This is why economies with high spending ratios become under-capitalised and find it difficult to compete internationally and to offer well-paid jobs.
- Inflation is not determined by the spending ratio, as long as central banks do their job properly. This includes recognising when there has been a supply withdrawal and not cutting interest rates when growth slows for supply-side reasons. The Bank of England and US Federal Reserve both appear to have made this mistake in the 21st Century, as they also did in earlier periods, exacerbating the risk of stagflation. Bank of England research carried out in 2001 estimated that the UK monetary policy

172. Smith, D. B. Public Consumption and Economic Performance, *National Westminster Bank Quarterly Review*, November 1975. The share of employment in agriculture was included because countries such as Japan, Spain, Italy and France were growing rapidly at the time by taking underemployed people out of peasant agriculture and moving them into manufacturing. The same applies to countries such as China today.

173. A 2005 literature review by Durlauf, S. N., Johnson, P. A. & Temple, J. R. *Growth Econometrics* in *Handbook of Economic Growth vol. 1*, listed no less than 145 economic variables that had been examined at some point in the growth literature.

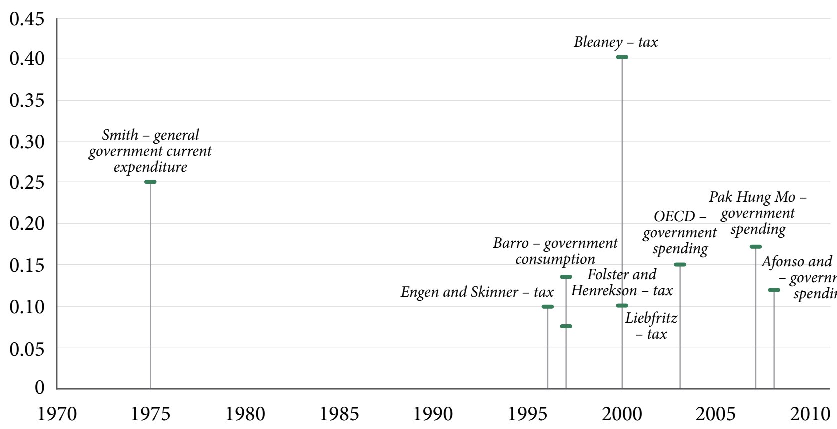
errors that resulted from overestimating the output gap contributed 3.0 to 7.1 percentage points to UK inflation in the 1970s and 0.7 to 5.5 percentage points in the 1980s.[174]

- It was predicted in 1975 that the sluggish growth, which was then regarded as a specifically British disease, would infect other countries as their spending ratios rose towards the higher British level. This has proved correct.

3.4.2. Modern panel data studies show that economies with larger market sectors grow faster

Such pioneering studies were hampered because of the limited data available. There were also econometric problems, including issues of the direction of causation and small sample sizes. The next big advances were: the introduction of panel-data studies, which combined time series and cross-section data; the introduction of more sophisticated econometric methods, and the development of large datasets incorporating over a hundred countries. The findings of a representative set of these studies between 1975 and 2011 are summarised in Figure 3.6 and, in more detail, Table 3.4.[175]

Figure 3.6: Timeline of studies showing the effect on growth of a one per cent decrease in tax or spending as a share of national income



By and large, the more sophisticated studies confirmed the results of earlier cross section studies, with strong evidence that increased public consumption crowded out private investment. In addition, quantitatively similar coefficients for the negative effects of government consumption on economic growth were often discovered. Numerous studies have shown that an extra one percentage point increase in the share

174. Nelson, E. & Nikoloy, K. *UK Inflation in the 1970s and 1980s: the Role of Output Gap Mismeasurement*, Bank of England, Working Paper no. 148, December 2001

175. The references between 1989 and 2002 (inclusive) in this table were largely taken from Table 1 in the article *"Public Spending, Taxation and Economic Growth"* by Patrick Minford and Jiang Wang in *"Sharper Taxes, Lower Taxes: Big Steps to a Smaller State"* edited by Philip Booth, Institute of Economic Affairs, 2011. More recent studies are: OECD *The Sources of Economic Growth in OECD Countries*, Paris, 2003; Mo, P H. *Government Expenditure and Economic Growth: The Supply and Demand Sides*, Fiscal Studies Volume 28 No. 4, 2007; Afonso, A. & Furceri, D. *Government Size, Composition, Volatility and Economic Growth*, ECB Working Paper Series, No. 849, January 2008; Johansson, A., Heady, C., Arnold, J., Brys, B. & Vartia, L. *Taxation and Economic Growth,* OECD Economics Department Working Paper No. 620, July 2008. Furceri, D. & Sousa, R.M. *Does Government Spending Crowd Out Private Consumption and Investment?*, World Economics, Volume 12, No. 4, October – December 2011. Afonso, A. & Jalles, J.T. *Economic Performance and Government Size*, ECB Working Paper No. 1399, November 2011.

of government consumption in GDP appears to be associated with a fall of somewhere between 0.1 percentage points and 0.4 percentage points in the growth rate of real GDP per head, with a strong clustering around 0.1 to 0.2 percentage points.

Table 3.4: Summary of studies of the negative impact of tax and spend policies on economic growth

Author	Data coverage	Main explanatory variables	Comment	Levels or growth effect
Smith (1975)	19 industrialised countries, using annual average data 1961–1972.	Two measures of general government consumption excluding and with transfers, change in share of workforce in agriculture, investment ratio.	1 per cent point on general government current expenditure reduced growth of GDP per head by 0.25 per cent, one per cent point on wide government consumption measure, including transfers, reduced growth by 0.10 per cent. one per cent point on narrow government current expenditure reduced investment ratio by 0.94 per cent. This was a pioneering early study. Its level of statistical sophistication would not be considered up to modern standards.	Growth
Koester & Kormendi (1989)	63 countries for which at least five years of continuous data exist for the 1970s.	Marginal tax rates, average tax rate, mean growth in labour force and population.	1 per cent point decrease in marginal tax rate would increase per capita income by more than 0.7 per cent in an average industrial country.	Level
Barro (1991)	98 countries in the period 1960–1985.	Human capital, government consumption, political instability indicator, price distortion.	1 per cent point increase in tax-to-GDP ratio lowers output per worker by 0.12 per cent.	Level
Hansonn & Henrekson (1994)	Industry level data for 14 OECD countries.	Government transfers, consumption, total outlays, education expenditure, government investment.	Government transfers, consumption and total outlays have a negative impact on growth while government investment is not significant.	Growth
Cashin (1995)	23 OECD countries over 1971–88 period.	Ratio of public investment to GDP, ratio of current taxes to GDP, ratio of transfers to GDP.	1 per cent point increase in tax/GDP ratio lowers output per worker by two per cent.	Level
Engen & Skinner (1996)	US Modelling together with a sample of OECD countries.	Marginal tax rates, human capital, investment.	2.5 per cent point in tax/GDP ratio reduces growth by 0.2 per cent to 0.3 per cent.	Growth
Barro (1997)	Sample of nearly 100 countries.	Government consumption ratio, educational attainment, life expectancy, fertility rates, inflation, measures of rule of law and democracy.	1 per cent point on government consumption reduces growth by 0.136 per cent.	Growth
Liebfritz et al. (1997)	OECD countries over 1965–95 period.	Tax/GDP ratio, physical and human capital formation, labour supply.	1 per cent point increase in tax/GDP ratio reduces growth by 0.05 per cent to 0.1 per cent.	Growth
Bleaney et al. (2000)	17 OECD countries over 1970–94 period.	Distortionary tax, productive expenditure, net lending, labour force growth, investment ratio.	1 per cent point increase in distortionary tax/GDP ratio reduces growth by 0.4 per cent.	Growth
Folster & Henrekson (2000)	Sample of rich OECD/non-OECD countries over the 1970–95 period.	Tax/GDP ratio, Government spending/GDP ratio, investment/GDP ratio, labour force growth, human capital growth.	1 per cent point increase in tax/GDP ratio reduces growth by 0.1 per cent.	Growth

Author	Data coverage	Main explanatory variables	Comment	Levels or growth effect
Bassanini & Scarpetta (2001)	21 OECD countries over the 1971–98 period.	Indicators of government size & financing, physical capital, human capital, population growth.	1 per cent point on tax/GDP ratio reduces output per head by 0.3 per cent to 0.6 per cent.	Levels
Alesina et al. (2002)	18 OECD countries over the 1960–96 period.	Primary spending, transfers, taxes on business, indirect taxes, government wage consumption. All as shares of GDP.	1 per cent increase in government spending/GDP ratio lowers investment GDP ratio by 0.74 per cent after five years.	Levels effect but reduced investment would imply lower growth in post neo-classical models
OECD (2003)	21 developed countries over the period 1971–98.	Lagged real GDP, stocks of physical and human capital, population growth, rate and volatility of inflation, indicators of government size, trade variable.	Detailed 248 page study of influences on economic growth. A one per cent point rise in government spending ratio considered in isolation cuts growth of GDP per head by 0.15 per cent. Including spending and taxes separately gives coefficient of plus 0.19 per cent on spending ratio but minus 0.44 per cent for tax ratio, implying minus 0.25 per cent growth effect for tax-financed spending.	Growth and Levels
Pak Hung Mo (2007)	Data set for large sample of countries running from 1970–1985 broken up into five year sub periods.	Paper uses a new approach to estimate how government spending affects GDP growth via total factor productivity, investment and aggregate demand.	1 per cent point rise in government consumption/GDP ratio reduced growth by 0.216 per cent and one per cent point rise in transfer payments cut growth by 0.172 per cent. However, a one per cent point rise in government investment boosted growth by 0.167 per cent. Hence, author's recommendation to switch government spending from current and transfers to investment.	Growth
Afonso & Furceri (2008)	EU 15 countries and residual OECD over the period 1970–2004, data broken up into five year periods.	Government expenditure and taxes are broken down into several components. Other variables include initial output, population growth, investment ratio, human capital and openness.	1 per cent point rise in government spending/GDP ratio cut OECD growth by 0.12 per cent, EU growth by 0.13 per cent. one per cent point increase in tax/GDP ratio cuts growth by 0.12 per cent in both cases. Larger effects can be found for individual expenditure and tax components. Indirect taxes and social contributions appear most damaging and worse than income tax. Subsidies and government current expenditure have worst negative effects on growth on the spending side.	Growth
Johansson et al (2008)	21 OECD countries over the period 1970–2005.	Tax/GDP ratio, physical capital, human capital, population growth, tax structure variables.	1 per cent point rise in tax/GDP ratio is associated with a fall of 0.14 per cent to 0.27 per cent in level of real GDP. Tax structure also a significant factor, with income taxes most damaging and taxes on immovable property least damaging.	Levels

Author	Data coverage	Main explanatory variables	Comment	Levels or growth effect
Furceri & Sousa (2011)	145 countries over the period 1960–2007.	Examines effects of government spending on private consumption and investment, separate results for OECD, non-OECD and Total provided. Also allows for effects of business cycle.	1 per cent point rise in government spending/GDP ratio reduces private consumption by 1.9 per cent and private investment by 1.9 per cent overall. For OECD countries, one per cent point on government spending/GDP ratio cuts consumption by three per cent and investment by eight per cent. Equivalent negative figures for non-OECD are 1.8 per cent and 1.5 per cent, respectively.	Levels
Afonso & Jalles (2011)	108 countries over the period 1970 to 2008.	Also considers the effects of institutional quality, and effects of fiscal rules in an EU context. Government size is a an amalgam of different measures, not a simple spending ratio.	There is a significant negative effect of size of government on growth, institutional quality has a positive impact, government consumption is detrimental to growth irrespective of the country sample considered.	Growth

As Table 3.4 confirms, most recent research has tended to be consistent with this rule of thumb. Pak Hung Mo,[176] for example, found that a one percentage point rise in the share of government consumption in GDP reduced growth by 0.216 percentage points and that a one percentage point increase in transfer payments had a negative effect of 0.172 percentage points while European Central Bank (ECB) economists Afonso and Furceri discovered that a one percentage point hike in the government spending ratio decreased growth by 0.12 percentage points in the OECD area and by 0.13 percentage points in the EU.[177]

In addition, the ECB authors found that the volatility of taxes had an adverse impact on output, over-and-above the reduction in growth that arose from the size of the tax burden. This should not be a surprise since capricious and unpredictable changes to the tax regime greatly add to the uncertainties of doing business and discourage investment in socially worthwhile high-risk/high-return projects, such as advanced technological innovation or energy exploration in the North Sea. There is an obvious analogy here with optimal financial portfolio investment theory which suggests that individual investors should seek to maximise the mean return on a portfolio of assets minus roughly two-thirds of the standard deviation. In contrast, society in general should seek to maximise mean returns because it can better absorb risk, in the same way that very large airlines often self-insure. In practice, one is unlikely to know the true parameters of the probability distributions concerned so there is uncertainty as well as risk.

In 2009, the British economy was nearly 2.7 times the size it was in 1965. If the spending ratio had been 33 per cent then it might have been more than four times the size.

The effect found in panel data studies is large and suggests that higher spending may have a severe impact on long-run prosperity. Using the Afonse and Furceri estimate that a one per cent rise in general government consumption is associated with a 0.13 per cent reduction in expected growth, Figure 3.7 shows the path of growth with the actual levels of spending in those years and the growth that might have been expected with the 33 per cent share recommended by the 2020 Tax Commission.

In 2009, the British economy was nearly 2.7 times the size it was in 1965. If the spending ratio had been 33 per cent then the economy might have grown to more

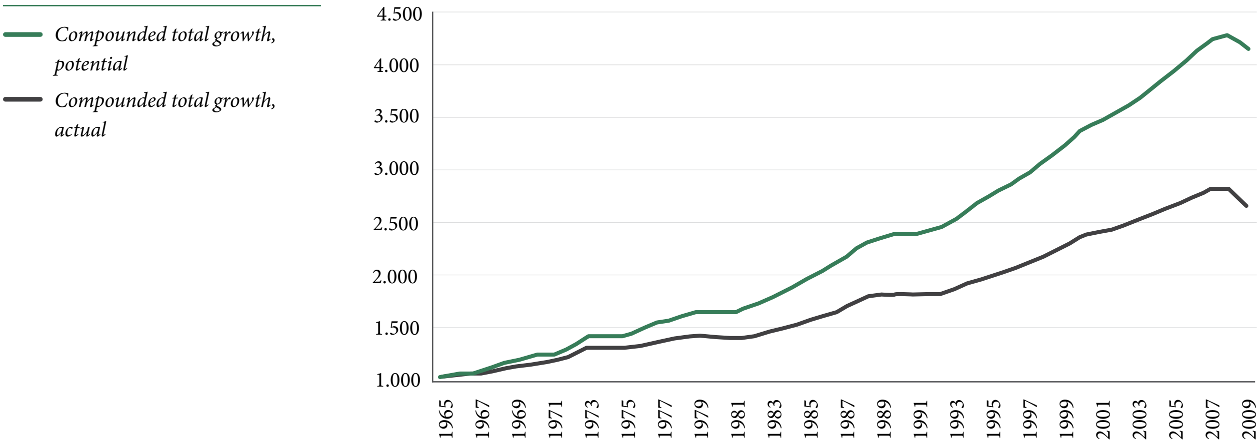
176. Mo, P. H. *Government Expenditure and Economic Growth: The Supply and Demand Sides*, Fiscal Studies Volume 28, No. 4, 2007, pgs. 497–522

177. Afonso, A. & Furceri, D. *Government Size, Composition, Volatility and Economic Growth*, European Central Bank, Working Paper No.849, January 2008

than four times the size it was in 1965 over the same period. That means final British national income would have been more than 50 per cent higher.

There are limitations with panel data studies. The first is that GDP is defined to include government spending. This will bias the results if the main concern is the health of the private sector, which also constitutes the tax base since the government cannot tax itself. If an extra £100 billion of government spending crowded out exactly £100 billion of private sector activity, there would be no apparent negative (or positive) relationship between an increased private sector share in GDP and either the level of GDP or its growth rate.[178] However, the ratio of tax receipts to GDP would fall in line with the decline in the private sector tax base and the budget deficit would swell under these circumstances.

Figure 3.7: Compound real growth, 1965–2009, actual and with 2020 Tax Commission spending ratio



A second caveat is that the direction of causation is not always clear, in part because the government budget constraint introduces problems of simultaneity between spending, taxes, and borrowing which can make interpretation of the results tricky. This has led to attempts in some of the more recent US studies to identify the purely-exogenous component of government spending, using either military expenditures or politically-determined Congressional earmark spending increases. A third caveat is the issue of data quality and consistency across a large sample of countries. Putting together data sets for many nations means that variables may not be measured consistently or with comparable accuracy. Such measurement errors are likely to cause both the size and statistical significance of the estimated effects to be understated.

Given these problems, it is remarkable that so many investigations have come up with such similar results over the past three and a half decades. It suggests that the underlying effect is robust.

3.4.3. Econometric modelling shows that economies with larger market sectors grow faster

The use of econometrics goes back to just before World War II. However, the subject did not take off until the late 1960s when advances in computer technology made the estimation and simulation of forecasting models a practical proposition. There was a

178. The same applies to the macroeconomic model simulations discussed in the next section, where the quoted multipliers always refer to the change in GDP resulting from a change in government spending.

heated crowding-out debate in the latter 1970s and early 1980s as to whether higher government spending was good or bad for the economy and which were the least damaging tax and borrowing options to finance it.

Modelling has fallen out of favour in recent years because it is now believed that the parameters of forecasting models shift whenever there is a change in the policy regime[179] and because such research generates too few publishable articles to appeal to most academics. This is bad news because model simulations still provide one of the best guides to the second-round effects of tax and spending changes on the wider economy and are certainly nearer the truth than the largely static calculations that underlie so much of the public debate. The Macroeconomic Modelling Bureau at the University of Warwick made this clear in 1993:[180]

> *In order to analyse the impact of the various fiscal policy instruments it is essential to consider both direct and indirect effects. For example, the direct effects of tax changes on government finances can be quantified through an assessment of the size of the tax base to which the tax change is to be applied, and such calculations may measure the short-run impact on government revenue quite well. However, over a period beyond the first few months following the tax change, the indirect effects through the operation of the economy as a whole come to dominate. Simulations of models of the macroeconomy are the only method of quantifying the size and time profile of these indirect effects.*

One of the great benefits of the Warwick Bureau studies, which were carried out between 1989 and the Bureau's closure in 1999, was that they performed comparative policy simulations of a range of tax and spending measures using nearly all the leading macroeconomic forecasting models of the day. This included the models then used by the Bank of England and HM Treasury as well as those of the London Business School, National Institute of Economic and Social Research (NIESR), Oxford Economic Forecasting and Liverpool University (now the Liverpool/Cardiff model). In the August 1991 NIESR Review, for example, the Warwick team simulated the effects of reducing the rates of VAT, Income Tax, and Employers' National Insurance contributions, as well as of increasing the level of general government expenditure. The advantages of such work were that: it was possible to assess the impact of different taxes on a wide range of economic variables in a way that was not unduly dependent on the quirks of any particular model; it indicated how the impact of tax changes often depended on other aspects of the models concerned – for example, the nature of the wage and exchange-rate equations; and revealed oddities in the models involved, which could then be corrected.

An updated version of such evidence would clearly have been invaluable recently, and could have highlighted the important adverse consequences of the decision to increase the standard VAT rate and Employers' National Insurance contributions. Unfortunately, the UK policy debate has tended to become over-reliant on the static calculations employed by bodies whose expertise lies in the microeconomic details of

---

179. This is the famous 'Lucas critique': Lucas, R. *Econometric Policy Evaluation; a Critique,* Carnegie-Rochester Conference Series on Public Policy 1, 1976, pgs. 19–46

180. The source for this quotation is Church, K.B., Mitchell P.R., Smith P.N., & Wallis K.F. *Comparative Properties of Models of the UK Economy*, National Institute Economic Review, August 1993. The Warwick Bureau existed from 1983 to 1999 and ran comparative simulations on all the leading academic and official models of the period. Comparable research is still being carried out by the ECB and in the US but it seems to have largely died out in Britain.

the tax structure rather than the wider second-round macroeconomic consequences. Such static calculations can misjudge the direction, as well as the magnitude, of the long-run effects of tax changes on public borrowing and other economic variables.

One of the few recent UK attempts to undertake a dynamic analysis using a properly specified macroeconomic forecasting model was published by the NIESR shortly after the general election in 2010, shown in Table 3.5.[181] The table shows the effect on the level of real GDP of fiscal tightening measures equivalent to one percentage point of GDP. The government spending cut simulation, for example, suggests that it reduces real GDP by 0.37 percentage points in the first year after its implementation, and 0.14 percentage points in the second year, but that GDP was 0.23 percentage points higher by the third year. The inclusion of government spending in the definition of GDP means that a one percentage point cut in the public spending ratio boosted the residual private sector component of national output by the equivalent of 0.63 per cent of total GDP in year one, 0.86 per cent in year two, and 1.23 per cent in year three.

This is pretty strong evidence in favour of the crowding-in effects of government spending reductions from what was once regarded as the main UK bastion of Keynesian economics. The NIESR research further suggests that the first-year effects of a VAT hike are more damaging than raising the same revenues from an increase in Income Tax, although both effects are close to zero in the second and third years of the simulation.

Table 3.5: Impacts on growth of one per cent of GDP budget improvement from fiscal measures

	Government spending cut	Income Tax increase	Government pay cuts	Increased VAT	Pension & benefits reductions
Year 1	-0.37	-0.11	-0.05	-0.16	-0.10
Year 2	-0.14	0.00	0.00	0.02	0.00
Year 3	0.23	-0.01	0.03	0.05	-0.01

Simulations of the effects of different tax and expenditure assumptions using the Beacon Economic Forecasting macroeconomic model have also been presented in research for the TaxPayers' Alliance.[182] The paper argued that the process of deficit reduction and economic recovery would be best served through a mixture of reduced public spending and tax cuts. A similar study was produced for the 2011 Institute of Economic Affairs publication *Sharper Axes, Lower Taxes: Big Steps to a Smaller State*.[183]

The main findings of that study were:

- The best buy amongst the counter-factual tax and spending options considered would have been one in which the VAT and NIC increases implemented in 2011 had not taken place but public spending had been cut by a further £20 billion instead.

181. Barrell, R. *What are the effects on growth of increases in taxes and cuts in spending?*, NIESR Press Release, 18 June 2010.
182. Smith, D. B. & Sinclair, M. *The economic effects of a rapid fiscal adjustment*, TaxPayers' Alliance, 21 June 2010
183. Booth, P. (ed) *Sharper Axes, Lower Taxes: Big Steps to a Smaller State*, Institute of Economic Affairs, 2011

- The increase in VAT to 20 per cent was an error that had boosted joblessness by some quarter of a million, cut national output by 1.2 per cent and made Public Sector Net Borrowing worse by 0.1 to 0.2 percentage points of GDP.
- Cuts in public consumption reduced headline GDP but had no immediate adverse effect on private activity while leaving real private domestic expenditure higher in the long run – a result that tallies with the NIESR research described above.
- The official UK borrowing projections were unlikely to be achieved, even if some modest reduction in the PSNB/GDP ratio remained possible in the longer term. That prediction has since been confirmed in the November 2011 Autumn Statement.

However, there are serious impediments to any attempt to incorporate the effects of taxes into time series-based macroeconomic forecasting models. One problem is the complexity and fluidity of the tax system itself. This makes it hard to incorporate tax measures into economic relationships which may include quarterly observations back to the early 1960s. In theory, and if the tax structure was fixed, all that changed was the rate of tax, and this changed fairly frequently, it would not be too difficult to incorporate taxes into a time-series modelling framework. Unfortunately, none of these conditions hold in practice, especially when stealth taxes are being employed to hide increases in the tax burden.

In the Beacon Economic Forecasting model the logarithmic ratio of non-oil tax receipts to non-oil GDP is explained statistically using the logarithm of a weighted average of the various UK tax rates, the logarithm of one minus the ratio of government spending to GDP, and a time trend. This statistical equation embodies noticeable fiscal drag, reflecting the progressive nature of the tax system, so that a one per cent rise in the weighted tax rate generates a 1.63 per cent rise in receipts, while there is also a positive time trend of 1.24 percentage points of national output per annum.[184] However, the tax receipts equation also has the property that revenues fall as the share of government spending (defined to exclude debt interest) in national output increases. This implies that only the private sector generates tax revenues, a consideration that has become increasingly important as it has shrunk over the years, as shown in Figure 2.3 (p. 41). The Treasury has consistently over-estimated tax receipts when government spending has risen because they do not properly allow for this effect (Section 3.6.5.3). This mistake works the opposite way round when the private sector is growing rapidly.

At a more detailed level, different taxes have different effects in the Beacon Economic Forecasting model, with a VAT increase being more immediately inflationary than a rise in Income Tax, for example. However, the practical difficulty of measuring the effective rates of tax concerned mean that there are effectively only two main categories of tax incorporated in the model, indirect and direct (including National Insurance contributions). Increases in both sets of taxes have serious adverse effects on a wide range of private activities, including household consumption, private investment, net trade, employment and the exchange rates.

In some cases, supply-side theory implies that it is the relative tax burden in Britain compared to overseas that is the more relevant. The export, import and

184. The error correction equation concerned was estimated using quarterly data from 1978 Q2 to 2011 Q3, had an R-Bar-Squared of 93.39 per cent and a standard error of 2.76 per cent. Much of the explanatory power resulted from the inclusion of seasonal dummy variables designed to pick up the marked seasonal fluctuations in tax receipts though.

exchange rate relationships are examples of where this hollowing out effect applies (Section 3.1.1.2). The main difference between the consequences of the two main tax types is that the higher inflation brought about by increased indirect taxes has initially more powerful second-round effects because it triggers increases in interest rates and reduces household consumption.

It is also important to note that, even in a model such as the BEF one that incorporates some of the strongest adverse feedbacks from high taxes to the wider economy of any UK forecasting model, those adverse effects are probably understated because of the difficulty of measuring the *ex ante* tax burden over time. The damage done by a tax rate that is high but unaltered throughout the estimation period cannot be picked up by conventional time-series methods, for example. Instead, its adverse effects will be allocated to other variables including the constant terms in the statistical relationships concerned. This is why the evidence from panel data studies provides an essential supplement to the results derived from macroeconomic modelling.

3.4.4. Neo-classical macroeconomics suggests countries with larger market sectors will have a higher level of income; Post-Neo-Classical Endogenous Growth theory suggests countries with larger market sectors will have a higher level and growth rate of income

There is some debate in the literature as to whether taxes and spending affect the level or growth of real GDP. That problem exists on two levels.

At its peak in 1993, spending in Sweden was 71.7 per cent of national income, but it has since been cut by 19.8 percentage points

The first is that the change in the size of the state within a given period may not be closely associated with its level at the start of the period, making it difficult to disentangle the two effects. At its peak in 1993, for example, spending in Sweden was 71.7 per cent of national income, but it has subsequently been cut by 19.8 percentage points to 51.8 per cent of national income in 2011. Does Sweden's current reasonable economic performance, therefore, indicate that the size of the public sector does not matter or that large spending cuts create such strong results that they can offset the adverse effects of a high starting level?[185] Leach has examined the reasons for the relative success of the Nordic economies in recent years. He concludes that "the success of Scandinavia is a triumph of government downsizing, and smart deregulation. Nordic countries are therefore a showcase of 'neo-liberalism', and not a counterexample."[186]

The second issue is to do with the growth model considered appropriate. In a so-called neo-classical model one would expect the path of the logarithm of aggregate supply to move from one growth line to a lower parallel one when non-productive government spending and taxes rose, but the slope of the line to remain unaltered. This means that the growth rate would fall in the transition period but would then return to its previous rate. In a post-neo-classical endogenous growth model, in contrast, the slope of the growth line would be flatter after the spending or tax burden rose, as well as there being a downwards shift. This means that both the growth and the level of output would be permanently reduced.

There is general agreement – and much empirical evidence – that an increased public consumption burden drives down the ratio of private capital formation to national output. The disagreement is entirely to do with whether technical progress

185. This issue is addressed in the statistical analysis reported by Bates, W. *How Much Does Size of Government Matter for Economic Growth?* Consultancy Report prepared for New Zealand 2025 Taskforce, 27 September 2010. In practice, modern econometric techniques can readily distinguish between growth and levels effects so this is not a problem in a serious analysis.
186. Leach, G. *Economic Lessons from Scandinavia*, Legatum Institute, 26 October 2011

proceeds exogenously – as the neo-classical school believes – or whether it has to be embodied in new capital equipment – in which case, no investment means zero technical progress – as the post neo-classical endogenous growth school believes.

Different taxes may also have different effects on the level and growth of income, many of those effects are set out in Section 4.1.2.

Figure 3.8: Effects in Neo-Classical Model

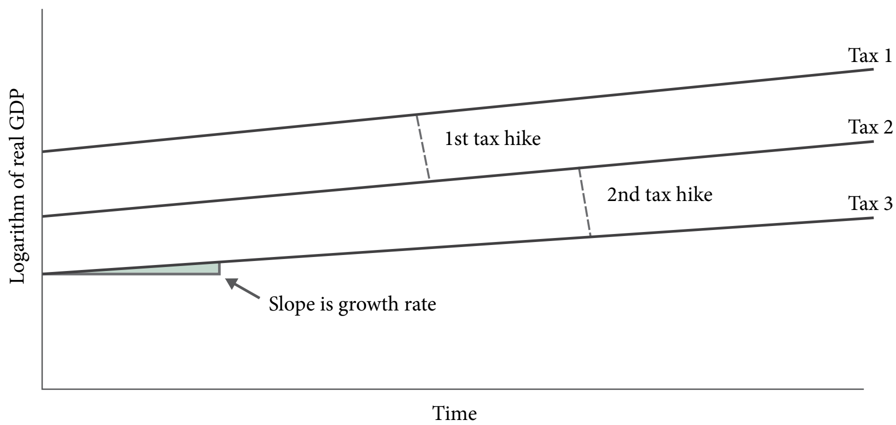
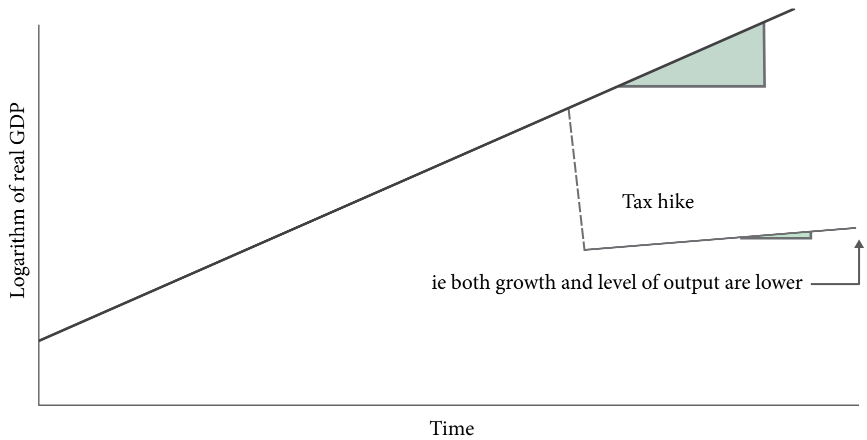


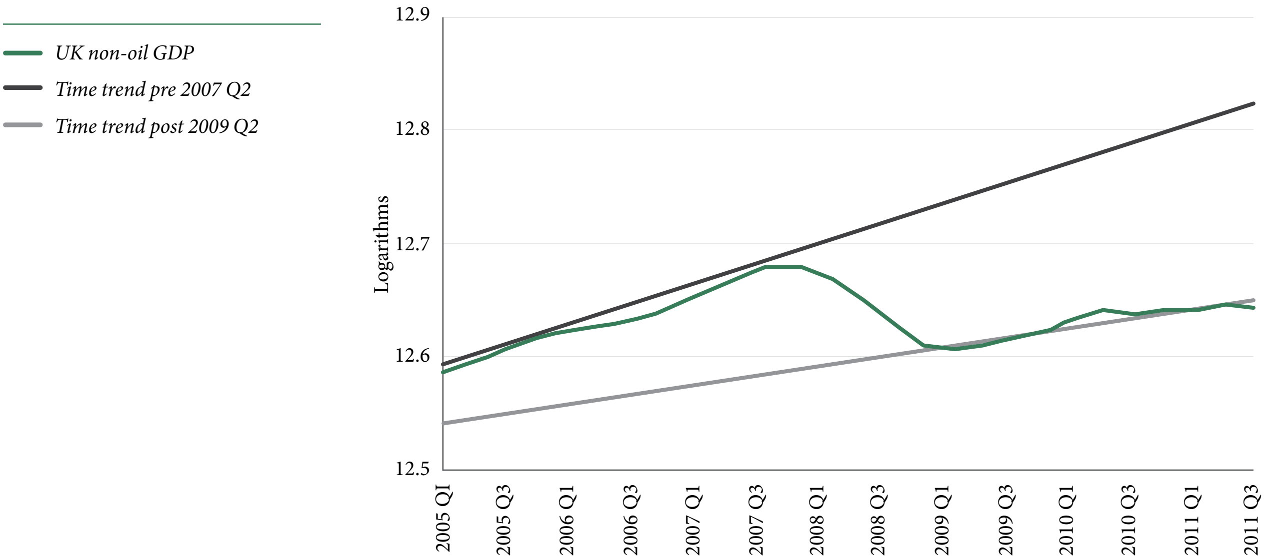
Figure 3.9: Effects in post-Neo-Classical Endogenous Growth Model



That the UK may have suffered from a post neo-classical supply withdrawal in recent years can be seen from Figure 3.10. This shows the logarithm of UK real non-oil GDP from 1995 Q1 to 2011 Q4, which is the longest back run currently available, and two time trends; one fitted from 1995 Q1 to 2007 Q2, and the other from 2009 Q2 to 2011 Q4. The similarities with the diagram showing the effect of a tax hike in a post-neoclassical-endogenous growth model are apparent, even if the small number of observations for the two periods means that the results need to be treated with caution.

The statistical results indicate that real non-oil GDP was 16.6 per cent below its pre-2007 Q2 trend in the fourth quarter of 2011 but it was then only 0.7 per cent below the post 2009 Q2 trend. The slope of the pre-2007 Q2 trend was equivalent to a growth rate of 3.5 per cent each year while the post 2009 Q2 trend was 1.6 per cent each year, representing a growth deceleration of 1.9 percentage points. Such differences explain why it is hard to measure the output gap in practice and why supply shocks can be quantitatively important. This remains the case even if it is accepted that the post 2009 Q2 trend is not yet well defined and that some of the recent weakness of GDP results from a demand shortfall as well as a supply contraction.

Figure 3.10: Logarithm of UK Real Non-Oil GDP 2005 Q1 to 2011 Q4 with fitted time trends



A good theory should be capable of explaining both microeconomic and macroeconomic phenomena. Indeed, one of the objections to Keynesianism in its early days was that it was not properly rooted in the older microeconomic approach. The development of 'representative-agent' models from the early 1980s onwards was an attempt to remedy this defect. However, the simplifying assumptions required to make these models work – especially those concerning the ways in which economic agents formed their expectations – meant that this approach failed to give any advance warning of the 2008 financial crash. The shortcomings in the Conventional Theoretical Macroeconomic Model (CTMM) meant that financial bubbles and crashes were considered to be so illogical by central bankers that they could not happen, leaving the monetary authorities in Britain and the US badly unprepared when they did occur.[187]

The Dynamic General Stochastic Equilibrium (DGSE) forecasting models that followed on from this approach – and were widely employed by central banks – assumed that output quickly reverted to its underlying trend following any disturbance.[188] However, no serious attempt was made to explain this trend in terms of the post-tax returns to supplying labour, new capital formation or engaging in entrepreneurship.

The increase in the British and US spending ratios in the 2000s could be expected to lead to a noticeable slowdown in the sustainable growth rate of those economies. In the case of the UK, for example, the 8.4 percentage point rise in the government spending ratio between 1996–2000 and 2006–2010, a comparison that smoothes

187. Smith D. B., *Cracks in the Foundations? A Review of the Role and Functions of the Bank of England after Ten Years of Operational Independence* Economic Research Council, Research Paper No. 23, May 2007

188. The issue of how to incorporate the supply side properly has recently been addressed in Vetlov, I., Hledik, T., Jonsson, M., Kucsera, H., & Pisani. M. *Potential Output in DSGE Models,* European Central Bank Working Paper, no. 1351, June 2011. Most current forecasting models do not incorporate such insights.

out the recent recession, might be expected to slow growth by 1.25 percentage points, for example from 2.75 per cent to 1.5 per cent (Section 3.4.2). Since the values of equities and property represent the net present values of future income streams deflated by the risk-free return on long-term bonds, such a slowdown would be expected to reduce the values of shares and property by some 45 per cent, other things being equal. This implies that the global financial crash was part of the transmission mechanism through which increased public spending in the US and elsewhere crowded out private activity and caused a supply withdrawal.

The global financial crisis may have partly been a consequence of the increased scale of government diminishing aggregate supply. Perverse tax incentives, such as the more favourable treatment of corporate debt than equity, may also have contributed to the crisis (Section 6.1.2).

3.5. Tax reform is only sustainable if it cuts the overall burden of tax

Tax reform tends to be contentious. Few tax reforms have been anything other than highly contentious when first concluded. Occasionally tax reform does evolve out of bipartisan deals (though very rarely in Westminster-style parliamentary democracies). And, at least if they think it raises revenue, people support measures like the 50p rate that our reforms would more than abolish.

The status quo has enormous power. Challenges to the status quo can be highly dangerous at least in prospect. Superficially this might suggest proposing tax reform is dangerous, and the Liberal Party of Australia in the mid-1980s and even more the early 1990s shows this can prove true (Section 3.5.3.2.3). But once tax reform has passed, the dynamics change and reformed systems have a history of stability and gaining popular support. This can be seen in the UK (Section 3.5.3.1), the USA (Section 3.5.3.2.1) and Eastern Europe (Section 3.5.3.3). Indeed even tax reforms that are initially unpopular at the time, for example Australia's introduction of the GST, can survive. This is much truer for lower rates, however, than for simplification. New deductions have a tendency to emerge to appeal to particular constituencies, but that of course takes time and in a Westminster Democracy a government that supports them.

A central factor in the popularity of tax reform is whether it reduces taxes for most taxpayers, (Section 3.5.2) with issues of redistribution or the support of elites mattering less. Tax reforms which represent a cut in the burden of taxes, even if in technical terms they are not progressive, have a strong record of popularity. In Britain, the most notable example was the Lawson tax cuts (Section 3.5.3.1.3) and this is also seen in the United States with the popularity of the Kennedy/Johnson and Reagan tax cuts. At the same time, the Poll Tax provides a supreme example of tax reform which was overturned (Section 3.5.3.1.4). It is no coincidence that it represented an increase in the tax burden.

The public also respond in different ways to different taxes. Taxes that are paid in lump sums, like Council Tax or the failed Poll Tax, tend to be particularly unpopular. Inheritance Tax, as discussed in Section 5.2.2.2, is seen as particularly unfair.

The economic rewards of tax reform tend to become obvious to elites over time and, having seen them, they rarely try to return to the status quo ante. This is true of most of the tax changes of Thatcher and Reagan, and can also be seen in the history of Eastern Europe during the last few years.

Leadership is key and not just because of the short term problems. Without a supportive Prime Minister, Westminster Democracies will not achieve radical tax reform, the pressures are too great.

There is a substantial electoral opportunity in tax reform, at least if it is combined with a reduced burden of taxation. This is partly because the success of governments depends so much on the state of the economy – and tax reform can play a key role in stimulating it – but also because some tax reforms have proven decidedly popular.

Elections are fundamentally about the future, not the past, and the defence of a reformed tax code can be a vote winner. In 1992, the reforms they had introduced were critical to the Conservative victory (and Labour defeat). Similar misfortunes befell the Australian Labor Party in 2002. Labour's success in 1997 was based on embracing the basics of the Thatcher tax structure. Even today, Thatcher's initial election represents a model where a clear but undetailed commitment to lower rates can make tax reform an election winner. There is every sign that public opinion now is more supportive of tax cuts than it was then.

Tax reform is not an issue that can be confined to parties of the right or the left, even if there is some evidence lower rates are particularly beneficial for the right. It is not the case that right wing parties automatically 'own' tax reform. In the 1980s in both New Zealand (Section 3.5.3.2.2) and Australia the electoral success of their respective Labour and Labor parties was in large part built on their own records of tax reform, which both provided electoral opportunities and helped defeat more radical proposals by the right wing parties. Similarly, the electoral dominance of the US Democratic Party once owed a great deal to its ability to champion lower taxes than Republicans, who were more concerned about balancing the budget. When they reversed that they had political problems.

No party can afford to turn down the economic and political opportunities offered by substantial tax reform. The public supports the case for tax cuts (Section 3.5.1). There is a large gap in the political market waiting to be filled.

3.5.1. Public opinion surveys suggest there would be support for tax reform that cuts overall rates

When the tax system is raised in the abstract, the public often responds by questioning current levels of spending, by suggesting they would vote for an explicitly tax-cutting party, and by telling pollsters that they would rather spend the tax money themselves. Back in 2004, when governments were raising taxes to fund increasing public spending, only 18 per cent said they would support a party that would increase taxes, with 43 per cent wanting a hold and 36 per cent preferring a reduction.[189] More recently, 54 per cent of respondents told ComRes that "the money I pay in tax doesn't benefit me as much as it would if I could spend it myself."[190] Again in 2009, 52 per cent thought the government "spends too much and therefore taxes us too much".[191] When the question of attitudes to the tax system is unlinked from specific taxes or from specific reference to where that tax money is spent, these three polls suggest the public is unwilling to pay any more in tax and would perhaps consider a substantial tax cut if they were able to spend the money themselves.

The public support a spending ratio of around a third, as proposed by the 2020 Tax Commission. In a 2011 poll carried out by ComRes, respondents were asked: 'what proportion of the UK's national income should government spending account

189. ICM Guardian, 17–19 September, 2004
190. ComRes Taxation, 2–4 July, 2010
191. ICM TaxPayers' Alliance, 1–4 May, 2009

for?' The average response was 33 per cent. This suggests that people in the UK find it fair that the government spends around £1 for every £3 of national income. Similar results were found when the answers to that question were broken down for voters of all three main political parties, as shown in Table 3.6.

Table 3.6: ComRes Poll, July 2011

What proportion of the UK's national income should government spending account for? (%)	
Conservative voters mean	33
Labour voters mean	35
Liberal Democrat voters mean	34
GB adult mean	**33**

Given that this is combined with the plentiful evidence linking tax cuts with economic growth in the public mind, an explanation is required for why broad reform of the taxation system is not a key demand for the public.

Part of the explanation for apparently contradictory public opinions towards the taxation system is the interrelationship between taxation and spending. Stephan Shakespeare explained these ambiguities in polling, in February 2008, as a result of the issues being "so important and so entangled with many aspects of our lives."[192] The questions asked of the public, and the answers received in response, demonstrate how opinions about taxation appear to change depending on the context.

One significant modifier to public opinion is when respondents are asked whether they would favour higher or lower taxes in conjunction with higher or lower spending on health and education. Health and education consistently poll as the public's highest priorities for public spending. The British Social Attitudes survey has tracked these priorities since 1983 and in no year has health or education not been among in the top two by some margin. For example, in 2009, 27 per cent thought education spending was the highest priority for Government and 43 per cent thought the same about health spending.[193] Similarly, a Populus poll in 2009 asked the public which areas of public spending should be protected in the event of cuts. 45 per cent chose the NHS and 35 per cent said schools.[194]

To some extent, this overwhelming interest in spending on education and health has limited the appeal of cutting taxes in polls which explicitly compare tax cuts with those items of spending. For example, an ICM poll in 2005 asked its sample about the appeal of tax cuts with explicit link to spending on health and education. 49 per cent said they would support "some increase in taxes" if it meant increased spending on health and education. Similarly in 2006, in the preamble to the question, respondents were told that NHS spending had almost doubled in real terms since 1997, only 30 per cent agreed that taxes are too high in Britain.[195]

This is an extreme case citing the most popular spending without identifying particular tax cuts, and specific parts of health and education spending may be less popular, but it does show the significance of the context with which these questions are posed.

192. Shakespeare, S. *Polling won't show you what tax policy will win an election*, ConservativeHome, 21 February 2008
193. British Social Attitudes 27, 2009
194. Populus Westminster Hour, 25–16 April, 2009
195. Populus BBC Politics Show, October 11, 2006

The public is much more hostile to current levels of spending, and much more in favour of tax cuts, when taxation is linked to other more unpopular areas of spending, and when taxation is linked to waste within the public sector.

Firstly, when taxation is linked to welfare spending it immediately becomes more unpopular. Attitudes to benefits have undergone a quiet revolution over the last 20 years as evidenced by the long-term tracking of the British Social Attitudes survey. The BSA survey has asked since 1987 whether respondents agree that "if welfare benefits weren't so generous, people would learn to stand on their own two feet." In 1987, only 33 per cent agreed with the statement and 45 per cent disagreed. In 2009 (the last time this question was asked), the positions were reversed, with, only 22 per cent disagreeing and 53 per cent agreeing.

Public antipathy towards generous welfare spending was confirmed in a 2009 poll, when only 14 per cent described "increase welfare benefits" as a priority for any spare money.[196] Again, in 2009, only one per cent thought unemployment benefit should be protected in the event of cuts to public spending.[197] In the latest BSA survey, 54 per cent thought welfare benefits were too high and discouraged people from finding jobs.[198] If taxation is linked to spending on welfare, public opinion can be relied upon to be much more critical of the current tax burden. A similar case can be made for the international aid budget. When asked how they would fund various policies for economic growth (including tax cuts), 73 per cent said they would support reducing the aid budget by £1.3 billion.[199]

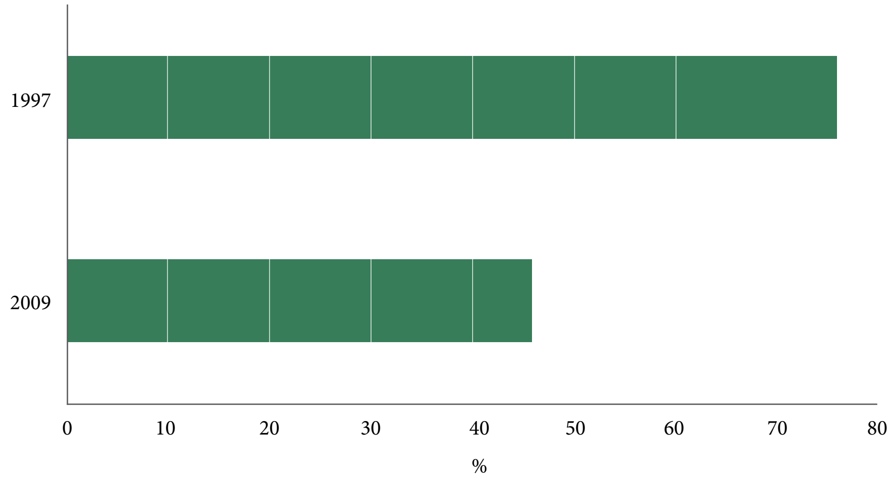
69 per cent agree that "if the government reformed public services and cut waste it could make services better and reduce tax at the same time"

Secondly, opinion is much more critical when the taxation system is linked to perceptions of waste in public spending. Increased spending on the NHS and schools is not necessarily seen as good value for money. A 2005 poll found 69 per cent agreeing that "if the government reformed public services and cut waste it could make services better and reduce tax at the same time."[200] This is an interesting statistic, since it gives lie to the assumption that the public is necessarily looking for increased spending. When this is taken in conjunction with the belief that extra spending has not resulted in real improvements in services (61 per cent thought the NHS had not improved despite increased spending),[201] and the belief that government does not put taxpayers' money to good use (65 per cent think it does not),[202] there is an opportunity to address any existing preconception that tax cuts would necessarily imply worse public services.

Opinion has changed over the last decade and certainly there is no longer any hard support for increasing taxes for increased public spending. The BSA survey has, since 1983, given respondents a choice of three options: reducing taxes and spending less on health, education and social benefits; keeping services at the same level; and increasing taxes to spend more in those areas. Enthusiasm for increased tax and spend reached a high-point in 1998, with 63 per cent wanting both. Since then it has declined considerably to 31 per cent in 2010, a low not seen since 1983. This is mirrored in Ipsos Mori's trend surveys, which have seen the numbers wanting an extension of government services "such as health, education and welfare, even if it means some increase in taxes" decline from 76 per cent in 1997 to 46 per cent in 2009.[203]

196. YouGov Daily Telegraph, 4–6 September, 2009
197. Populus Westminster Hour, 15–16 April, 2009
198. British Social Attitudes Survey 28, 2010
199. ComRes Economic Growth, 23–25 September, 2011
200. ICM 30 November – 1 December, 2005
201. ICM 30 November – 1 December, 2005
202. ICM Guardian, 15–17 February, 2008
203. Ipsos MORI trend, 1997–2009

Figure 3.11: A decreasing number of people think that government services such as health, education and welfare should be extended, even if it means some increases in taxes



Both of these surveys, however, do not use a neutral framework for eliciting public attitudes. They both specify exactly where extra spending might go but do not suggest where specific tax cuts could be made. In fact, it is striking that, despite the leading question, the BSA could still note in 2010 that the public has reacted "strongly against sharp increases in public spending".[204] A more impartial question was asked by ICM for the TaxPayers' Alliance in 2009. This provided respondents with a choice between the government spending too much (and therefore taxing too much), the government getting the balance right, or the government spending too little and therefore taxing too little. A full 53 per cent thought the government taxes and spends too much.[205] The figure was even higher, at 62 per cent, among the 18–24 age group.

There is evidence that a tipping point has been reached. The public is clearly opposed to any new increase in tax and spend, but not yet in favour of substantial tax cuts (even if theoretically they think the government spends too much as a proportion of national income). This can largely be accounted for by a caution in public opinion, a belief that cutting taxes is to some degree a risky business. The public may see substantial waste and little value for money in public services but still treasures spending on health and education. Opinion agrees that taxes should go no higher but is sceptical about cuts in government budgets in order to fund tax cuts. This conservatism is partly down to the belief that tax cuts should be placed on a sound fiscal basis, with 73 per cent agreeing in 2009 that tax cuts should not be paid for by extra borrowing.[206] But it is also dependent on a lack of connection in polling between tax cuts (or reform) and hard benefits for the average family.

3.5.2. Public opinion surveys suggest people are more likely to support tax reform that cuts their own rates

YouGov has asked its respondents since June 2010 to list what they see as the three most important issues facing the country and their family. Unlike a similar ICM tracker, YouGov separates tax from public spending, and the results are illuminating.

204. British Social Attitudes Survey 28, 2010, pg. 28
205. ICM May 1–4, 2009
206. ComRes BBC, 28–29 January, 2009

There is a substantial disconnect between the percentages seeing tax as an issue for their family and those who see it as an issue for the country. In nearly all these polls since June 2010, roughly twice as many have seen tax as an important issue for the former than the latter. For example, in October 2011, 28 per cent saw tax as an important issue facing their family, against only 13 per cent thinking the same in relation to the country as a whole.[207] These polls are an imperfect measure of what the public actually thinks about taxation, since seeing something as an 'important issue' does not indicate any opinion about why it is important. Similarly, the absolute percentages are untrustworthy since respondents are allowed to choose up to three. But, the rank issues are given relative to each other does provide some indication, and tax (for families) consistently ranks above issues like education and immigration, only below the economy, health and pensions. The disconnect between importance for the family and the country is also important, since it implies that concerns about tax as an abstract problem for the country has less impact on public opinion than concerns about tax when it affects the individual.

Survey evidence suggests that when respondents are likely to be affected by the tax being considered they are far more likely to be in favour of cutting or reducing the impact of that tax, and would certainly not support any increase. For example a June 2010 survey asked whether 'people like me' should pay more in tax and 73 per cent disagreed.[208] Similarly, the British Social Attitudes survey has asked its whole sample whether they perceive certain income groups as paying too much, about right, or too little in tax. In 2009, two per cent thought low earners paid too little, 4 per cent thought middle income groups paid too little, and 37 per cent thought high earners paid too little.[209] Evidently, therefore, while there is no majority for any group to pay substantially more than at present, the public does not believe that taxation should be higher for groups like themselves.

When asked if 'people like me' should pay more in tax, 73 per cent disagreed

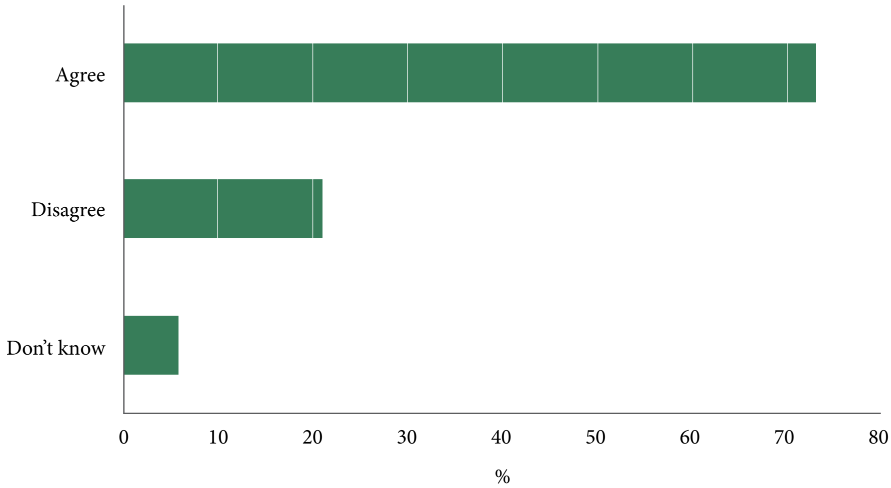
These figures are mirrored in questions about those taxes that tend to affect most taxpayers. 55 per cent disapproved of increasing National Insurance rates by 0.5 per cent in December 2009,[210] and only 26 per cent thought extra public spending should be funded through an increase in the basic rate of Income Tax in July 2010.[211] Significantly, when respondents were told that a reduction of government spending to around 30 per cent of national income would leave the average household £7,500 better off, 70 per cent supported that reduction.[212] The evidence suggests that voters would even support a reduction in higher rate taxpayers' tax burden if those on the basic rate also benefited, with 78 per cent supporting an increase in the personal tax allowance by £630 for both basic and higher rate taxpayers.[213] The polling demonstrates that the public would broadly support a decrease in taxation for lower and middle income groups – the majority of those being polled – and would even consider reductions for higher rate taxpayers if the reduction also benefitted those on lower incomes. This suggests the public do not share the view expressed by Kayte Lawton in a recent Institute for Public Policy Research report on the Government's tax policy. She argued against the gradual increase in the personal allowance for basic rate taxpayers to £10,000 on the grounds that, although the rise would be of benefit to all taxpayers earning less than £115,000, it would be of more benefit to

207. YouGov 17–18 October, 2011
208. ICM *The Guardian* 18–20 June, 2010
209. British Social Attitudes Survey 27, 2009
210. ICM Guardian 11–13 December, 2009
211. ComRes taxation 2–4 July, 2010
212. ComRes National Income 8–10 July, 2011
213. YouGov 23–24 March, 2011

higher income deciles.[214] Opinion polling shows that the public would support the move.

There is evidence to suggest that concern about the public's personal tax burden is affected by the economic situation. When in the last few years the public has been asked how the government should deal with the budget deficit, the preference has overwhelmingly been for cutting spending over an increase in taxes, with 73 per cent choosing the former over the latter in June 2010.[215]

Figure 3.12: The government's priority should be to cut spending rather than increase taxes

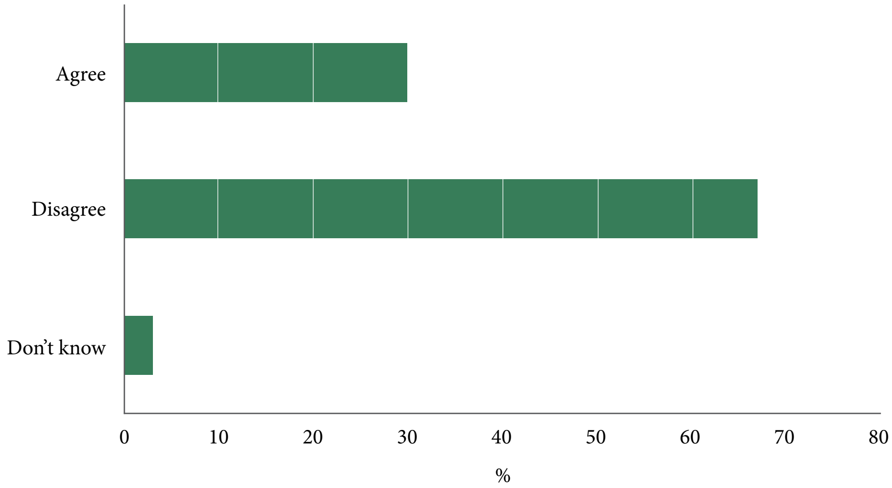


The same result was obtained in July 2009, when 67 per cent disagreed with the statement that "in the current economic climate I would be prepared to pay higher taxes in order to reduce the level of national debt".[216] This implies that the public thinks the taxpayer is burdened too much, both by the current level of tax and by any general squeeze on income, to support any further tax increase. Secondly, if one uses the British Social Attitudes survey as a guide, support for increased tax and spending coincides with times of economic prosperity and declines again when the economy is performing badly.

Further conclusions can be reached by looking at which groups in particular are disproportionately in favour of cuts to taxation. It is rarely the older or higher income socioeconomic groups but more often the C2's or DE's and the young. Although in February 2010 67 per cent thought 'people they know' pay too much in tax, the figure was 70 per cent among C2s and 73 per cent among DEs.[217] Again, in October 2011, when 23 per cent said high taxes were one of the most pressing problems in Britain, it was 30 per cent among C2s, 28 per cent among 18–24s and 31 per cent among 25–34s.[218] This is confirmed again by a June 2010 poll, when 73 per cent said 'people like me' should not pay more in tax. The figure was 80 per cent among C2s and 84 per cent among 18–24s.

214. Lawton, K. *Coalition Tax Policy*, Institute for Public Policy Research, 2011
215. ICM Guardian, 18–20 June, 2010
216. ComRes BBC, 7–8 July, 2009
217. ICM Guardian, 15–17 February, 2010
218. ICM Guardian, 21–23 October, 2011

Figure 3.13: In the current economic climate I would be prepared to pay higher taxes in order to reduce the level of national debt



These figures suggest that it is the hardest pressed groups, people with less established wealth but perhaps ambition to improve their standard of living, who are particularly concerned about the impact of taxation on their personal finances.

3.5.3. The political history of tax reform suggests that the most successful tax reforms are those associated with cuts in the overall burden of tax

The experience of the last century shows that tax reform is possible and can be highly successful electorally.

First, for the UK, we examine the missed opportunity of the 1950s (Section 3.5.3.1.1). We then examine the reforms of the 1980s, particularly Howe's revenue neutral Budget of 1979 (Section 3.5.3.1.2) and Lawson's successful tax cutting one of 1988 (Section 3.5.3.1.3). We consider the causes of the political failure of the Poll Tax (Section 3.5.3.1.4). In doing so we show the dangers of tax reform which takes the form of tax hikes and the political opportunities when tax reform is linked to tax cuts.

Second, we look abroad. In the United States there have been notable political successes under both Democratic (John F. Kennedy/Johnson in the 1960s) and Republican (Reagan in the 1980s) administrations (Section 3.5.3.2.1). Low rates have been critical to winning public support – even if elites are often sceptical. In New Zealand we examine both the successful and abortive attempts at flattening taxes (Section 3.5.3.2.2). Similarly in Australia we examine both supposedly election-losing tax reform proposals and the successful tax reforms of both the left and the right (Section 3.5.3.2.3). Australia is of particular interest as a Westminster Democracy of a somewhat similar size, demographic position and culture as the UK. We look at Switzerland's long standing commitment to lower corporate taxes. Finally we examine the recent radical tax reforms in eastern European countries, reforms which were initially highly contentious but have since been successfully bedded down (Section 3.5.3.3). Finally we look at some evidence on the effects of income tax rates on election outcomes cross-nationally (Section 3.5.3.4).

3.5.3.1. Tax reform in the United Kingdom

3.5.3.1.1. 1950s Britain

The 1950s saw a considerable reduction in the burden of taxation as a proportion of the economy. However the caution of most Conservative Chancellors of the period (all save Peter Thorneycroft) was reflected in the lack of wide ranging tax reform. However, as a result of economic growth and fiscal restraint, tax rates did in some cases fall with profits tax cut (the main ancestor of Corporation Tax) and some reductions in Income Tax rates.[219] However, inflation, rising prosperity in the context of an extremely 'progressive' tax code, and other tax changes meant average rates (particularly for the worst off) if anything had a slight upward tendency in the 1950s with many ups and downs influenced by fiddling with thresholds.[220] However, the overall tax structure established by the post war Attlee ministry remained,[221] in contrast to the radicalism of 1950s governments on price controls and spending. This was despite considerable pressure from the Conservative Party and the Treasury (but not the Inland Revenue) for a tax system with flatter rates. One of the leading historians of the UK's fiscal history has stated that 1951–64 represented a break in the usual pattern where "changes in the fiscal constitution arose from strong-willed Chancellors battling with the innate caution of officials".[222]

This failure to reduce direct tax levels to rates comparable to those adopted in many other advanced Western economies probably played a significant role in the UK's long term relative economic decline. In large part due to the controls on spending effected in the 1950s, by 1962 taxation as a percentage of GDP was 34 per cent in the UK to 41 per cent in France and West Germany. However, direct taxation (exempting National Insurance contributions and equivalents) on individuals was nonetheless slightly higher than in Germany and much higher than in France.[223] Moreover by 1964 the Conservatives lacked a convincing agenda for reversing Britain's relative economic decline.[224] Indeed the Conservatives' unimpressive record on tax reform allowed Labour in 1964 to claim the mantle of tax reform stating they would bring a "tax system […] less complicated and fairer" though the need for changes to the tax system was not prominent in the campaign. The economic achievements of the 1950s, now largely forgotten, helped the Conservatives to win three consecutive majorities. However their failure to build on this helped precipitate their eventual defeat.

3.5.3.1.2. The Thatcher Government

The Thatcher Government by contrast engaged in the most radical and successful tax reforms of post-war UK history.

A pledge of tax reform helped Thatcher win her initial election, giving her the chance to introduce a radical agenda. The 1979 general election saw the greatest swing to the Conservatives since 1945 (and the second greatest of either main party, only outdone by Labour in 1997). They won 43.9 per cent of the vote to Labour's 36.9 per cent, with an 8.7 per cent increase in their vote (compared to an increase of 3.7 per cent in 2010, for example).[225] This occurred despite Thatcher, as Conservative leader, being less popular as a candidate for Prime Minister than the Labour incumbent, Jim Callaghan, by about ten percentage points (about 40 per cent to 30 per cent

219. Daunton, M, *Just Taxes The Politics of Taxation in Britain 1914–1979*, 2002, pg. 277
220. Johnson, P. Lynch, F., Walker, J. G. & Pattie, C. J. *Income Tax and elections in Britain 1950–2001* Election Studies 24, 2005, pg. 400–401
221. Daunton, M. J*ust Taxes: The Politics of Taxation in Britain 1914–1979*, 2002, pg. 229–278
222. Daunton, M. *Just Taxes: The Politics of Taxation in Britain 1914–1979*, 2002, pg. 232
223. Daunton, M. *Just Taxes: The Politics of Taxation in Britain 1914–1979*, 2002, pg. 305
224. Butler, D. E. & King, A. *The British General Election of 1964*, 1964, pg. 138
225. British Government and Elections since 1945, http://lowtax.es/HRfHPx

on polling day).[226] In the words of the leading analyst of the election: "It was issues not organisation or personalities that won the election for the Conservatives".[227]

The Thatcher leadership did not get tied down to a detailed policy blueprint, allowing losers to be identified and the results demonised. Rather they appealed to a general desire for tax reductions. Their manifesto stated "We shall cut income tax at all levels" and vowed to "simplify" VAT. The language was filled with terms like "cutting to the European average" rather than precise figures.[228]

"We shall cut income tax at all levels"

Margaret Thatcher

That formula delivered great results. The Conservatives' clear commitment on tax raised the salience of the issue (in the same election survey five years before taxes had been such a minor issue as not to be mentioned). Taxes were the third issue for the electorate (behind prices and unemployment) and among those saying it was important, the Conservatives won by 61 points. Polls showed that the public believed the Conservatives would reduce Income Tax by a majority of 49 percentage points;[229] in the year before the election the Conservative lead on tax rose from two to 42 percentage points. Tax was also one of the top two issues for new Conservative voters. It was particularly effective in attracting first time voters. When presented with a list of issues of which they were invited to pick the two most important, tax was cited by 43 per cent of first time voters. This helped explain why compared to 1974 the swing to the Conservatives among eighteen to twenty four year old manual voters was a staggering twenty one points.[230]

All this was despite Labour having cut taxes in its 1978 Budget, for example the basic rate was reduced by 1p.[231] They also pledged to reduce Income Tax, though in weaker terms than the Conservatives, and to introduce a new wealth tax on those worth over £150,000.[232] By contrast in 2010 after a long period of Labour tax increases the Conservative advantage over Labour on taxes was only 15 points and perhaps more significantly their net rating on the issue was minus 11 points.[233]

The 1979 General Election represents the most successful use of the tax issue by an Opposition party in the post-war era. It suggests that the key to winning on a platform of tax reform is a credible commitment to reducing income rates without necessarily being committed to specific details. Despite this success the Conservatives might easily have been deterred from their strategy by opinion polls. A Gallup poll in 1979 asked whether people wanted to "cut taxes even if it means reduction in government services like health, education and welfare"; only 29 per cent were in favour and 71 per cent against.[234]

Though virtually every Budget under Thatcher was significant, two were especially important for tax reform, the first being the 1979 Budget under the chancellorship of Geoffrey Howe and the second being Nigel Lawson's 1988 Budget.

---

226. Crewe, I. Why the Conservatives Won in Penniman, H. R. (ed) *Britain at the Polls 1979*, 1991, pg. 274
227. Crewe, I. Why the Conservatives Won in Penniman, H. R. (ed) *Britain at the Polls 1979*, 1991, pg. 282
228. 1979 Conservative Party Manifesto, http://lowtax.es/HiamCr
229. Crewe, I. Why the Conservatives Won in Penniman, H. R. (ed) *Britain at the Polls 1979*, 1991, pg. 286
230. Crewe, I. Why the Conservatives Won in Penniman, H. R. (ed) *Britain at the Polls 1979*, 1991, pg. 279
231. BBC Budget 97 *Budgets 1945–79* http://lowtax.es/HkSp
232. Labour Party Manifesto 1979, http://lowtax.es/HHiD1Q
233. Laycock, S. & Bartle, J. *Just How Important were the 'important issues' in the 2010 election* http://lowtax.es/HP0KAO
234. Ramsey, A. *Britain at the Polls 1983*, 1985; Crewe, I. *How to Win a Landslide Without really Trying: Why the Conservatives Won in 1983*, 1985, pg. 189

The 1979 Budget involved a big shift in the burden of taxation from Income Tax to Value Added Tax (VAT). There were sharp reductions in Income Tax rates including in the top rate, which was cut from 83 per cent to 60 per cent on 'earned' (i.e. not derived from savings) income, and the basic rate, which was cut from 33 per cent to 30 per cent. Various extra, punitive taxes on certain kinds of investment and saving were also abolished. VAT rose from two rates of eight per cent and 12.5 per cent to 15 per cent and petrol tax was also raised.[235] This seems to have precipitated a short term fall in the opinion polls.[236]

Even more unpopular was when the Thatcher government raised taxes as a whole, notably in the famous deflationary Budget of 1981, which increased revenue by over £4 billion.[237] However this was mainly done through increases in various indirect taxes and by introducing a tax on North Sea oil, although individual Income Tax allowances were also frozen.[238] Combined with inflation this meant that effective Income Tax rates actually rose by 1983 (despite marginal rates falling fairly sharply).[239] Nevertheless by the 1983 election it was clear the Conservatives aim was to reduce them, they promised "further improvement" and could boast of the cuts in rates.[240]

In 1983, Labour and 'Alliance', the third party and ancestor of the Liberal Democrats, did not run on a platform of lower taxes. Labour called for large tax increases on the rich (for example by raising the National Insurance ceiling) and made vague promises of giving lower paid workers a higher allowance and zero rating some products for VAT (the only example given explicitly being on sanitary products).

Given the notorious and detailed radicalism of Labour's manifesto, what is most striking is how moderate their challenge to the Howe tax reform was, the VAT rates and Income Tax rates going unchallenged (though also unconfirmed).[241] The Alliance called for a complicated series of tax changes including new tax breaks for business and reductions in thresholds.[242] This is an example of a fundamental truth: once passed, even unpopular tax reforms generally stick in broad terms. It also meant that, while the Conservatives had a mixed record on tax, opposition parties were incapable of exploiting this. That had the effect of underlining Conservative dominance.

As we shall see, by 1997 the Conservatives could no longer rely on such own goals by their opponents. If Labour had sought to avoid rather than accept, even embrace, a high tax label in 1983, it is likely that Thatcher's majority would have been much less than the massive 144 she won.

After the election Howe was replaced as Chancellor by Nigel Lawson who continued the strategy of tax simplification, reducing tax rates by broadening the tax base, notably through the abolition of exemptions. For example, in 1987 he was able to reduce the basic rate of Income Tax by 2p to 27p and freeze most taxes even while the budget moved into balance.

235. Hillman, J. & Clarke, P. *Geoffrey Howe: A Quiet Revolutionary*, 1988, pg. 141–142
236. Zolnnhofer, R. *The politics of budget consolidation in Britain and Germany: the impact of blame-avoidance opportunities*, CES Germany & Europe Working paper, no. 05.2, 2005
237. Zolnnhofer, R. *The politics of budget consolidation in Britain and Germany: the impact of blame-avoidance opportunities*, CES Germany & Europe Working paper, no. 05.2, 2005
238. Howe, *G. Conflict of Loyalty*, 1994, pg. 206
239. Johnson, P., Lynch, F., Walker, J. G. & Pattie, C. J. Income Tax and elections in Britain, 1950–2001, *Election Studies*, 24, 2005, pgs. 400–401
240. Conservative Party Manifesto 1983, http://lowtax.es/HHiHyN
241. Labour Party 1983 Manifesto, http://lowtax.es/HUBMOD
242. Alliance SDP-Liberal 1983 Manifesto, http://lowtax.es/HP11nm

3.5.3.1.3. The 1988 Budget

Probably the most important post-war act of tax simplification was Lawson's 1988 Budget. Its core was a reduction in Income Tax rates across the board. For the top band the rate fell from 60 per cent to 40 per cent and the standard rate from 27 per cent to 25 per cent. It was tax reform as well as tax relief, eliminating numerous tax breaks notably for mortgages, company perks and forestry. It also equalised the rate of Capital Gains Tax with Income Tax rates but, despite that, it was probably the Budget closest to the recommendations of this report in terms of its effects. Indeed Thatcher hesitated over its radicalism; she appears to have suggested a top rate of 50 per cent rather than 40 per cent.

The Budget was enormously controversial. Proceedings in Parliament were raucous, the Parliamentary sitting had to be suspended for ten minutes and Alex Salmond of the SNP was suspended from the House for disruption.[243] The divisions among the elite were reflected in the media, with right-wing commentators expressing strong support and left-wing ones intense opposition.

According to the British Social Attitudes Survey (BSAS), in 1987 there was evidence that support for increases in public spending had increased over the previous four years. The percentage responding that more should be spent on health, education and welfare went up from 32 to 46.

Moreover polling then indicated less support for a radical flattening of the tax system than there is now. In particular when answering the same question in the British political attitudes survey in 1987, 79 per cent considered income differences too wide (compared to 78 per cent in 2009) and support for the notion the government should redistribute income from the better off to the worst off was at 45 per cent (compared to 37 per cent in 2009).[244] BSAS found in 1987 that five per cent wanted lower taxes and spending, 44 per cent wanted to keep taxes and spending the same and 45 per cent to increase taxes and spending. By 2009, the respective figures were eight per cent, 55 per cent and 34 per cent. To put it another way, those favouring higher taxes constituted 11 per cent less of the population in 2009 (and that was before the further tax increases introduced by the current Government).[245]

In assessing the results of polls, the wording of the questions is crucial. A PoliticsHome poll in 2008 (on behalf of the TaxPayers' Alliance) with different questions got a very different response. After being reminded that the money the government spends on public services and other things comes mainly from taxation, 67 per cent believed the government "spends too much and therefore taxes too much".[246]

However the BSAS provides a continuous measurement of public opinion, so even if the headline figures should be treated warily it is still noteworthy that they found public opinion in 1987 was significantly more hostile to tax cuts than it is today.

The 1988 Budget was polarising rather than unpopular overall. Noteworthy from the perspective of the 2010s is that the measure included a large reduction in the top rate, but only as part of a general reduction in rates. Mori polling showed over 50 per cent thought it would improve the economy; 51 per cent believed the Budget would help get the economy going; 55 per cent that it would keep inflation down;

243. Lawson, N. *The View from Number 11*, pg. 818
244. Rowlinson, K., Orton, M. & Taylor, E. *Do we still care about inequality in Park*, A., Curtice, J., Clery, E. & Bryson, C. *British Social Attitudes: Exploring Labour's Legacy*, pg. 24
245. Curtice, J. & Park, A. *A tale of two crises: Banks, MP's expenses and public opinion in Park*, A., Curtice, J., Clery, E. & Bryson, C. *British Social Attitudes: Exploring Labour's Legacy*, pg. 154
246. *PHI5000 survey of the British public for the TaxPayers' Alliance*, October 2008

and 64 per cent that it would increase business confidence. Views on whether it was good for the economy or not divided 40 per cent to 49 per cent and on whether it would benefit them and their families the breakdown was 40 per cent to 43 per cent. The tax cuts for higher earners were opposed by 63 per cent to 27 per cent and 77 per cent believed it would make the rich richer and the poor poorer.

However, Thatcher's economic competence ratings actually rose after the Budget and 60 per cent supported the cut in the basic rate. The best measurement is probably the effect on the Conservative Party's poll ratings. These stayed stable. There are two reasons that this suggests the Budget won support. First, the stability achieved in the polls came in the context of the promise of large cuts in taxation beforehand. Secondly, and crucially, this stability was at an enormously high level of 46 per cent, which was higher than Thatcher had achieved in her landslide a year before and higher than any Conservative vote in any general election since. The Budget, and the lead up to it, saw Tory support rise to a level that would be regarded as fantastically high today.[247]

These results obviously have to be reconciled with the BSAS polling above which, taken at face value, would suggest that 90 per cent of the country or something close to it would have opposed the Budget. One obvious explanation is that the public might think of tax and spending in terms of absolute tax revenue and spending levels rather than in terms of proportions of GDP. On this basis spending and tax revenues were rising and continued to do so almost every year.

Given the vehemence of their initial opposition, and the apparent polarisation in public opinion, Labour accepted most of the new Lawson architecture remarkably quickly. Indeed their 1992 manifesto, while proposing new taxes, did so mainly through proposing changes to National Insurance by eliminating the National Insurance contributions threshold which the Mori Poll in 1988 mentioned above had shown would have been supported in principle by some 76 per cent of the public.[248] The main other change proposed was a partial reversal of the higher rate, increasing it to 50p rather than reverting entirely to 60p. Labour actually included a tax cut in their 'shadow budget' in 1992 and went to great pains to claim that 80 per cent of Britons would pay the same or less. In the long term, the most vulnerable part of Lawson's changes has been the simplifications. Many new complexities have been introduced since. This suggests an important truth about tax reform: it is easier to defend lower rates than a simplified code. This is because increasing rates can be seen to create losers, while the outcome of increased complexity is less obvious.

Politically, it was important that polls showed voters consistently believed their taxes would be higher under Labour. This was famously critical for the surprise Conservative victory in 1992, where posters highlighting "Labour's tax bombshell" dominated the campaign. What is less remembered is the emphasis on lower taxes in the Conservative manifesto, which pledged to "continue to reduce taxes as fast as we prudently can". More specifically, it promised to make further progress towards a basic Income Tax rate of 20p, to raise the tax threshold for Inheritance Tax and to abolish stamp taxes on shares. There have been attempts at revisionism on this issue claiming that there is little evidence tax was a bigger factor in 1992 than in the (even worse) Labour performance of 1987.[249] This may just suggest that there had

247. Hughes, D. Thatcher Jubilant at Lawson's Super Tuesday but voters unimpressed with 'rich man's budget' *Sunday Times*, 20 March 1988
248. *Ibid.*
249. Heath, A., Jowell, R. & Curtile, J. *Britain: Labour's Last Chance? The 1992 Election and Beyond*, 1994; Ramsey, A. *Britain at the Polls 1983*, 1985; Crewe, I. *How to Win a Landslide Without really Trying: Why the Conservatives Won in 1983*, 1985, pg. 277

been similar fears of Labour in 1987 and indeed the Conservatives had then claimed that Labour might raise taxes. Lawson suggested they might raise the standard rate of Income Tax to 58p. But on both occasions, the Conservatives successfully claimed the tax cutting mantle for themselves and put Labour in a position where they were regarded with suspicion on tax issues.

The architects of New Labour addressed that problem. In a way reminiscent of Thatcher, by 1997 Labour was running on a pledge not to increase basic or higher rate taxation and fiercely derided the tax rises of the Major administration.[250]

The 1988 Budget was the most radical piece of tax flattening since the war. It was also electorally shrewd.

3.5.3.1.4. The Poll Tax

In contrast to the success and popularity of the Thatcher Government tax reforms described above, the Community Charge, or Poll Tax as it was commonly known, was in political terms spectacularly unsuccessful.[251] It replaced local revenue rates (property taxes) with a charge for every adult. It rapidly became and remained highly unpopular and as a consequence played a significant role in the fall of Margaret Thatcher from office.

Public views were always strongly negative. As early as February 1988, 54 per cent opposed the tax and 33 per cent supported it, figures that rose to 63 per cent and 27 per cent respectively by September, possibly due to the number of attacks on it, including some by leading Conservatives such as Michael Heseltine,[252] and possibly due to more awareness of the measure's implications. This latter number stayed fairly consistent even after the repeal of the tax. The British Election survey in 1992 found that 65 per cent thought it was a bad idea. 37 per cent of respondents mentioned it as a major issue affecting their voting intentions by 1990.[253] It contributed to a substantial reduction in the popularity of the Conservatives. By 1989 Thatcher's ratings as preferred Prime Minister fell below 35 per cent and remained so for the last year of her tenure. Labour developed a consistent lead in the opinion polls of between 10 and 20 percentage points. When he replaced Thatcher, John Major (who had not been identified with the Poll Tax and quickly announced plans to abolish it) rapidly improved the Government's position in the polls.[254]

The decision to repeal the Poll Tax has been seen as crucial to the Conservatives' recovery and victory in 1992. Even so, the Conservatives did badly in 1992 in areas with a high community charge.[255] Why was it so unpopular?

For most voters the Poll Tax represented a substantial tax increase

The first problem was a mirror image of the advantage of the 1988 Budget. For most voters the Poll Tax represented a substantial tax increase. The average bill for rates had been £275. For the Poll Tax the figure was £360, an increase of 35 per cent. The number of people who got a large increase in their tax bill heavily outnumbered those who got a large decrease.[256] This suggests if the Poll Tax had been explicitly integrated with the Lawson tax cuts and phased in at the same time it might have been less unpopular.

250. Seldon, A. *Blair*, 2004, pg. 242
251. Butler, D., Adonis, A. & Travers, T. *Failure in British Government: the Politics of the Poll Tax*, 1994
252. Gibson, J. *The Politics and Economics of the Poll Tax: Mrs Thatcher's Downfall*, 1990, pg. 2
253. Heath, A,, Jowell, R. & Curtile, N. *Labour's Last Chance? The 1992 Election and Beyond*, 1994; Smith, J. & McLean, I. *The Poll Tax and the Election Register*, pg. 232
254. Heath, A,, Jowell, R. & Curtile, N. *Labour's Last Chance? The 1992 Election and Beyond*, 1994
255. Johnston, R. J. & Pattie, C. J. *Unemployment, the poll tax, and the British general election of 1992, Environment and Planning C: Government and Policy*, August 1992, pgs. 467–483
256. Gibson, J. *The Politics and Economics of the Poll Tax: Mrs Thatcher's Downfall*, 1990, pg. 238

Secondly it failed to produce accountability in the way proper decentralisation would have done. This is reflected in the evidence from local elections. While Tory councils suffered when they raised the Poll Tax significantly (and in some cases like Westminster gained when they set a low rate); support for Labour councils was barely affected by the rate set.[257] The key reason was that there was a squeeze on grants. Despite a 4.7 per cent increase in their average level, inflation was significantly higher meaning a decrease in real terms overall. Councils could undoubtedly have made efficiency savings but without a referendum lock to force accountability it was simpler to set a high Poll Tax. This underlines how important local accountability is to making fiscal decentralisation work.

This problem was made worse by the Thatcher and Major administrations' attempts to rectify the situation. Rather than impose a referendum lock they imposed caps on the level of the charge and increased grants and subsidies clouding any attempt at accountability. In sharp contrast to the initial squeeze, central government subsidies to local councils increased. Over the decade to 1990, the Thatcher Government had managed to make the share of local spending paid by local revenue rise from 40 per cent to 50 per cent. It fell to below 30 by 1993, and even by 2000 was still below 40 per cent.[258] Now, well under 20 per cent of local authorities' revenue comes from taxes they raise for themselves locally.

In one respect the Poll Tax shared a problem with its predecessor and successor in local taxation. The pattern appears to be that taxes which are paid as a lump sum tend to be the most unpopular.[259] That is reflected in recent UK polling that finds Council Tax, the BBC licence fee and Inheritance Tax are regarded as the most unfair.[260]

Thus the Poll Tax provides a case study of the dangers of raising taxes as part of a tax reform or, failing that, to make it clear that any tax rises are part of a broader package that lowers taxes. It shows the importance of decentralisation being linked with clear local accountability and avoiding if at all possible large single payments.

The new subsidies to local government seeking to resolve the problem of the Poll Tax played a significant role in creating the deficit of the early 1990s, which were as much as £50 billion a year (considered at that point a shocking amount). This underlines the importance of the fiscal decentralisation in council revenue called for by the 2020 Tax Commission (Section 8), not just in terms of improved efficiency (though that is key), but in terms of direct fiscal cost. Moreover the Major ministry in part closed the fiscal gap through higher taxation rather than reducing planned spending (indeed real spending rose every year of the Major ministry). This was ruthlessly exploited by Blair. The Labour manifesto of 1997 called not just for no increase in Income Tax, a cut in VAT on fuel and a move towards a 10p rate long term, it also attacked the Tories as tax risers stating: "The increase in taxes under the Conservatives is the most dramatic evidence of economic failure".[261] In the campaign for the 1997 election, Tony Blair repeatedly pushed the theme of "22 Tory tax rises" since 1979, with a great deal of success too.

An examination of UK electoral history from 1950 to 2001 also suggests that cutting taxes while reforming them improves election outcomes for incumbent parties. It shows that substantial increases in the average rates of income taxes have

257. Gibson, J. & Stewart, J. D. *Poll Tax, Rates and Local Elections, Political Studies*, 40, 1992, pgs. 516–531
258. Shakespeare, T. & Simpson, T. *The Rate Escape: Freeing Local Government to Drive Economic Growth* pg. 19 http://lowtax.es/HJwKm6
259. See for example the polling done by YouGov on the BBC licence fee which found putting the cost in terms of shorter periods increased support for it progressively. Kellner, P. Why Question Wording Matters, *Prospect*, November 2011
260. YouGov poll for the TaxPayers' Alliance in 2007
261. Labour Party Manifesto 1997, http://lowtax.es/HkSJhT

been associated with defeats while low increases or decreases in average rates were associated with victory. Moreover this effect was stronger if only taxes on voters on higher incomes are considered. For example for single voters in the higher income group elections in which governments held office were associated with average reductions in effective tax rates of 1.02 per cent compared to an increase of 1.35 per cent for elections in which they lost. These patterns remained true after adjustments were made for economic growth and inflation and unemployment. However marginal rates did not affect election outcomes separate from average rates, which shows tax reform needs to take the form of a tax cut to be effective.[262]

3.5.3.2. Tax Reform in other English speaking countries

3.5.3.2.1. The United States

The three most significant US tax reforms of the last half a century are the Revenue Act of 1964, generally known as the Johnson/Kennedy Tax cuts of 1964; the Economic Recovery Act of 1981, often known as the Reagan tax cut; and the Tax Reform Act of 1986, also passed during the Reagan presidency.

"... the soundest way to raise the revenues in the long run is to cut the rates now ..."

John F. Kennedy

The Johnson/Kennedy tax cut was signed by President Johnson but most of the decisions supporting it occurred under President Kennedy's administration. It very much fits the profile of tax cutting tax reform. It included increased depreciation for businesses, increasing their net average tax deprecation by 7.8 per cent (which may have been the most economically beneficial element); a seven per cent tax credit (these both took place in 1962 and may have helped drive the economic boom of the US in the mid-1960s); minor cuts in corporate taxation rates; and sweeping cuts in individual taxation (for example the top rate on income over $200,000 fell from 91 per cent to 70 per cent and the bottom rate on income from $0 to $500 from 20 per cent to 16 per cent).[263] Indeed, in 1962 President Kennedy said:[264]

> *It is a paradoxical truth that tax rates are too high and tax revenues are too low and the soundest way to raise the revenues in the long run is to cut the rates now.... Cutting taxes now is not to incur a budget deficit, but to achieve the more prosperous, expanding economy which can bring a budget surplus.*

Politically speaking, 1964 was not an obvious time for a tax cut. 1961–62 was one of only two periods in US post-war history when fewer than half of Americans considered they paid too much in income tax. There were worries in the administration that cuts would be seen as fiscally irresponsible. Possibly partly as a consequence, Johnson agreed to keep spending below $100 billion for the 1964–65 fiscal year.[265]

It seems this nervousness was not justified. By the end of the process, Johnson was able credibly to assure key figures in both parties that the proposed cuts would improve their popularity.[266] Republican opposition was initially overwhelming (on balanced budget grounds) but cracked with the leader of the Senate Republicans backing the proposal. Partly as a result Johnson became for a few years one of the most popular presidents in American history.

262. Johnson, P., Lynch, F., Walker J. G. & Pattie, C. J. *Income Tax and elections in Britain 1950–2001*, Election Studies, 24, 2005, pg. 401
263. Robbins, G. & Robbins, A. Tax Policy and the 1960s: Another Look At the Kennedy Tax Cuts, *Issue Brief*, 20 September 1996
264. John F. Kennedy, President's news conference, 20 November 1962
265. Savage, S. *JFK, LBJ and the Democratic party,* 2004 pg. 119
266. Savage, S. *JFK, LBJ and the Democratic party,* 2004 pg. 119

Two factors contributed to that popularity. Economic growth was very strong. Between 1961 and 1966 the US economy averaged 5.7 per cent growth.[267] That growth was clearly supported by the reduction in tax rates. And the tax reform itself, because it took the form of a large tax cut, was popular. Goldwater, the Republican presidential candidate who opposed Johnson in 1964, in sharp contrast to Reagan decades later, was unable to use tax as an issue. Indeed, Goldwater actually voted against the tax cut in the Senate, as did most strong conservatives in Congress, worrying it would unbalance the budget. This of course underlines one of the potential advantages of tax reform to a left-wing party, it helps to neutralise the tax issue. To this day, Johnson's 61 per cent of the vote remains a record for his party in a presidential election. There are many reasons why, but part of the explanation is that Democrats have not been the party of lower and flatter taxes as they were in 1964.

The Reagan tax cuts in 1981 are somewhat similar. This time it was a conservative Republican President seeking to secure tax cuts over real, if confused, opposition in Congress, this time mostly from liberals. There was strong popular support for the tax cuts and that helped ensure passage of the legislation. Indeed there had been a series of proposals for widespread tax cuts which culminated with the 1981 tax cuts. This in large measure reflected the growing 'bracket creep' whereby the high inflation of the period drove an increasing number of Americans into higher taxation brackets.[268]

The form the Reagan tax cuts took were more controversial including much sharper falls in tax rates (ironically they were less regressive than the tax changes of the Kennedy administration). They included a 23 per cent decrease in tax rates, a fall in the top rate of income tax from 70 per cent to 50 per cent and cuts in various business taxes.[269]

Unsurprisingly since it was a straight tax cut, the polling on the tax cut at the time was strongly positive, which was key to its passage through the US House of Representatives, which had a Democratic majority.

Subsequently at the elite level there was a consensus that higher taxation was necessary to close the record deficits of the 1980s, despite the fact that if spending had been frozen or even risen at a lower rate the deficits would have been eliminated. Higher revenues thanks to the economic growth produced by Reagan's policies, including lower tax rates, could have closed the gap. This consensus was overwhelming among Democratic leaders but the same view was also held by many Republican leaders. At the same time the main falls in rates were broadly accepted by the elite. This partly represented the difficulty of running on a platform of tax increases, but also an increasing awareness among left-wingers and Democrats of the advantages of lower tax rates. All this helped lead to a series of modest tax increases without increasing income tax rates. Every year from then until 1986 there was a modest reduction of allowable deductions, particularly for business. Payroll taxes, which are roughly equivalent to National Insurance, were however raised in 1982, as were some sales taxes.[270]

The public was much more supportive. Asked about whether income taxes were too high, polling suggested a slight fall in public support for the proposition but support remained well above 55 per cent.[271] In the 1984 election Walter Mondale, a strong opponent of the Reagan tax cuts and an open supporter of higher taxation,

267. Robbins, G. & Robbins, A. Tax Policy and the 1960s: Another Look At the Kennedy Tax Cuts, *Issue Brief*, 20 September 1996
268. Morgan, I. W. *Deficit government: Taxing and Spending in Modern America*, 1995, pg. 143
269. Tempalski, J. *Revenue Effects of Major Tax Bills*, Office of Tax Analysis, September 2006, pg. 12
270. Morgan, I. W. *Deficit government: Taxing and Spending in Modern America*, 1995, pgs. 164–165
271. Newport, F., Moore, D. W. & Saad, L. *Long-Term Gallup Poll Trends: A Portrait of American Public Opinion Through the Century*, 20 December 1999

was the Democratic nominee. The result was the worst defeat for a Democratic presidential nominee since the Second World War. Reasons probably included Reagan's successful defeat of inflation and negative memories of Jimmy Carter's administration (under whom Mondale had been vice-president), but the power of the tax issue was clearly part of the story.[272]

Thus there was a powerful elite consensus for higher taxation particularly via broadening the tax base, but a newfound scepticism about higher tax rates.

This helped set the stage for the tax reform of 1986–87. This consisted in essence of big cuts in individual and corporate rates (for example the top rate fell from 50 per cent to 28 per cent) paid for by broadening the base, particularly on corporate income (and within that particularly on real estate) but also on personal income (for example, getting rid of deductions for state sales tax). In doing so the reform took on a whole range of very powerful interests including the real estate industry. This got a much more enthusiastic reaction among political elites than either the Kennedy/Johnson or earlier Reagan tax cuts but the evidence of public enthusiasm is low, for example a majority said they did not think it had reduced their taxes or made them simpler.[273] Reflecting this political reality, deductions have been revived in the code, but the new lower rates have basically endured.

Due to the way the US political system works, it is perfectly possible for bipartisan reforms to be reversed. In the Reagan administration this happened to Medicare Catastrophic Coverage Act (providing emergency medical care for retirees with taxes and charges to pay for it), which passed by much bigger margins than the 1986 Tax reform[274] but was then repealed in the face of popular opposition. This rare case of a bipartisan Tax reform shows that it can be done and can endure but that if it is revenue neutral popular support is likely to be feeble. Preventing new tax breaks such as deductions, even if that is supported in principle by political elites, is always difficult and more difficult than resisting increases in the rate, which creates obvious losers.

3.5.3.2.2. New Zealand

The new Labour Prime Minister, David Lange, entrusted Roger Douglas with economic policy in 1984. Douglas reformed New Zealand's economic policy in a number of different ways, for example by introducing unilateral reductions in tariff barriers. It is perhaps the paradigmatic example of a Social Democratic party introducing radical free market reform.

A crucial part of this was reforming New Zealand's complex tax code. When Labour took power, there were five income tax rates: 20 per cent (up to NZ$6,000); 31 per cent ($6,001–$24,000); 45.1 per cent ($24,001–$30,000); 56.1 per cent ($30,000–$38,000); and 66 per cent (above $38,000). By 1988, those income tax bands had been replaced with two: a lower rate of 24 per cent – up to $30,875 – and a higher rate of 33 per cent above that level, which was equivalent to 125 per cent of average earnings. To make up the shortfall in revenue, Douglas introduced a General Sales Tax. Exemptions and allowances which had proliferated under the old system were abolished. This was a revenue neutral tax reform, partly because there was an attempt to balance the budget and partly because of the creation of benefits for lower income families to prevent the changes adversely effecting them.

272. White, T. H. Election '84: The Shaping of the Presidency 1984, *Time*, 19 November 1984
273. Patashnik, E M. Reforms At Risk: what happens after major policy changes are enacted, pgs. 35–54
274. Holstein M. & Minkler, M. The short life and painful death of the Medicare Catastrophic Coverage Act, *International journal of health services*, 21, 1, 1991

However, even better known than these fiscal reforms is Douglas's failure to secure a full flat tax despite having succeeded in having it announced as government policy (in Labour's second term). This led to Douglas's resignation in 1988.

Two differences between the situations are particularly worth underlining. Lange had been supportive of the first term changes, but was fervently opposed to the changes in the second term. The failure of Douglas's proposal occurred at almost the same time as the passage of the Lawson tax cuts in 1988, which had Thatcher's support. In a Westminster-style democracy, a supportive Prime Minister is necessary if tax reform is to succeed. Lange's opposition (and that of many others in the Labor Party) seems to have been heavily rooted in objections to the reduction in planned social service expenditure of NZ$600 million (13 per cent) necessary to pay for Douglas's proposal. As mentioned earlier, the earlier tax reform had been revenue neutral.[275]

3.5.3.2.3. Australia

In 1993, John Hewson, the Liberal leader (the Liberal Party in Australia is the larger of the two 'coalition' parties which are roughly equivalent in ideology and support base to the Conservative Party in Britain), ran for office on a platform of introducing a much flatter tax system partly through the introduction of a GST (goods and sales tax). This is often seen as a classic case of an election losing tax reform proposal. Indeed Labor, which had been deeply unpopular in a recession, secured a come-from-behind victory with a campaign which attacked the proposed tax of 15 per cent on all goods. This forced the coalition into concessions, in particular an exemption for food from the proposed tax. Though consistently behind in the polls, Labor ended up winning the election in an upset reminiscent of the Conservative victory in the UK in 1992.[276] This seems a rare case where the promise of tax reform proved poisonous to a party of the right, and a reminder of the danger 'losers' (or potential losers) pose for tax reform.

It is hard to avoid the conclusion that a less specific proposal which emphasised income tax cuts, reminiscent of Thatcher in 1979, would have worked better for the Liberals. However some particular factors about this defeat should be noted.

First, while the GST was blamed for the defeat within the Liberal Party[277] it is not clear this was the case. Proposed reforms of the health system were highly unpopular as well and one attempt to measure the effect of the GST actually found it might have been viewed neutrally by the electorate.[278]

Second, this election occurred in the context of an extremely shrewd Labor strategy on tax. In particular they pledged to match the income tax cuts promised by the Liberals. After the election this, combined with their lack of spending restraint, was to lead to increases in indirect taxes and broken election promises.[279]

Crucially, Labor had credibility in this because they had embraced tax reform in a way somewhat reminiscent of their namesakes in New Zealand. In a sense, the 1993 victory can be seen as a victory for more moderate tax reform over a more radical vision. The Australian Labor Party had kept power partly by attacking the radicalism of the Liberals' tax reform proposals, but had already brought in significant measures itself (thresholds had been frozen with the result that an increasing proportion of the electorate was paying in higher bands).

---

275. Stevens, R. J. Flattening the Tax Rate Scale in New Zealand in Head, J. G. & Krever, R. (eds) *Flattening the Tax Rate Scale: Alternative Scenarios and Methodologies*, 1990

276. Eccleston, R. *Taxing Reforms: The Politics of the Consumption Tax in Japan, the United States, Canada and Australia*, 2007, pg. 77

277. Barnett, P. & Goward, P. *John Howard: Prime Minister,* 1997, pg. 613

278. Bennett, S. *Winning and losing Australian National Elections*, 1996, pg. 167

279. Eccleston, R. *Taxing Reforms: the Politics of the Consumption Tax in Japan, the United States, Canada and Australia*, 2007, pg. 75

In 1983, when Labor entered office, income tax rates had consisted of a nil rate band up to Aus$4,462; 30.67 per cent ($4,463–$17,894); 35.33 per cent ($17,895–$19,500); 46 per cent ($19,501–$35,788); and 60 per cent (over $35,788). By 1990, the marginal rates were a nil rate band up to $5,100; 21 per cent ($5,101–$17,650); 29 per cent ($17,651–$20,600); 39 per cent ($20,601–$35,000); 47 per cent ($35,001–$50,000) and 48 per cent (over $50,001). Though inflation meant this was less impressive than it sounds, it was still a flattening in the code.[280] This helped neutralise Liberal calls to go further, of which 1993 was the culmination. In 1987 for example they had called for the introduction of three thresholds: one of 0 per cent (to $5,900 but clawed back at 52 cents in the dollar when income rose about $20,000), another of 25 per cent ($5,901–$31,350) and a third of 38 per cent ($31,351 and above).[281]

There is a significant sequel to the 1993 Liberal disaster. After over a decade out of power, the party won under the leadership of John Howard in 1996. An election was held just two years later, and in the run up to the 1998 election he then made the intention to introduce a GST clear. Strong advertisements clearly linked it to income tax cuts. Polls now showed a much more clear 56 per cent to 37 per cent support for a GST, albeit one linked to income tax cuts.[282] This is partly ascribed to careful preparation, for example setting out protection for the poor with increases in welfare payments.

Nonetheless, there was a sharp swing against the government (they actually got fewer votes than their Labor opponents) and they lost their majority in the Senate (Australia's upper house) but were able to pass a slightly modified GST with support from the minority Democrats (essentially equivalent ideologically to the Liberal Democrats).

Once passed however the GST was quickly accepted. Labor attempted to run on a 'rollback' in the 2002 election but only for utilities (that is, it was arguably more supportive of the GST than the Liberal policy of 1993) and this time Labor ended up unexpectedly losing the election. Polling suggested their modest attempt to rebalance away from the GST was actively unpopular.[283] The career of the most successful Australian politician of the late 20th Century illustrates both the dangers of tax reform and the opportunities. In particular it suggests both the dangers of specific tax reform proposals, and the degree to which they are easily accepted and even popular once passed.

3.5.3.3. Tax reform in Central and Eastern Europe

Aspects of the tax system proposed by the 2020 Tax Commission can be seen beyond the English speaking world. For example Switzerland has an extremely low corporate tax rate of 8.5 per cent (there are also canton-level corporate taxes of five to 18 per cent). Not only is this accepted by elites but also by the public. Switzerland is unique among western democracies in the ease with which laws, including tax laws, and the constitution can be changed by referendums, but the low corporate tax rate has not faced serious attack. Indeed the chief challenge to Switzerland's exceptionally low rate has been from the right, not the left. The Swiss People's Party, which over the last fifteen years has grown from the fourth to the largest political party, has attacked

280. Head J. G. & Krever, R. E. *Flattening the Tax Rate Scale: Alternative Scenarios and Methodologies*, 1990

281. Head J. G. & Krever, R. E. *Flattening the Tax Rate Scale: Alternative Scenarios and Methodologies*, 1990

282. Lewis, C. The Howard Government: The Extent to which Public Attitudes Influenced Australia's Federal Policy Mix. *Australian Journal of Public Administration*, 66, 83–95, 2007

283. Eccleston, R. *Taxing Reforms: the Politics of the Consumption Tax in Japan, the United States, Canada and Australia*, 2007, pg. 75–76

the corporate tax rate, calling for a cut in corporate tax from 8.5 per cent to five per cent.[284] However, Switzerland's tax rates are stable and for native Swiss there is not a flat tax or anything resembling it.

The collapse of the Soviet Bloc replaced a system where in the main the government collected its revenues directly from industry to one reliant on taxation. There have been a series of reforms in Eastern Europe that resemble the proposals of this report. These tend to introduce a common personal tax rate (albeit usually with allowances and some retention of a National Insurance equivalent) and a separate (but similar or identical) corporate tax rate. The most famous is Estonia, where it was introduced in 1994 replacing varying personal rates of 16 per cent to 33 per cent and a corporate rate above 26 per cent with both being set at 26 per cent.

Similar rates have been achieved in other Eastern European Countries: in Lithuania in 1995, (personal income tax of 18 per cent to 33 per cent being replaced with one of 29 per cent); in Latvia in 1997 (personal rates of 10 per cent and 25 per cent being replaced by one rate of 25 per cent). A further wave of reform followed after 2003, spreading beyond the Baltic States. It included Slovakia in 2004 (personal income taxes of 10 per cent to 38 per cent being replaced by a common rate of 19 per cent); Romania in 2005 (personal rates of 18 per cent to 40 per cent being replaced by one of 16 per cent and corporate tax rates cut from 25 per cent to 16 per cent); Bulgaria (personal rates of 10 per cent to 24 per cent and a corporate rate of 14 per cent replaced by 10 per cent across the board); the Czech Republic in 2008 (personal rates of 12 per cent to 22 per cent replaced by a standard rate of 15 per cent and the corporate rate cut from 24 per cent to 15 per cent); and most recently Hungary in 2011 (corporate rates of 10 per cent and 19 per cent and personal rates of 17 per cent and 32 per cent replaced by corporate and personal rates of 16 per cent).

In all cases the initial reform was highly controversial, disagreement being generally on right/left lines. Only in Latvia was it introduced by a government of National Unity. In every other country the main opposition initially opposed it, in many cases fervently, sometimes threatening to repeal it. However these flat taxes have so far stood the test of time. In no case has there been a wholesale reversal, the nearest being Slovakia which has abolished the allowance for the most affluent. In several, including Estonia, there have been further cuts in rates.

Flat taxes have so far stood the test of time

Again we find that, once a tax reform has been passed, repealing it becomes politically difficult. In the case of Eastern Europe, several other interrelated factors should perhaps be emphasised. Eastern European economies, with the exception of Slovenia,[285] have become reliant on high levels of foreign direct investment. This makes sending out signals in favour of markets and enterprise particularly important. Flat taxes have been regarded as a key signal.

However this experience also reinforces another aspect, namely the degree to which the effectiveness of tax reform in promoting increases in revenue tends to win over political elites once the tax reform is established.[286] The introduction of flat taxes in Eastern Europe has not been associated with sudden falls in revenue as a percentage of GDP and so has become a stable part of the fiscal environment.

Such reforms might, of course, endure in good times but fail in a crisis. The financial crisis has seen a reversal of certain market reforms in order to raise revenue, for example by raiding the recently set up private pension accounts. However tax reforms seem to

284. Swiss People's Party Manifesto, http://lowtax.es/HbI2DK
285. Drahokoupil, J. *Globalization and the State in Eastern Europe The Politics of Foreign Direct Investment*, 2009
286. Miroslav, B. *Why has the crisis been bad for private pensions, but good for the flat tax? The sustainability of 'neoliberal' reforms in the new Member States*, CEPS Working Document, October 2011

have survived. This in part probably reflects the degree to which tax reform is very hard to override due to the number of potential losers and the fact that the flattening elements of tax reform do not reduce revenue as much as expected before the reform, or at all.

Eastern Europe provides a contemporary example where radical recent tax reform along lines broadly similar to this report does tend to be controversial and unpopular when passed. But it rapidly beds down and becomes part of the fiscal furniture afterwards.

3.5.3.4. International evidence

The importance of reductions in rates is examined cross-nationally in a recent academic study. Comparing the results for 102 elections from 1990 to 2006 in 19 well established western democracies and controlling for unemployment and growth, this found that on average for a right wing party a one per cent increase in the basic income rate reduces the vote by 0.75 per cent. The effect was much less significant for left wing parties (the authors suggest because they are expected to deliver more spending rather than lower taxes) but the effect was still about half as strong.[287] This emphasises the importance of tax reform not increasing the standard rate for normal voters and ideally reducing it. As we have seen the evidence when examining the UK alone over a half century is slightly different suggesting higher rate income tax is more important than tax rates on lower incomes for election results. Reducing income tax rates is popular with most voters, increasing them dangerous, even ignoring the damage high tax rates do to the economy.

3.6. Spending should be cut to 33 per cent of national income, too

In 2011–12, Britain had Public Sector Net Borrowing of some £126 billion (or 8.3 per cent of Market Price GDP). At the end of that financial year, the official national debt was £1,039 billion. To some extent that constitutes an obstacle to plans for ambitious tax reform, and real total public sector liabilities will have been much higher (Section 3.6.2.1). But the most successful fiscal adjustments are based on lower spending, not higher taxes (Section 3.6.3). More than that, the scale of the crisis means that serious tax reform is essential to deliver the economic growth that will ease those pressures over time.

The main conclusion of the first annual Fiscal Sustainability Report, released by the Office for Budget Responsibility in July 2011, was that demographic pressures would be a key source of pressure on the public finances over the next few decades. Population pressures on their own were anticipated to lead to a 5.4 per cent increase in the ratio of government spending (excluding debt interest) to national output between 2015–16 and 2060–61, the equivalent of £80 billion in today's prices, in the central scenario. Increased age-related spending on health and higher state pension costs were both expected to account for an additional 2.4 per cent of national output over this period, while social care costs were expected to add an extra 0.8 per cent to the share of government spending in GDP.

As a result, the primary budget balance (the difference between revenues and non-interest spending) was expected to deteriorate by 4.5 per cent of national output, or £66 billion in 2011 prices, between 2015–16 and 2060–61 while public

287. Tillman, E. & Park, B. Unemployment, Do Voters Reward and Punish Governments for Changes in Income Taxes? *Journal of Elections, Public Opinion and Parties*, 19, 3, 2009

sector net debt was expected to increase by 47 per cent of GDP over the same period. Things may be worse as the short term forecasts have since been downgraded leading to a worse starting position.

Recent research by the Bank for International Settlements (BIS),[288] setting out public debt projections for the thirty years, also led the authors to conclude that: "the path pursued by fiscal authorities in a number of industrial countries is unsustainable".

That is why tax reform should not proceed at the price of higher deficits over time. Higher borrowing has its own harmful economic effects (Section 3.6.2.2). And Keynesian claims that deficits will spur growth are not just short termism but likely misguided as the Multiplier is too low in an open economy like Britain's (Section 3.6.2.3.1), and there is evidence that people respond to higher deficits by saving more to offset higher expected taxes in the future (Section 3.6.2.3.2).

After the reforms set out in this report – cutting marginal Income Tax rates, increasing the personal allowance and cutting or abolishing other taxes – the tax system would have been able to generate around 33 per cent of national income in 2010 and therefore should not mean adding to the deficit if spending can be reduced to that level (Section 3.6.4). To get there, further spending restraint would be needed and a spending target of 33 per cent of national income would help achieve that, along with other supporting policies (Section 3.6.5).

3.6.1. In some regions spending is particularly high and crowding out the private sector

Research by the Centre for Economics and Business Research shows dramatic disparities in the extent that spending is a higher or lower as a share of income in different regions.[289]

Table 3.7: Government spending and deficits in UK regions, percentage of GDP at Market Prices, 2010–11

Region/country	Total receipts	Expenditure	Deficit	Deficit compared with UK
North East	29.7	61.9	-32.2	-22.2
North West	37.5	55.9	-18.4	-8.5
Yorkshire & the Humber	35.0	53.7	-18.7	-8.8
East Midlands	34.1	49.0	-14.9	-4.9
West Midlands	35.4	53.8	-18.4	-8.4
East	36.7	45.1	-8.4	1.5
London	45.2	34.9	10.3	20.3
South East	41.1	40.3	0.7	10.7
South West	35.7	47.4	-11.7	-1.7
Scotland	43.0	53.0	-10.0	0.0
Wales	30.3	66.3	-35.9	-26.0
Northern Ireland	27.7	67.0	-39.3	-29.4
UK	37.9	47.9	-10.0	0.0

288. Stephen G Cecchetti, Ms Mohanty and Fabrizio Zampolli, *The Future of Public Debt: Prospects and Implications*, BIS Working Paper No. 300, March 2010
289. Centre for Economics and Business Research *One pound in five earned in London subsidises the rest of the UK – Northern Ireland, Wales and North East receive more than a fifth of their income as subsidies from outside the region*, 13 February 2012

Those substantial disparities are the result of pronounced differences in earnings and productivity. Unfortunately they may be exacerbated and entrenched by high spending and high taxes.

Before regional spending data became available, it was possible to believe that the main problem was not that public spending was harmful but that it had to be paid for and that all practical funding methods had adverse consequences that increasingly outweighed the gains. The underperformance of certain areas, despite decades of massive transfers from outside, suggests that high levels of government spending may themselves be responsible for the problems of the poorer regions, even when the public spending is funded by transfers from elsewhere. How can large amounts of free money be damaging?

Receipt of transfers can be harmful because they encourage people to look towards political activism and state dependency, rather than their own efforts in the marketplace. It leads to a misallocation of entrepreneurial talent of the kind envisaged by Baumol.[290]

Transfers will also affect the labour market. In particular, policies such as a minimum wage, out of work benefits and non-wage labour costs are often understood on the basis of their effect on the national economy. But if there are a series of distinct regional labour markets, with imperfect mobility between them, the impact of additions to labour costs will vary from place to place with the adverse impact being greatest in the low cost and low productivity regions and least in the high cost and high productivity areas. More jobs will be destroyed – or never created – in low productivity areas, such as the North East, than in London and the South East.

This point is illustrated in the third column of Table 3.8. That column scales the current £6.08 per hour minimum wage for the differences in median gross weekly earnings in the various regions of Britain. The table suggests that the minimum wage should range from £5.39 in Northern Ireland and £5.40 in the North-East, to £6.68 in South-East England, and £7.40 in London, if it were to reflect regional differences in median earnings. The fact that it does not do so explains why the minimum wage is likely to price more people out of employment in the North East than in London, for example. The percentage of the working age population with no qualifications was 8.4 per cent in the South East but 21.4 per cent in Northern Ireland in mid-2009.

290. Baumol, W. J. Entrepreneurship: Productive, Unproductive, and Destructive, *The Journal of Political Economy*, 98, 5, October 1990

Table 3.8: Median weekly earnings, productivity and minimum wage and tax thresholds corrected for regional differences

	Labour productivity (basic-price GDP per head in 2010)	Median gross weekly earnings in April 2010 (£)	Adult minimum wage scaled to reflect differences in median earnings (£'s per hour)	Scaled personal allowance for Income Tax in 2012–13 (£'s)	Inheritance Tax threshold corrected for house prices in December 2011 (£000's)	Percentage of working age population with no qualifications in 2009 Q2	Population of working age claiming a key social security benefit in February 2010 (%)
North-East	77.2	443	5.40	7,210	208	14.4	20.4
North-West	84.7	471	5.74	7,666	232	12.8	19.3
Yorkshire & the Humber	82.3	463	5.64	7,535	231	11.5	16.7
East Midlands	89.0	470	5.73	7,649	252	11.7	15.2
West Midlands	82.9	469	5.72	7,633	259	14.5	18.0
South-West	90.3	468	5.71	7,617	332	8.1	13.3
East	92.2	523	6.38	8,512	355	10.2	12.6
London	172.0	607	7.40	9,879	549	11.8	15.1
South-East	107.8	548	6.68	8,919	415	8.4	11.6
England	102.5	506	6.17	8,235	338	11.2	–
Scotland	98.7	487	5.93	7,926	246	13.0	17.9
Wales	73.3	456	5.56	7,421	231	14.3	20.3
Northern Ireland	75.1	442	5.39	7,194	212	21.4	–
UK	100.0	498	6.08	8,105	325	11.8	15.9

Welfare benefits in Northern Ireland, Wales, Scotland and Northern England – even when financed through taxes collected in London and the South East – can diminish employment in the recipient regions due to their micro-economic effects. That was the situation in the former East Germany, where West German employment costs were imposed on an economy where output per head was only around one-third of that in the former West. Similar problems have been observed in Poland by Zientara, where benefit levels set at a national level have almost no observable harmful effects in Warsaw but have been associated with a serious structural unemployment in the old centres of heavy industries.[291] And it is a well-understood problem for the Italian Mezzogiorno.

One response to the regional anomalies in the labour market associated with the present system would be to introduce regional differentials in welfare benefits and the minimum wage, to reflect the divergent productivity and living costs of the regions concerned.

Another response, widely practised in nations with a federal structure, is to make welfare benefits a responsibility of devolved arms of government, such as states, provinces or cantons. The local administration of welfare allows benefits to be set

291. Zientara, P. Regionalism and Free-Market Reform: The case of Poland, *Economic Affairs*, Institute of Economic Affairs, Volume 27, No. 2, June 2007

appropriately to local conditions, and reduces the problems caused by setting one benefit level across a heterogeneous area.

Public sector pay also needs to better reflect conditions in different regions. At Budget 2012 the Government announced it had "provided evidence to the Pay Review Bodies on the economic case for reforming public sector pay to better reflect local labour markets".

It has been known for some time that a relatively high tax burden at the level of individual states is associated with a poor economic performance in federal systems. However, recent years have seen the appearance of US studies which suggest that high government spending levels are damaging, even when they have been funded from outside. Such studies typically apply a neo-classical growth model to look at the effect of externally determined transfers from the US Federal government to individual states. One feature of such models is that exogenous transfers tend to lead to increased consumption but a withdrawal of labour hours, as citizens of the state can now afford to take more leisure, and also reduced private sector capital formation because of crowding-out effects and increased shareholder payouts.

Cohen, Coval and Malloy used the fact that the politically powerful Chairmen of Congressional Committees could use their powers to 'earmark' extra Federal spending for their constituencies to study the issue.[292] Since these expenditures were politically determined, they could then be treated as exogenous with respect to their effects on activity and employment within the recipient states concerned, which were examined using a sample of 16,734 firms over the period 1967 to 2008. The Harvard Business School authors concluded:

> *The central finding of this paper is that positive shocks to the seniority of a state's congressional delegation cause large and persistent increases in government allocated funding to the states, and significant retrenchment on the part of corporations headquartered in the state. This retrenchment appears to be a response to the large and persistent increase in federal funding that the state receives following the shock. Following the appointment of a senator to the chair of a powerful committee, we estimate that his state experiences, on average, a 40 per cent to 50 per cent increase in its share of congressional earmark spending, a nine per cent to 10 per cent increase in its share of total state-level government transfers, and a 24 per cent increase in its share of government contracts. At the same time, firms residing in the state cut their capital expenditures by eight per cent to 15 per cent, reduce their research and development spending by seven per cent to 12 per cent, and increase payout by four per cent to 13 per cent. Employment and sales growth are also impacted, as corporations scale back employment growth by 3 per cent to 15 per cent, and sales growth falls by up to 15 per cent.*

This finding is of interest because of the details it provides on the 'crowding-out' transmission mechanism involved when funds are allocated primarily for political purposes, irrespective of whether that occurs in the US or Britain.

Overall there is good evidence that receiving substantial fiscal transfers is depressing the economies of Britain's struggling regions.

292. Cohen, L., Coval, J. & Malloy, C. *Do Powerful Politicians Cause Corporate Downsizing?* Harvard Business School and National Bureau of Economic Research Discussion Paper, 7 October 2011

3.6.2. Public sector debt is a large and growing burden on taxpayers and the economy

3.6.2.1. Britain's official debt is substantial but the real national debt is much higher

The official national debt is only part of the public sector's total liabilities. Research for the TaxPayers' Alliance estimated that total liabilities are much higher and have risen dramatically. The findings are shown in Table 3.9.[293]

The intergenerational accounting measure of the off-balance sheet commitments of the state calculated by Hagist et al. suggests that Britain was already in the weakest situation of any industrialised country in 2004, well before the international financial crisis struck, as shown in Table 3.10.[294]

Table 3.9: Official and real public sector liabilities, 2000–01 to 2009–10

£ billion	2000–01	2005–06	200--07	2007–08	2008–09	2009–10
Official national debt (PSND)	311	462	498	622	742	890
Plus						
Unfunded public sector pensions	434	907	931	1104	1119	1283
Unfunded state pensions	1411	2028	2199	2370	2542	2717
RBS/Lloyds debt	0	0	0	0	3439	2585
PFI (capital only)	10	24	28	35	35	38
Network Rail debt	0	18	18	20	22	23
Nuclear decommissioning	14	31	37	44	45	45
Other	109	148	133	81	171	292
Real National Debt	2289	3617	3844	4276	8114	7873
Real National Debt (% of GDP)	231	285	286	302	566	560

Table 3.10: Fiscal gaps as a share of GDP in 2004 (%)

Country	Explicit debt	Implicit debt	Total
Spain	45.4	35.4	80.8
Switzerland	55.2	64.8	120.1
Austria	62.8	179.9	242.7
Norway	40.6	250.8	291.3
Germany	62.5	252.6	315.1
France	60.4	254.9	315.3
USA	57.1	350.8	407.9
Britain	37.2	510.0	547.2

293. Denham, M. *The Real National Debt: A Decade of Reckless Growth*, TaxPayers' Alliance, 19 October 2010
294. Hagist, C.. Moog. S.. Raffelhuschen, B., & Vater, J. *Public Debt and Demography – An International Comparison Using Generational Accounting,* CESifo Dice Report 4/2009, 2009

3.6.2.2. High and rising debt tends to mean lower economic growth

The seriousness of the debt issue across the developed world, and its potentially catastrophic consequences for monetary union, has caused the European Central Bank (ECB) to carry out several major studies of the subject. The conclusions are likely to apply to many other similar industrialised economies, including the UK.

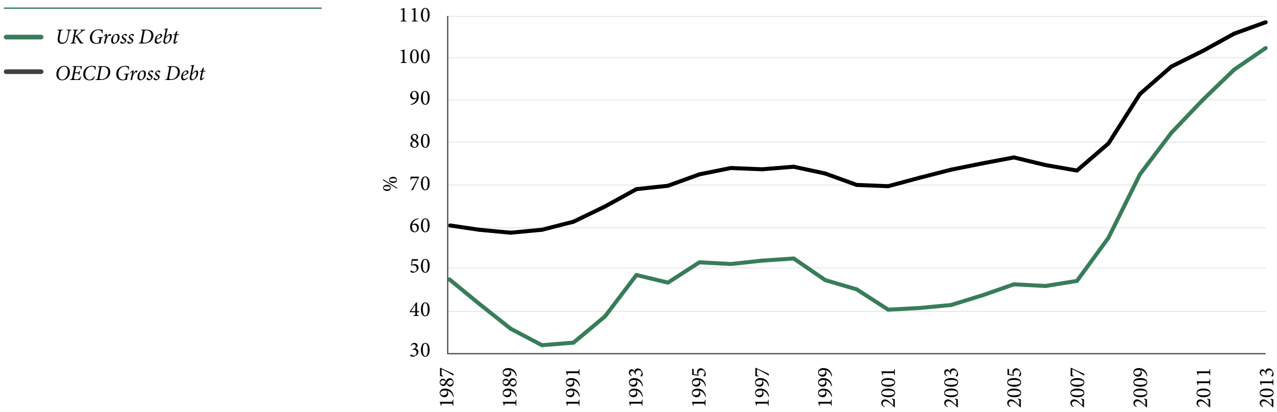
There is an independent negative crowding out effect through the budget deficit

A recent study by Checherita and Rother investigated the relationship between the government debt to GDP ratio and the growth rate of GDP per head for a sample of twelve eurozone countries for the four decades from 1970 onwards.[295] The basic empirical growth model related the growth rate of real GDP per head to the initial level of income per head, the ratio of investment/saving to GDP, population growth and the level of gross government debt as a share of national income. The relevant coefficients were estimated using a sophisticated panel-data approach, which allowed the effect of the debt to GDP ratio to take on an inverted U shape – i.e. positive initially and then switching to negative beyond a certain point.

The ECB researchers found several channels through which the level, or the change, in the government debt ratio adversely affected real growth including through: private saving; public investment; total factor productivity, and long-term interest rates. A robust conclusion was that public debt was harmful for economic growth above a threshold of some 90 per cent to 100 per cent of GDP but crowding out effects through the budget deficit (the change in the debt stock) had an independent negative effect below this threshold.

While that study's use of gross rather than net debt may not be ideal, it is significant that the aggregate OECD gross government debt to GDP ratio rose from 73.3 per cent in 2007 to 105.7 per cent in 2011, with figures of 90 per cent in the UK, 95.6 per cent in the eurozone, 97.6 per cent in the US and 219.1 per cent in Japan being recorded for last year. This implies that further increases in public debt and budget deficits will have a negative effect on growth in all the leading economic areas.

Figure 3.14: Ratios of General Government Gross Financial Liabilities to Nominal GDP at Market Prices 1987 to 2011 with OECD forecasts for 2012 and 2013



Reinhart and Rogoff also found that when debt as a share of GDP is above "90 per cent, median growth rates fall by one per cent, and average growth falls considerably more", and argue that "the economic impacts of high public

295. Checherita C. & Rother, P. *The Impact of High and Growing Government Debt on Economic Growth: an Empirical Investigation for the Euro Area*, Working Paper No. 1237, August 2010

indebtedness are not limited to […] episodes of high drama, as rising public debts are not universally associated with rising interest rates and imminent expectations of sovereign default".[296]

3.6.2.3. Keynesian demand management is unlikely to be effective

3.6.2.3.1. The Keynesian multiplier is not likely to be high enough in Britain for fiscal demand management to be effective

The main justification for the big increases in deficit-financed public spending, which followed the 2008 global financial crash in countries such as the US and the UK, was that this would help maintain economic activity in the wider economy. The fiscal multiplier is usually defined as the absolute change in real GDP caused by a one-unit increase in the volume of government expenditure. For example, if a $1 billion increase in US government consumption caused a $1.6 billion increase in US GDP, then the multiplier is 1.6 (this figure has been used by Obama administration officials to justify the increased US Federal government spending of recent years). Multipliers may differ across time horizons, and they may change sign as crowding out effects accumulate. This means that it is normal to distinguish between the *impact multiplier*, which reflects the effect in the current period (often one year); the *cumulative multiplier*, which measures the cumulative change from the time of the impulse to government expenditure to the reported time horizon; and the *long-run multiplier*, defined as the cumulative multiplier over all time periods.

Government expenditure is a component of GDP, so that any value of the multiplier less than unity implies a contraction in the private sector of the economy. It is only if the multiplier takes a value greater than unity that extra government spending provides any stimulus to private GDP. In the early days of Keynesian economics, it was occasionally argued that the multiplier took on extremely high values such as five or 10. However, empirical research from the early 1970s onwards suggested that the multiplier was at most 1.5 to two and that it could be unity or less. There was also some agreement that deficit financed spending would only be expansionary if monetary policy was accommodating. Otherwise, the likelihood was that extra public spending would crowd out an equivalent or greater volume of private activity. Much of the research into the multiplier has also assumed (usually implicitly) that aggregate supply and the structural rate of unemployment were unaffected by increased government expenditure, so that it was only demand side crowding out that was relevant.

The big increase in deficit financed public expenditure in recent years, and the apparent destabilisation of the public finances that has resulted, has led to new research into the value of the multiplier and what determines it. Ilzetzki, Mendoza and Vegh employed a quarterly data set for 20 high income and 24 developing countries to investigate the effect of government expenditure shocks in a working paper at the IMF.[297] The main findings were that the output effect of an increase in government consumption was larger in industrial than in developing countries; the fiscal multiplier was zero in countries operating under flexible exchange rates, such as Britain; fiscal multipliers were lower in open economies than in closed ones, and fiscal multipliers in relatively high debt countries where public debt was over 60 per cent of GDP were zero.

---

296. Reinhart, C. & Rogoff, K. *A Decade of Debt*, Centre for Economic Policy Research Discussion Paper No. 8310, April 2011

297. Ilzetzki, E., Mendoza, E. G. & Vegh, C. A. *How Big (Small?) are Fiscal Multipliers*, IMF Working Paper WP/11/52, March 2011

The IMF staffers found that the fiscal multiplier was generally very small on impact and less than unity in the long run and that it was also negative under certain circumstances, all of which implies that private expenditure is reduced not boosted by increased government spending. There was also no sign that higher public investment was stimulatory where developed countries were concerned, although it may be in developing countries as their infrastructure is in greater need of improvement. The authors concluded that:

> *Our results suggest that seeking the Holy Grail of fiscal stimulus could be counterproductive, with little benefit in terms of output and potential long-run costs due to larger stocks of public debt. Moreover, fiscal stimuli are likely to become even weaker, and potentially yield even negative multipliers, in the near future because of the high debt ratios observed in countries, particularly in the industrialised world.*

A broadly contemporaneous paper from Cwik and Wieland, researchers at the European Central Bank,[298] used five different macroeconomic models with Keynesian features, such as wage and price rigidities, to investigate whether the spending packages announced by euro area governments for 2009 and 2010 were likely to boost GDP by more than the one-to-one needed to avoid damage to private activity. They concluded that New Keynesian models do not support the old-fashioned textbook Keynesian multiplier effect and that European governments' increased spending plans would result in a reduction in private sector spending for consumption and investment purposes. One reason was the forward-looking behaviour of households and firms who anticipated higher tax burdens and interest rates in the future and therefore reduced their consumption and investment (Section 3.6.2.3.2). They also argued that New Keynesian Dynamic Stochastic General Equilibrium models provided a strong case for government spending cuts. Announced with sufficient lead time, anticipated future cuts induced a significant short run stimulus and sustained crowding in of private spending.

Other studies have come to different conclusions. Guajardo, Leigh and Pescatori found that fiscal consolidation leads to weaker private domestic demand in another IMF working paper.[299] The IMF authors attempted to identify the truly autonomous element of fiscal consolidation using Budget speeches and IMF documents and claimed that estimates based on conventional measures of fiscal policy appeared to be biased towards overstating the expansionary effects of fiscal consolidation. Adams and Ganges found that the multipliers for government expenditure on real GDP were around one to two in the case of the US.[300] This relatively high value may reflect the fact that the US is a more closed economy than most European ones, as well as the different properties of the specific forecasting model employed.

Those results have been challenged by an ingenious recent paper by Barro and Redlick, which examined the multiplier effects of US military spending over the years from 1912 to 2006, and incorporated a measure of the average marginal rate of income tax. They found that the multiplier was significantly greater than zero but

298. Cwik, T. & Wieland, V. *Keynesian Government Spending Multipliers in the Euro Area*, ECB Working Paper Series no. 1267, November 2010

299. Guajardo, J., Leigh, D. & Pescatori, A. *Expansionary Austerity: New International Evidence*, IMF Working Paper WP/11/158, July 2011

300. Adams, F. G. & Ganges, B. Why Hasn't the US Economic Stimulus been More Effective: the Debate on Tax and Expenditure Multipliers, *World Economics*, 11, 4, October – December 2010

less than one.[301] Estimated multiplier values of around 0.6 to 0.7 at the median unemployment rate were a typical result. This confirmed that there was a considerable crowding out of private expenditure when military expenditure rose and possibly other exogenous government spending components as well.

Britain may possess an unusually low – or even negative – fiscal multiplier because of its openness, floating exchange rate and high debt stock

An important conclusion from the various international studies is that Britain may possess an unusually low – or even negative – fiscal multiplier because of its openness, floating exchange rate and high debt stock.

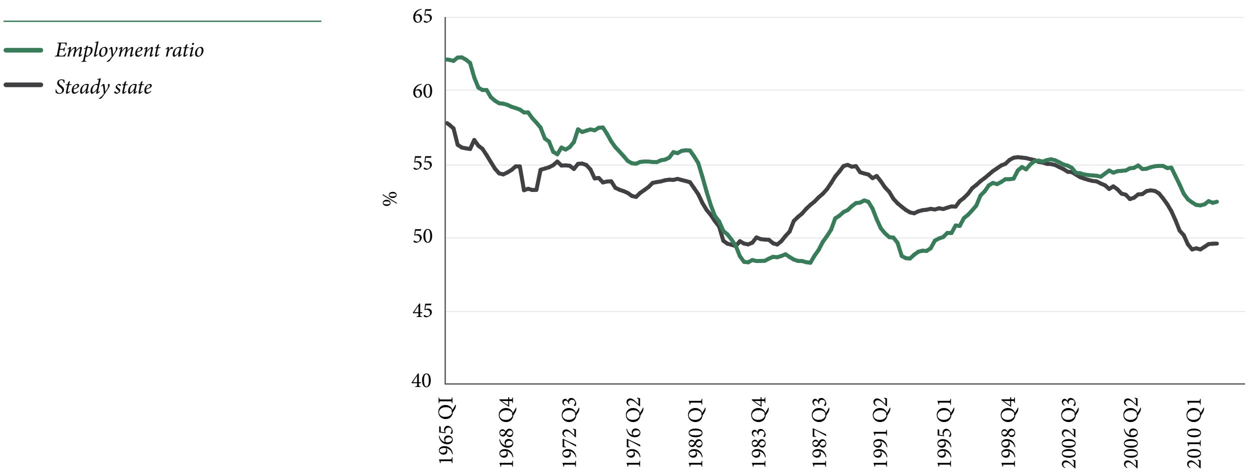
Perhaps the most basic claim of Keynesian economics is that high levels of government spending can create private sector jobs, through the expansionary second-round effects of the fiscal multiplier. But the research discussed so far tends to imply that extra government spending crowds out private expenditure, irrespective of whether it is financed by taxation or by borrowing.

It is not difficult to test the claim that high spending levels are positively related to high levels of private sector employment though. Since the public spending ratio is a bounded variable, in the sense that it can never exceed 100 per cent, the fairest statistical comparison is with the ratio of private sector employment to the population of working age, since this is a similarly bounded variable. Using a normal general to specific modelling strategy, the long-run steady state relationship that emerged was:

*EMPRAT%= 77.0754 – 0.5182*SPENDRAT%*

Where: EMPRAT% = ratio of private-sector employment to the population of working age expressed as a percentage, and SPENDRAT% = ratio of General Government Expenditure to non-oil GDP measured at basic prices, also expressed as a percentage.

Figure 3.15: Ratio of UK private sector employment to population of working age and 'fitted' using long run steady state from a statistical relationship with the share of general government expenditure to non-oil money GDP at basic prices, 1965



301. Barro, R.J. and Redlick, C.J. *Macroeconomic Effects from Government Purchases and Taxes*, Harvard Discussion Paper, October 2009. The authors chose to work with military expenditure because it can be considered as exogenous to the wider economy.

The error correction relationship involved had an R-bar-squared of 48.87 per cent where the quarterly changes in the employment ratio were concerned and the standard error was 0.23 percentage points. There was also a satisfactory Durbin Watson statistic of 2.04, suggesting that there were few systematic elements in the residuals that had not been accounted for.

The interpretation is that 77.1 per cent of the population of working age would be employed in the private sector if there was zero government spending[302] – this should not be taken literally, because zero is completely outside the range of the spending ratio data (the mean government spending ratio over the estimation period from 1964 Q4 to 2011 Q3 was 46.1 per cent with a range of 37 per cent to 53.9 per cent) – and that each one percentage point rise in the spending ratio was associated with a 0.52 percentage point drop in the private-employment ratio. There was a two quarter 'dead start' before changes in the spending ratio adversely affected the private-employment ratio so the direction of causation involved seems to be reasonably unambiguous. Figure 3.15 provides a comparison of the private employment ratio with the long run steady state of this estimated relationship.

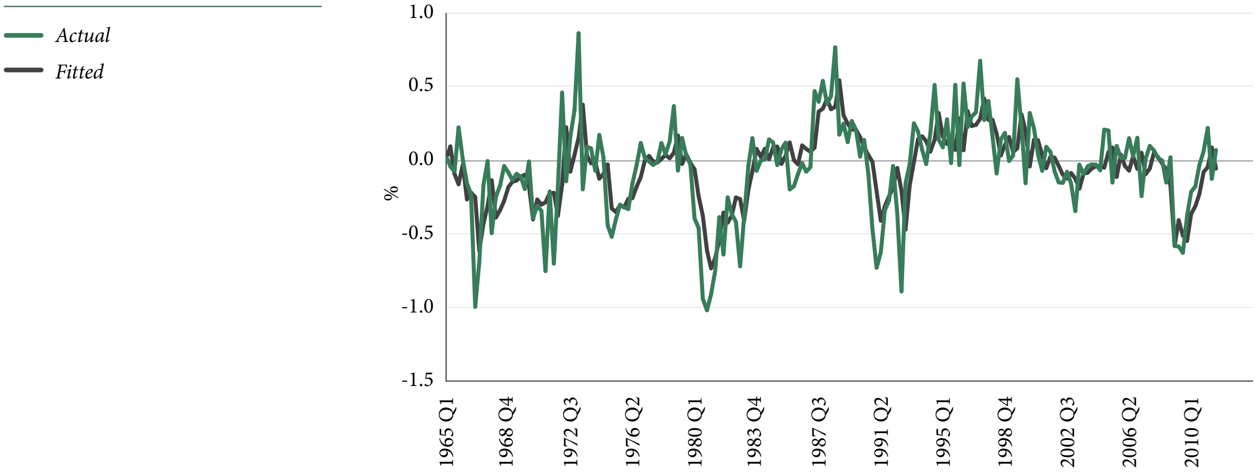
The fact that government spending can be used to increase public sector payrolls means that it remains possible that extra government jobs could more than compensate for the employment lost in the private sector as a result of an increased spending ratio. However, this leaves a financing problem because net tax receipts are generated by private sector employment while public sector costs are driven by the government wage bill.

Public sector pay is 7.8 per cent higher than private sector pay

With public sector wages now significantly higher than those in the private sector it seems unlikely that increasing government spending leads to higher employment in the economy as a whole. The Office for National Statistics has estimated that even after accounting for "differences in the types of job and characteristics of employees […] as far as possible" public sector pay is 7.8 per cent higher than private sector pay.[303] The Institute for Fiscal Studies has come to a similar estimate and found that average hourly wages were 8.3 per cent higher after adjusting for public sector workers having "greater experience and more education". The difference is particularly stark in those Northern regions where living costs are noticeably lower than they are in London and the South East. The Institute for Fiscal Studies reported that there was "no evidence of a public sector pay premium in the South East of England, while in Wales the estimated premium is 18.0 per cent for men and 18.5 per cent for women."[304]

302. Stay at home parents, students and the incapacitated all help explain why one would not expect a 100 per cent private employment to working age population ratio even in a theoretical state with zero government.
303. Damant, A. & Jenkins, J. *Estimating differences in public and private sector pay*, Office for National Statistics, July 2011
304. Emmerson, C. & Jin, W. Public sector pensions and pay, *Institute for Fiscal Studies Green Budget 2012*, February 2012

Figure 3.16: Plot of actual and fitted values for quarterly changes in the private sector employment ratio, 1965 Q1 to 2011 Q3



The relationship considered here is far simpler than those typically incorporated in econometric models, which operate at a higher level of detail. In the Beacon Economic Forecasting model, for example, total employment is broken down into manufacturing jobs, other private employment and government employment, while the self-employed, armed forces personnel and those on work-training programmes are also separately distinguished. The evidence here represents no more than a simple statistical challenge to Keynesian claims that higher government spending boosts private sector growth and employment.

3.6.2.3.2. There is evidence that the public respond to higher deficits by saving more to pay for the future taxes expected as a result, which undermines the efficacy of fiscal demand management

Ricardian equivalence is the concept that, because people see that higher taxes or lower spending will be needed in the future to pay for current budget deficits, they save more than they would have done otherwise straight away. This then negates the effects of the intended Keynesian fiscal stimulus.

"Ricardian equivalence holds as a close approximation"

The concept has been controversial since it was first introduced by Barro.[305] While a number of economists have been highly critical, and quite extreme behavioural assumptions would need to hold for it to apply exactly, many studies have found that it holds to a sufficient extent that it undermines the effectiveness of fiscal stimulus. Seater has summed up the evidence:[306]

> *Needless to say, so revolutionary a theory has not gone unchallenged, and its revival has led to extensive research, both theoretical and empirical, into the effects of government debt on the economy. The fruit of that effort is the subject of this essay. Although the aggregate effects of public debt and deficits have not yet been fully determined, two overall conclusions are now clear.*
>
> *The first appears uncontroversial: it seems almost impossible that Ricardian equivalance holds exactly. The theoretical foundations for any effects of debt on the economy depend on subtle concepts such as the*

305. Barro, R. J. Are Government Bonds Net Wealth? *Journal of Political Economy*, 82, 6, December 1974
306. Seater, J. J. Ricardian Equivalence, *Journal of Economic Literature*, 31, 1, March 1993

intensity of intergenerational altruism, the possibility of strategic behaviour by individuals in their family relations, the nature and extent of liquidity constraints, and the effects of various kinds of uncertainty on the household maximisation decision. Careful examination of those factors suggests that exact Ricardian equivalence is implausible.

The second conclusion is far more controversial: despite its nearly certain invalidity as a literal description of the role of public debt in the economy, Ricardian equivalence holds as a close approximation. Although there is much empirical evidence appearing to reject Ricardian equivalence, a dispassionate reading of the literature leads to the stated conclusion. Testing theories of government debt's effects is not trivial. Estimation is sensitive to the treatment of specification, simultaneity, and data stationarity, as well as simple measurement of the quantities involved, so that careful attention to interesting issues of econometric methodology is essential. Much of the published evidence on Ricardian equivalence, both favourable and unfavourable, fails to attend to those issues and is sufficiently flawed to be uninformative. When attention is restricted to the more methodologically sound studies, it is difficult to find statistically significant effects of debt, suggesting that Ricardian equivalence holds approximately.

Real PDE is the volume of private domestic expenditure (real PDE), which is defined as non-welfare-financed household consumption, private investment and stock building. This was equivalent to some 67.1 per cent of the basic-price measure of UK GDP[307] last year.[308] It is the main domestic variable that is operated on by monetary policy, although net exports are weakly influenced by the real exchange rate, which reflects the relative stringency of UK monetary policy compared to overseas. In theory, the government's fiscal decisions should be taken with a view to moderating the volatility of PDE, if one accepts the original Keynesian demand management view that the task of fiscal policy is to counterbalance an inherent instability in the private sector.

307. Both the factor cost adjustment and the similar basic-price adjustment take out indirect taxes and add back subsidies, to correct for the fact that both are included in the main expenditure items. The main difference between the two is that the factor cost adjustment takes out *all* indirect taxes the basic price adjustment takes out *most* indirect taxes. If the GDP components were individually expressed at factor cost and/or basic prices the main effects would be to reduce the shares of household consumption and PDE. The other GDP components are only lightly affected by taxes and subsidies.
308. Or 55.2 per cent if the basic price adjustment is taken off PDE.

Table 3.11: Private and government sector components of expenditure measure of UK Money GDP at Basic Prices in 2008

	Value (£bn)	Basic price GDP (%)	Volume change 2008 to 2011 (%)
Privately-financed household consumption	713.4	55.6	-7.1
Welfare-financed household consumption	164.6	12.8	12.4
Non-profit institutions	35.8	2.8	-2.4
Government consumption	315.6	24.6	1.5
Government investment	32.9	2.6	5.0
Private & 'other' investment	208.4	16.2	-14.4
Stock building & valuation changes	2.3	0.2	–
Exports	422.9	32.9	1.7
Equals: total final expenditure	**1,895.9**	**147.7**	**-2.3**
Less: imports	462.0	-36.0	-3.5
Less: basic price adjustment	150.0	-11.7	0.4
Equals: GDP at basic prices	**1,283.8**	**100.0**	**-2.0**

Table 3.11 is an attempt to make the distinction between Real PDE and other parts of the economy clearer.[309] It does so by breaking up the GDP identity to distinguish between its general government and private sector sub-components. The second column shows the shares of each component in basic price GDP, while the third column shows the volume change between 2008 and 2011. The table brings out the very different experiences since 2008 in privately-financed household consumption, which contracted by 7.1 per cent in the three years to 2011, and welfare-financed consumption, which increased by 12.4 per cent. A similar contrast between government and private sectors can be observed in the case of investment, with government capital formation rising by five per cent but private investment falling by 14.4 per cent.

These divergent experiences explain why aggregating government spending and private expenditure can lead to a serious underestimation of the extent to which the private sector reacts to a tax shock, for example. This can be seen from Figure 3.17. The chart confirms that real PDE is noticeably more volatile than overall GDP, reflecting the way in which imports act to offset fluctuations in domestic consumer demand as well as counter-cyclical movements in government spending.

309. Office for National Statistics data. Non-profit institutions serving households are a hybrid of private charities and government-funded institutions such as universities. Some 80 per cent is probably funded by government, but there is no official breakdown available.

Figure 3.17: Annual per cent Changes in UK Real GDP at Basic Prices and Real Private Domestic Expenditure 1965 Q1 to 2011 Q4

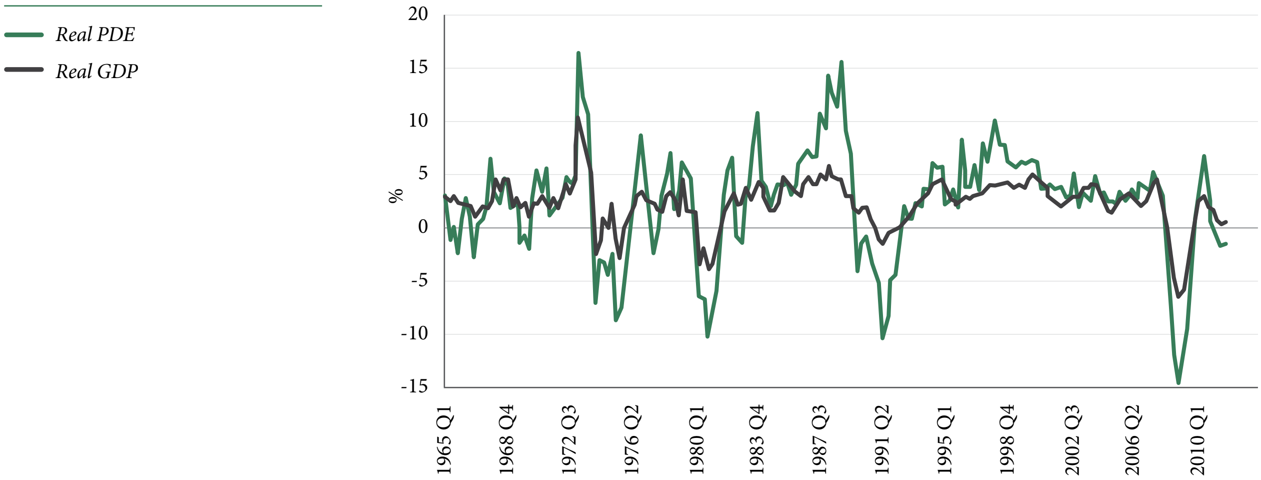
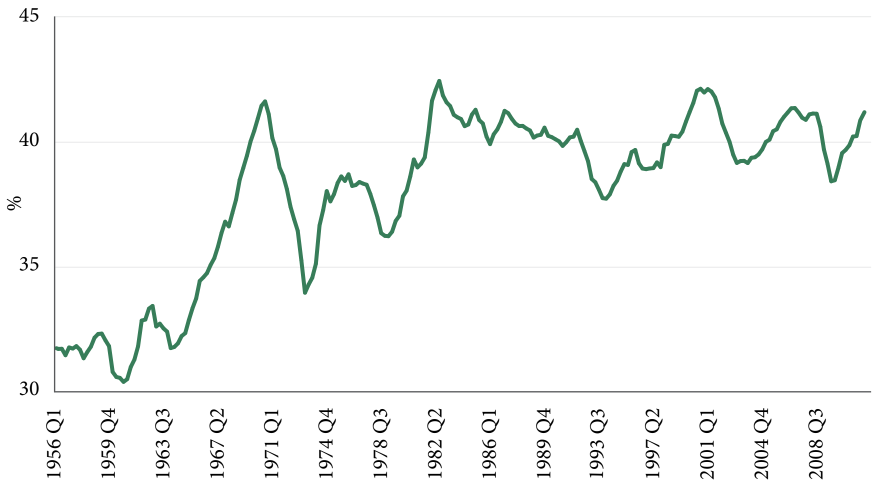


Figure 3.18: Ratio of Smoothed UK Non-Oil Tax Receipts to Non-Oil Money GDP at Basic Prices 1956 Q1 to 2011 Q4



In order to evaluate whether there was a significant difference between the effects of the budget deficit and the tax burden, a standard general-to-specific modelling strategy was employed in which the logarithm of real PDE was initially related to: its own past levels, the change in the logarithm of the price-deflated M4ex broad money stock; the real three-month inter-bank rate; the non-oil tax burden and General Government Net Borrowing, both expressed as smoothed ratios to non-oil GDP;[310] a time trend; a 'post-crash' dummy variable covering 2008 Q2 to 2011 Q3; and a separate dummy for 2008 Q4 when Lehman Bros. failed. A standard nesting-down procedure was then employed until a final error-correction model in mixed changes

310. Neither series is seasonally adjusted by the Office for National Statistics, despite the existence of very large seasonal swings which badly distort the data. A trailing four quarter moving average was correspondingly employed for estimation purposes. This is how the data is presented in charts 10 to 12. This smoothing process meant that there is an implicit two quarter lag built in. The interest rate and M4ex terms also appeared with a one quarter lag before they took effect. Such lags helped to reduce the simultaneity problem and mean that the direction of causation was more clearly identified.

and levels was achieved. The final long-run steady state in levels over the period 1964 Q2 to 2011 Q3 was:

*log RPDE = 11.5257 -0.0155*RRIB –TAXRAT –BRGRAT+3.06% per annum -17.35% post-2008 Q2.*

Where: RPDE = Real Private Domestic Expenditure, RRIB = real three-month inter-bank rate, TAXRAT = ratio of non-oil taxes to non-oil GDP, and BRGRAT = ratio of General Government Net Borrowing to non-oil GDP

In theory, broad money should not affect the level of real PDE in equilibrium, which is why real M4ex is only present as a short-term growth effect. The economic interpretation of the full error-correction model is that real PDE normally grows by 3.06 per cent per annum.[311] However, private activity falls by one per cent for each one percentage point rise in the burdens of taxation and government borrowing, while a 100 basis points rise in the real rate of interest cuts activity by 1.55 per cent. In the short term, a rise of one percentage point in the borrowing ratio cut real PDE by 0.53 percentage points, but there was a dead start of two quarters before the tax burden kicked in with a negative coefficient of 0.88. This result suggests that budget deficits do not stimulate private activity, even in the short run, but crowd it out right from the start. An increase in the real rate of interest also has a discernible negative effect on the growth of real PDE, while an increase of one per cent in real M4X boosts PDE growth by 0.48 per cent with a one quarter delay.

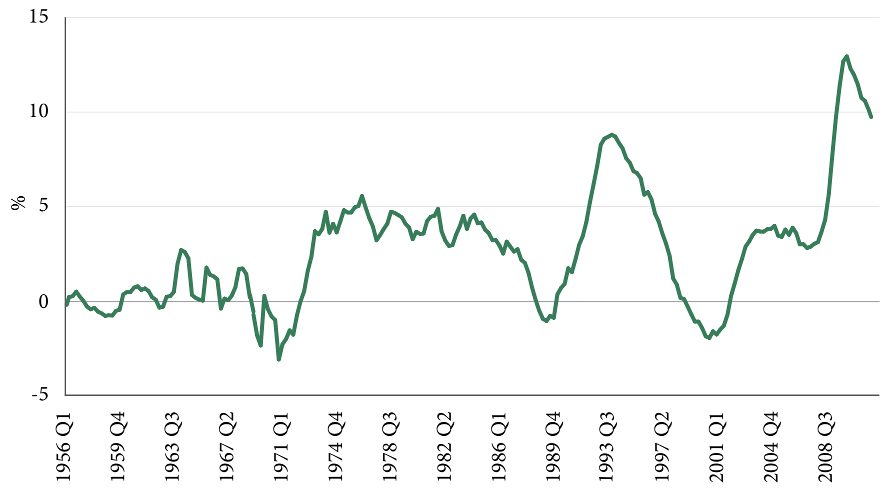
The likelihood that the long term coefficients on the borrowing and tax ratios are not significantly different from each other is consistent with the view that government spending crowds out private activity, irrespective of how it is financed. However, the statistical relationship for real PDE explained a relatively modest 21.9 per cent of the quarterly changes in real PDE between 1964 Q2 and 2011 Q3 and had a standard error of 2.0 per cent. In addition, the dummy variable for the period 2008 Q2 to 2011 Q3 appeared with a powerful coefficient of minus 17.35 per cent. This clearly picked up the disruption that followed the worsening of the global financial crash during the course of 2008. However, it probably also reflects problems with the new 2008 base-year national accounts introduced by the Office for National Statistics (ONS) in 2011.[312]

---

311. This specification is equivalent to a neo-classical growth model rather than a post neo-classical endogenous growth one because output always returns to the same growth trend, once the spending ratio has settled at a particular level. It is not being claimed that this represents a satisfactory growth model. It is just being hoped that the equation is good enough for the purpose at hand, which is to test the similarity of the spending and borrowing effects. Adding measures of exogenous world activity, and possibly the real exchange rate, would probably improve the fit if attempted in future research. Removing the volatile stock building component, which also picks up statistical errors generated elsewhere in the national accounts, from PDE results in noticeably closer statistical fits.

312. The same relationships were estimated using the previous 2006 base-year national accounts data and an estimation period that ended in 2010 Q4. These produced broadly similar long-term results. However, there was no need for a sustained post 2008 Q2 dummy variable, just three negative single quarter ones for 2008 Q4 and 2009 Q1 and Q2. The short-run negative impact effects of borrowing and taxes were not significantly different from each other using this data set and the coefficient on spending alone was insignificantly different from minus unity. Adding three more quarters to such a long data set would not normally be expected to noticeably alter the results, so the explanation must lie in the changes made by the UK Office for National Statistics (ONS). The ONS arguably botched the introduction of the new 'ESA 2010' national accounts, which were delivered months behind schedule and are still only available in partial form where historic back runs are concerned. It is not unreasonable to be deeply suspicious of the accuracy of the current ONS statistics, as a consequence.

Figure 3.19: Ratio of Smoothed UK General Government Borrowing to Non-Oil Money GDP at Basic Prices 1956 Q1 to 2011 Q4



The similarity between the tax and borrowing effects in the long run suggested that it made statistical sense to replace the pair with the general government spending ratio, since this represented a better specification. The resulting statistical relationship represented only a minor deterioration on the earlier equation, had an R-bar-squared of 20.0 per cent and had a standard error of 2.03 per cent. The long-run steady state of this relationship was:

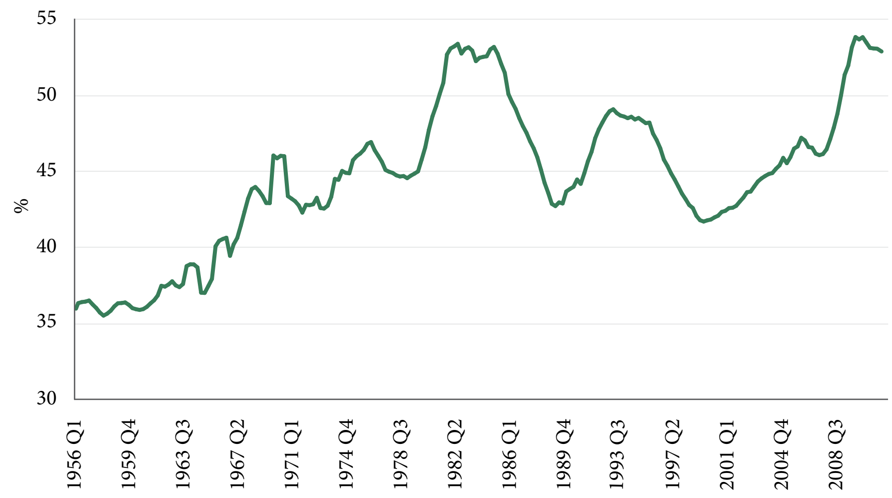
*log RPDE = 11.5617 -0.0160*RRIB –SPENDRAT+2.91% per annum -11.68% post-2008 Q2.*

Where: SPENDRAT = ratio of General Government Expenditure to non-oil GDP

The short-term coefficient on the smoothed government spending ratio was minus 0.35, confirming that there was no stimulus to the private sector from increased government spending even in the short run, but instead a reasonably powerful 'crowding-out' effect. Furthermore, the post-2008 Q2 dummy variable was noticeably less significant in this specification and could be dropped entirely if the long-run coefficient on the spending variable was unconstrained, when it became minus 1.66 (the difference from minus unity also had a reasonably significant 't' statistic of 1.92).

That result suggests that the growth in the share of national income spent by the state after 2000 has contributed to the severity of the recession that followed the financial crisis, and the weakness of the recovery. And, at the same time, the planned reduction in public spending may be more likely to prove inadequate – if the intention is to encourage private activity – rather than excessive.

Figure 3.20: Ratio of smoothed UK General Government Expenditure to non-oil Money GDP at Basic Prices 1956 Q1 to 2011 Q4



3.6.3. Fiscal adjustments pursued through lower spending are more effective than those pursued through higher taxes

Organisations such as the IMF and, more recently, the European Central Bank (ECB) and the European Commission, which are responsible for organising bailouts, have contributed to the development of the fiscal stabilisation literature. This literature essentially uses a case study approach to see which fiscal retrenchment packages have worked in practice and which have not. In the fiscal stabilisation literature two types of adjustment package are usually identified:

'**Type 1**' fiscal adjustments that implement government expenditure cuts and reductions in transfer payments and public sector wages and employment and **'Type 2'** adjustments, which mainly rely on tax increases and cuts in public investment.

Britain's fiscal adjustment is mostly Type 1 in theory, as the spending cuts are expected to be larger than the tax rises over time, but in the short term the relatively rapid implementation of the increase in VAT arguably makes it more of a Type 2 adjustment. In 2011–12, spending cuts were only 56 per cent of the total discretionary consolidation, and at Budget 2012 were only expected to reach the 80 per cent of the fiscal consolidation initially announced by 2016–17.[313]

There seems to be general agreement, based on many years of practical experience, that only Type 1 adjustments can achieve a lasting improvement in the budget deficit. In addition, Type 1 retrenchments seem to expand national output and boost employment and competitiveness to an extent that often confounds conventional forecasters. In contrast, Type 2 adjustments appear to have backfired in nearly every country that has tried them, leading to a worse budget deficit, and reduced activity.[314] A recent empirical study by ECB economists into public debt reduction

313. HM Treasury *Budget 2012*, Table 1.2

314. Alesina, A. F. & Ardagna, S. *Large Changes in Fiscal Policy: Taxes Versus Spending*, NBER Working Paper No. 15438, October 2009, is relevant here. This is because, not only does it confirm that attempts at tax-based fiscal consolidations tend to fail, whereas spending cuts succeed, the authors also found that a one percentage point hike in the government consumption ratio cut growth by 0.75 percentage points. This is a noticeably larger effect than the other studies discussed in this chapter. This may be because of non-linearity, so large changes are more powerful than small ones, or differences in statistical methodology.

programmes in the European Union between 1985 and 2009,[315] for example, found that:

> *First, major debt reductions are mainly driven by decisive and lasting (rather than timid and short-lived) fiscal consolidation efforts focussed on reducing government expenditure, in particular, cuts in social benefits and public wages. Second, robust real GDP growth also increases the likelihood of a major debt reduction because it helps countries to 'grow their way out' of indebtedness. Third, high debt servicing costs play a disciplinary role strengthened by market forces and require governments to set up credible plans to stop and reverse the increasing debt ratios.*

The fiscal history of Continental Europe provides insights into the potential effects of fiscal consolidation in Britain for several reasons. There are a large number of individual fiscal 'experiments'. Most of the countries concerned are at a similar stage of development to the UK. Those countries also have analogous political institutions, which can hamper ambitious reforms if they are captured by vested interests. Last, the large size of some of the fiscal adjustments concerned reflects the challenges facing Britain.

Large fiscal changes also provide information on the relative merits of modest and bold fiscal adjustments and of the extent to which the relationships involved may be non-linear. Between 1993 and 1997, the share of government spending in GDP in Sweden fell by 19.8 percentage points, for example, while the spending ratio in the Slovak Republic fell by 19.4 percentage points between 1996 and 2007, the Finnish government spending ratio fell by 17 percentage points between 1993 and 2001, the Irish Republic reduced its spending ratio by 13.3 percentage points between 1993 and 2000, the Czech Republic reduced its spending ratio by 11.4 percentage points between 1995 and 2000, and the Spanish government spending ratio fell by 10.9 percentage points in the ten years 1993 and 2003.

The consolidations that turned out to be expansionary were in general based on expenditure cuts rather than on revenue increases

Many of the earlier fiscal retrenchment episodes carried out within the boundaries of the European Union were examined in a comprehensive paper by the European Commission.[316] This examined every fiscal retrenchment carried out within the community over the previous three decades and remains important because of its exhaustive analysis. The results became a major contribution to the literature on the Type 1 and Type 2 fiscal adjustments and it found that "roughly half of the episodes of fiscal consolidations that have been undertaken in the EU in the last thirty years have been followed by an acceleration in growth. The consolidations that turned out to be expansionary were in general based on expenditure cuts rather than on revenue increases."

Schuknecht and Tanzi investigated the effects of the cutbacks in the government spending ratios in a number of major economies over the two decades from the early 1980s to the early 2000s, which amounted to a reduction of around seven percentage points on average.[317] The authors concluded that there was little evidence of undue cuts to public education or investment and that the main savings were on transfers, subsidies and debt interest payments. The more detailed picture showed improvements in fiscal indicators with deficit and debt reductions and some scope for tax cuts, without

---

315. *Major Public Debt Reductions: Lessons from the Past, Lessons for the Future,* by Christiane Nickel, Philip Rother, and Lilli Zimmermann, ECB Working Paper Series, no 1241, September 2010
316. Turrini, G. G. *Can Fiscal Consolidations Be Expansionary in the EU? Ex-post Evidence and Ex-Ante Analysis*, European Commission Economic Paper, No. 195, December 2003
317. Schuknecht, L. & Tanzi, V. *Reforming Public Spending: Great Gain, Little Pain*, Politeia, 2005

substantial macroeconomic or social harms. Ambitious reformers also experienced a recovery in trend growth and employment. The distribution of income was rendered less equal by ambitious fiscal retrenchments but the effect on absolute living standards was mitigated by faster economic growth. The main conclusion was that the early and ambitious reformers had benefitted the most overall and that public spending on desirable goals such as education and investment had not suffered as a result.

More recently Rother, Schuknecht and Stark revisited the issue of fiscal sustainability and fiscal risks in the light of the sovereign debt crisis in the eurozone.[318] They argued that the benefits of aggressive fiscal consolidation have recently increased enormously, given that rising public debts are now unsustainable and huge contingent liabilities across sectors and countries are combined with fiscal and financial crises in many countries. Short-term fiscal consolidation is urgently required just to stabilise the situation, over and above the accepted economic benefits from long-term fiscal consolidation. Four specific recommendations were:

- Consolidation should generally be based on public spending cuts, which made spending more efficient, improved incentives to work and demonstrated the political resolve of governments, especially to the bond markets.
- Fiscal reforms should be coupled with structural reforms of social security and financial systems and of labour and product markets in order to maximise the benefits for growth and sustainability.
- The chances of successful and sustained fiscal consolidation could be increased by strengthening the institutional environment for fiscal policy at the national and international level. In the British context, this criterion explains the establishment of the independent Office for Budget Responsibility (OBR).
- The uncertainty about the magnitude of public liabilities and what constitutes a sustainable fiscal position; the effects of fiscal policy on the economy; the strong and non-linear reaction of financial markets; the risk of a cascade of policy errors, and adverse political-economy incentives, all provided additional reasons for early and determined fiscal consolidation. These factors also suggested a need for caution in any attempt at Keynesian demand management.

3.6.4. The tax system proposed in this report can deliver revenues equivalent to 33 per cent of national income

Three steps are needed to model the static impact on revenue that would result from enacting the 2020 Tax Commission proposals:

- Establish the size of the new bases for taxes where the structure is being altered, for example:
  - The distribution of income tax liabilities is described in the HMRC document *Income tax statistics and distributions*.
  - The base for the new tax on capital income is based on interest paid and received and distributed income of corporations paid and received by financial and non-financial corporations, all taken from the *Blue Book 2011* published by the Office for National Statistics.

318. Rother, P., Schuknecht, L. & Stark, J. *The Benefits of Fiscal Consolidation in Uncharted Waters*, European Central Bank Occasional Paper Series, No. 121, November 2010

  - The value added under the various Value Added Tax rates can be established from the HMRC document *Estimated costs of the principal tax expenditure and structural reliefs*.
- Multiply those bases by the new rates and apply any cuts to other taxes on the basis of a linear increase of decrease in their revenue – obtained from *Autumn Statement 2011* in line with the increase or decrease in the rate.
- Adjust for the extent to which tax cuts for families or business will then be spent or distributed in a way which is taxed. For example, under the 2020 Tax Commission proposals Corporation Tax is abolished and replaced with a new tax on dividends and interest paid. But just looking at existing dividends and interest clearly understates the revenue obtained as that money which would have been taken in Corporation Tax will instead either be paid to workers or shareholders – creating a tax liability – or invested producing other tax liabilities at that point and in the future. A conservative estimate of that feedback effect is that it will reduce the effect on revenue of an increase or decrease in taxes by a share equal to the proposed share of taxes in national income.

It is important to note that the last step does not mean modelling for any changes in behaviour that might result from this change in the tax system. It is not an assessment of the dynamic effects of our proposals. Over time our view is that revenue will increase as the range of measures we have set out lead to growing tax bases, the dynamic modelling presented in Section 1.2.1 suggests that the reduction in revenue would erode over time. But the calculations set out in this section are based on a purely static analysis.

They suggest that the taxes and rates set out in this report would have raised around 33 per cent of national income in 2010–11, the most recent year for which full data is available. That means, even with significant room for error, they would be sustainable at that level of spending in normal economic conditions.

3.6.5. Other policies are needed to support restraint in public spending

The 2020 Tax Commission is not aiming to produce reforms that are revenue neutral overall. A critical objective for these reforms is to increase the pace of economic growth, which will lessen pressure on the public finances particularly in the long term. But there will also need to be restraint in public spending. The lower that spending can be kept, the lower the rates that can be applied with any tax system. In considering the final proposals we have aimed to raise 33 per cent of national income, this is roughly equivalent to the share of spending in national income in Australia.

The challenge of reducing spending to the extent that will be possible without a deficit will partly depend on the rate of economic growth. With faster growth, a given share of national income will mean a higher level of spending and there will be less pressure on the welfare budget as fewer people will be unemployed. But there are other measures that can be taken.

3.6.5.1. New spending targets should be introduced, to supplement the government's current fiscal mandates

Clear spending targets were a key part of the successful fiscal adjustments in Canada and Sweden. Research suggests that rules can play an important part in a fiscal adjustment to control spending in Britain. A staff report from the IMF suggests that fiscal rules are associated with larger adjustments. And it suggests that they are effective when put in place during the adjustment:[319]

> *While most fiscal rules were in place at the outset, some were adopted only during large adjustments. In nearly half of the 24 successful cases since 1980, countries started the fiscal consolidation with national fiscal rules in place in many cases they had just been introduced specifically with a view to reversing a trend of fiscal deterioration. For example, in Finland and Sweden, the adoption of fiscal rules was a major building block of adjustment efforts that followed the countries' banking and economic crisis of the early 1990s.*

That implies that if the government introduced rules while cutting spending they could significantly improve the results. The results of the IMF survey are shown below:

Table 3.12: IMF survey results: Fiscal Rules – Anchoring Expectations for Sustainable Public Finances

	Extent of rules			
	No rules	In place at start and during adjustment	In place at start	Put in place during adjustment
	(% of GDP, unless indicated otherwise)			
Initial public debt	48.5	69.7	70.3	68.8
Reduction in public debt	20.3	29.7	24.0	38.5
Relative reduction in debt (% of initial public debt ratio)	42.6	42.9	33.1	58.2
Adjustment length (years)	6.3	8.2	7.1	10.0
Annual reduction in public debt	4.0	3.7	3.3	4.3
Front-loading of reduction in public debt ratio (%) 1/	49.5	39.1	40.0	44.0
Front-loading of adjustment in CAPB (%) 3/	1.3	9.6	40.0	0.1
Memorandum item				
Number of countries	6.0	18.0	11.0	7.0

Another report, from the OECD, might shed some light on why Britain's rules have not been effective in the past. Their research suggests that expenditure-based rules are associated with success in fiscal consolidation, and that other rules are not. In other words, rules need to directly address spending rather than just setting targets for borrowing or debt:[320]

> *Historical observation is consistent with the regression results in suggesting that in general budget-balance rules that are not combined with expenditure rules are less effective. A striking example of this is the United States experience: neither the Gramm-Rudman-Hollings (GRH) Act of 1985 nor its*

319. IMF *Fiscal Rules – Anchoring Expectations for Sustainable Public Finances*, 16 December 2009, http://lowtax.es/Hc8RD6
320. OECD *Economic Outlook: Preliminary Edition, IV. Fiscal Consolidation: Lessons from past experience*, http://lowtax.es/HdkFX7

revised version in 1987 succeeded in significantly reducing the fiscal deficit. A further example is the Stability and Growth Pact (SGP), which has not so far led to sustainable positions being attained, notably in large EU countries. On the other hand, when the United States turned to an expenditure-based rule, the Budget Enforcement Act (1990–2002), a surplus was achieved and maintained for a time. Some EU countries (e.g. Netherlands, Spain, Sweden, Finland and Czech Republic) supplemented the SGP by national rules (in most cases including some expenditure ceilings) and also enjoyed success. There were, however, some failures. For instance, after France introduced multi-year objectives for real government expenditure in 1998, its structural fiscal position deteriorated continuously until 2003, at which time it came under the European excessive deficit procedure.

The Institute of Directors has argued since 2010 that spending needs to be frozen in real terms for a decade. That would bring spending as a share of national income down from around 50 per cent to around 35 per cent.

Introducing spending targets will make it more likely that a fiscal adjustment is successful. By giving ministers, public sector workers and the public a clear sense that spending is going to be controlled, it will make planning for the adjustment easier.

3.6.5.2. The full cost of raising taxes should be embedded in spending decisions

Anything that ensures policymakers look more carefully at the cost of proposed new spending, as well as the benefits, will help in avoiding new projects that represent poor value. The estimate would need to change over time though as the structure of taxes changes. As rates rise, the cost of raising further revenue is likely to increase. And it will cost more to raise a certain amount of revenue from a less efficient set of taxes.

In the United States the deadweight cost of new spending is embedded in policy appraisals by the White House Office of Management and Budget (Section 4.1.3). If that was introduced in Britain it could provide a more honest account of the costs and benefits of policy.

3.6.5.3. Full dynamic analysis of proposed tax changes should be produced

It is important that policy projections are based on a full dynamic analysis of the likely effects on the economy. Otherwise the government will routinely overstate the revenue cost of some measures, such as cutting high marginal rates of tax on labour or capital income.

TaxPayers' Alliance research has shown that before the crisis the Treasury was continually overstating tax revenues. Over the period 2000–01 to 2005–06, net current receipts outturns were net £33.3 billion lower than expected and net spending outturns were £3.4 billion higher than expected.[321] Better accounting for the effects of higher or lower taxes on the supply-side performance of the economy is likely to improve forecasting.

It will also provide a better sense of the extent to which tax reforms will affect revenue and economic growth over time. That will also affect the distributional analysis of changes, as a certain group may gain or lose more than they would on a purely static analysis once effects on economic performance (including wages and investment returns) are included (Section 4.3.2).

321. Sinclair, M. *Budget 2008 Report*, TaxPayers' Alliance, March 2008

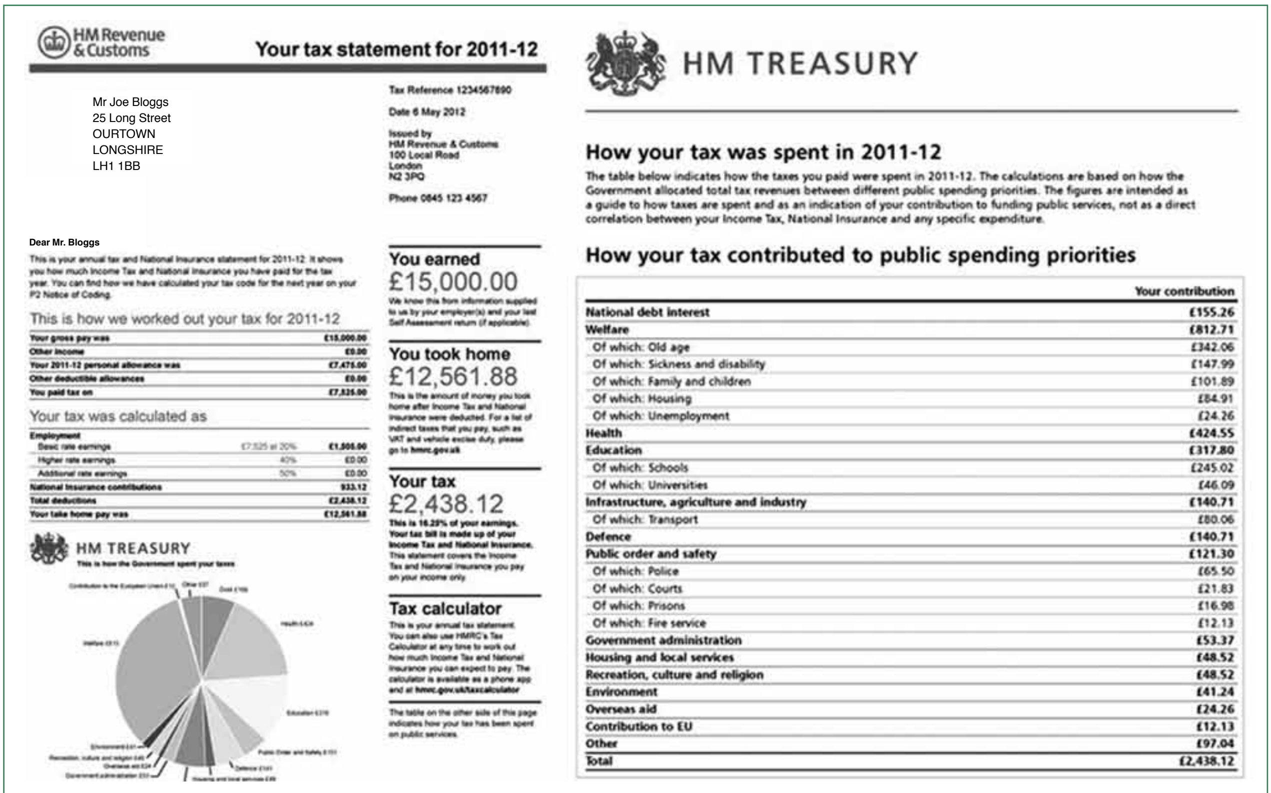
Chancellor of the Exchequer George Osborne has pledged to introduce dynamic scoring to assess effects of changes in tax policy a number of times, most recently following the 2012 Budget.[322]

3.6.5.4. All taxpayers should get a statement each year setting out the amount how much they are paying in tax, and how that money is spent

The Coalition Government has substantially increased spending transparency. Almost all local authorities now publish all payments to suppliers over £500, central government publishes details of contracts out to tender and departments like Education, Health and Communities and Local Government put more data online than ever before.

Tax transparency is just as important though. That requires substantial changes to the tax system, including the abolition of National Insurance as a separate tax on labour income (Section 5.2.5) and complex repeated taxes on capital income (Section 5.1.5). In the 2012 Budget, Chancellor of the Exchequer George Osborne announced that every taxpayer would be sent a yearly statement outlining how much tax they had paid in the financial year, with a breakdown of how that money had been spent. This initiative was first proposed by Ben Gummer MP in January 2012. A simple annual statement will hugely increase public awareness of how much tax they individually pay, and their share of what the government spends it on. Figure 3.19 shows how those statements could look.[323]

Figure 3.21: Example tax statement



HM Revenue & Customs

Your tax statement for 2011-12

Mr Joe Bloggs
25 Long Street
OURTOWN
LONGSHIRE
LH1 1BB

Tax Reference 1234567890

Date 6 May 2012

Issued by
HM Revenue & Customs
100 Local Road
London
N2 3PQ

Phone 0845 123 4567

Dear Mr. Bloggs

This is your annual tax and National Insurance statement for 2011-12. It shows you how much Income Tax and National Insurance you have paid for the tax year. You can find how we have calculated your tax code for the next year on your P2 Notice of Coding.

This is how we worked out your tax for 2011-12

Your gross pay was	£15,000.00
Other income	£0.00
Your 2011-12 personal allowance was	£7,475.00
Other deductible allowances	£0.00
You paid tax on	£7,525.00

Your tax was calculated as

Employment		
Basic rate earnings	£7,525 at 20%	£1,505.00
Higher rate earnings	40%	£0.00
Additional rate earnings	50%	£0.00
National Insurance contributions		933.12
Total deductions		£2,438.12
Your take home pay was		£12,561.88

HM TREASURY

This is how the Government spent your taxes

You earned

£15,000.00

We know this from information supplied to us by your employer(s) and your last Self Assessment return (if applicable).

You took home

£12,561.88

This is the amount of money you took home after Income Tax and National Insurance were deducted. For a list of indirect taxes that you pay, such as VAT and vehicle excise duty, please go to hmrc.gov.uk

Your tax

£2,438.12

This is 16.25% of your earnings. Your tax bill is made up of your Income Tax and National Insurance. This statement covers the Income Tax and National Insurance you pay on your income only.

Tax calculator

This is your annual tax statement. You can also use HMRC's Tax Calculator at any time to work out how much Income Tax and National Insurance you can expect to pay. The calculator is available as a phone app and at hmrc.gov.uk/taxcalculator

The table on the other side of this page indicates how your tax has been spent on public services.

HM TREASURY

How your tax was spent in 2011-12

The table below indicates how the taxes you paid were spent in 2011-12. The calculations are based on how the Government allocated total tax revenues between different public spending priorities. The figures are intended as a guide to how taxes are spent and as an indication of your contribution to funding public services, not as a direct correlation between your Income Tax, National Insurance and any specific expenditure.

How your tax contributed to public spending priorities

	Your contribution
National debt interest	£155.26
Welfare	£812.71
Of which: Old age	£342.06
Of which: Sickness and disability	£147.99
Of which: Family and children	£101.89
Of which: Housing	£84.91
Of which: Unemployment	£24.26
Health	£424.55
Education	£317.80
Of which: Schools	£245.02
Of which: Universities	£46.09
Infrastructure, agriculture and industry	£140.71
Of which: Transport	£80.06
Defence	£140.71
Public order and safety	£121.30
Of which: Police	£65.50
Of which: Courts	£21.83
Of which: Prisons	£16.98
Of which: Fire service	£12.13
Government administration	£53.37
Housing and local services	£48.52
Recreation, culture and religion	£48.52
Environment	£41.24
Overseas aid	£24.26
Contribution to EU	£12.13
Other	£97.04
Total	£2,438.12

322. Wallace, T. Osborne vows to think through tax impacts, *City A.M.*, 28 March 2012
323. The image was produced by the Liverpool Daily Post.

That statement must give at least some indication of the full burden of all taxes though, including indirect taxes and those levied through companies. If all taxes are not included then the statements would mislead the public. For example, in the example above, there is no indication that Employers' National Insurance contributions depress wages, meaning the incidence falls on employees. As a result of failing to include all of the taxes, the values given for different items of spending also understate their true cost.

Chapter four

Marginal tax rates should not exceed 30 per cent, and the personal allowance should rise to £10,000

4. Marginal tax rates should not exceed 30 per cent, and the personal allowance should rise to £10,000

4.1. Higher taxes reduce the incentive to work and invest

The simplest microeconomic reason for the macroeconomic result that higher taxes reduce incomes and economic growth is that high taxes drive a wedge between the prices perceived by consumers and those received by producers (Section 4.1.3). That means working is less likely to be worth it (Section 4.1.2.1), investments are less likely to pay off for businesses (Section 4.1.2.2), and the rewards for entrepreneurs are less likely to justify the risks that come with starting a new business (Section 4.1.2.3). British businesses find it increasingly difficult, particularly where they have to compete in international markets (Section 4.1.2.5).

The 2020 Tax Commission's recommendations would do something about this: cutting marginal income tax rates across the income distribution (Section 4.1.1.1) and taking more people out of income tax altogether (Section 4.1.1.2); cutting the effective corporate tax rate (Section 4.1.1.3); and cutting the range of taxes that diminish the rewards available to entrepreneurs (Section 5.2.1).

4.1.1. The 2020 Tax Commission's proposals will cut marginal tax rates for families and businesses

4.1.1.1. Cutting marginal tax rates to 30 per cent would be a substantial reduction from current rates

Taxes on labour income – Income Tax and National Insurance – raised £248 billion in 2010–11. That was around 45 per cent of total receipts and shows the importance of these taxes to financing public spending. The ability to raise that amount of revenue is due, in large part, to the very large base the tax is levied upon. Total income of taxpayers in 2010–11 was £875 billion.

But even with such a large base, marginal rates are high and rising. That is particularly the case when Income Tax, Employees' National Insurance and, as its incidence is on workers in the form of lower pay or fewer jobs (Section 5.1.2), Employers' National Insurance, are taken together.

As a result, income taxes can have serious economic consequences. The decision by the Schröder Government in Germany to raise Value Added Tax in order to reduce social overhead costs – equivalent to Employers' National Insurance contributions – appears to have led to a noticeable reduction in German unemployment, in conjunction with the phased Hartz reforms to unemployment benefits from 2002 onwards. It represented a shift from taxing income to taxing consumption.

High rates of taxation on income are not just a problem for high earners but across the income distribution. Income Tax is now paid by many people who also qualify as living in poverty and receive significant benefits. Many people on middle incomes pay very high marginal rates when National Insurance contributions are included.

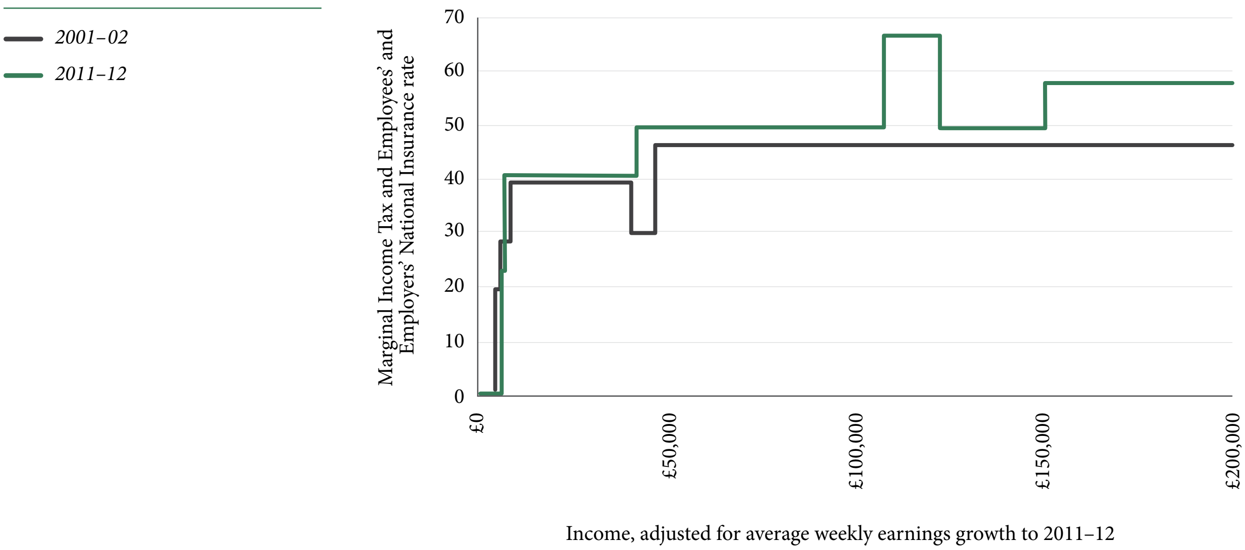
The number of people subject to the 40 per cent higher rate fell with the onset of the recession, but is now rising with the cuts in the threshold that accompanied increases in the personal allowance. In 2007–08, there were 3.9 million higher rate taxpayers; 3.7 million in 2008–09; 3.2 million in 2009–10; 3.1 million in 2010–11;

and 3.7 million in 2011–12. Over the longer term, there has been a very large increase in the number paying the higher rate, for example in 1990–91 it was paid by 1.7 million.[324] And the number is set to rise further, to five million by 2014.[325] At the same time as more people have to pay the higher rate of 40 per cent Income Tax, there is also a new top rate of Income Tax at 50 per cent, falling to 45 per cent by 2013–14.

Over the longer term, there has been a very large increase in the number paying the higher rate

To understand the full picture about how marginal rates have changed over time it is necessary to adjust thresholds for changes in average earnings and add together all three taxes on earned income: Income Tax, Employees' National Insurance contributions and Employers' National Insurance contributions. The results for people of working age in 2001–02 and 2011–12 are shown in Figure 4.1. After a personal allowance of around £7,500 in both periods, there is a combined tax rate of around 40 per cent. Then from around £40,000 of total income the rate rises to around 50 per cent. At £100,000, until the personal allowance is clawed back, the rate rises to well over 60 per cent. Then at £150,000 the rate rises to nearly 60 per cent with the additional rate of Income Tax, though that is set to be cut.

Figure 4.1: Marginal tax rate schedule, adjusted for average earnings growth, 2001–02 and 2011–12



Three key changes are evident:

- The higher rate starts earlier at around £42,000 rather than around £47,000 in 2001–02 (after adjusting to 2011–12 average earnings).
- Marginal tax rates for all higher earners have increased substantially. Those earning above the higher rate threshold pay nearly 50 per cent including National Insurance contributions. That is largely due to an increase in the rate of those contributions.
- There are much higher marginal rates between £100,000 and £115,000 and above £150,000 thanks to the clawing back of the personal allowance and the new 50p rate respectively. When combined with National Insurance the 50p rate is actually a marginal income tax rate of nearly 60 per cent.

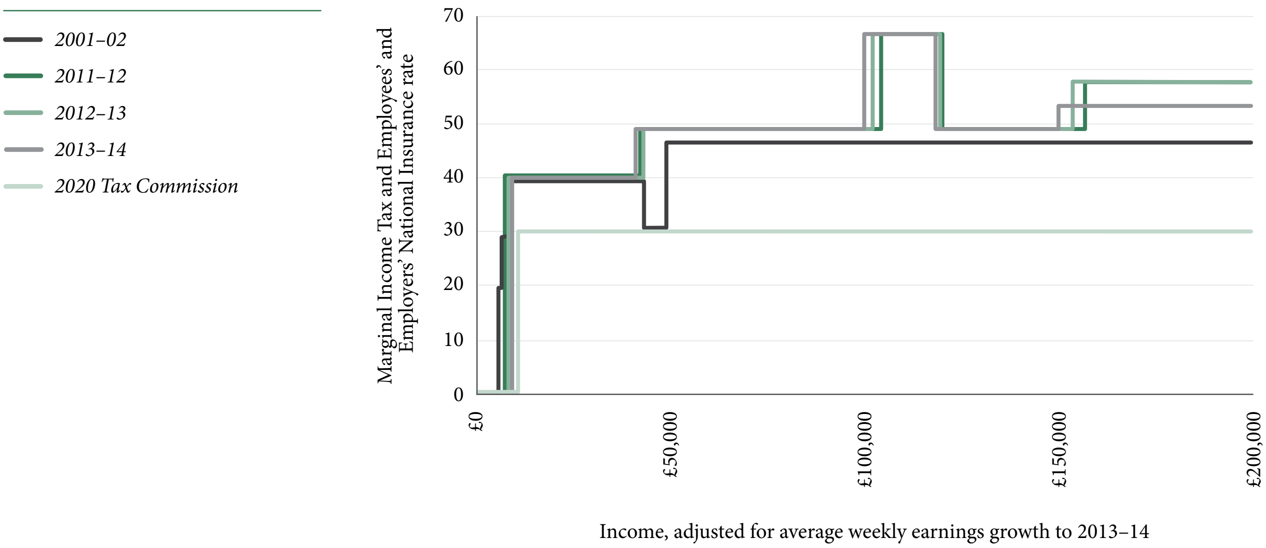
324. HMRC *Income Tax Statistics*, Table 2.1: Number of individual income taxpayers by marginal rate, gender and age, 1990–91 to 2011–12

325. Johnson, P. *Opening remarks: Tax changes do not amount to a reform programme*, Post-Budget briefing 2012, Institute for Fiscal Studies, 22 March 2012

The withdrawal of the personal allowance is a particularly unnecessary complication in the tax system. The Institute for Fiscal Studies says that it "is equivalent to a 60 per cent income tax rate in this range." That high rate can be seen in Figure 4.1.

The 2020 Tax Commission's recommendations would improve the situation considerably. Marginal tax rates on personal income would fall substantially compared to the 2011–12 tax code, and the tax code for future years as announced at Budget 2012, across the income distribution. The marginal tax rate schedule would also be much simpler. For future years, the National Insurance thresholds have not been announced, so they have been assumed to rise in line with the personal allowance and the threshold for higher rate Income Tax.

Figure 4.2: Marginal tax rate schedule before and after the 2020 Tax Commission recommendations



4.1.1.2. Increasing the personal allowance will improve incentives for low earners

In *Our Programme for Government*, the Liberal Democrats and Conservatives agreed that:[326]

> *We will increase the personal allowance for income tax to help lower and middle income earners. We will announce in the first Budget a substantial increase in the personal allowance from April 2011, with the benefits focused on those with lower and middle incomes.*

Two objections have been raised to that proposal, and other proposals to increase the personal allowance:

- The measure is not progressive.
- If a smaller proportion of the public pay Income Tax, then that will reduce the political pressure for lower taxes over time.

Horton and Reed have produced a briefing, published on the website Left Foot Forward, which argues that an increase in the personal allowance would not be

326. HM Government *The Coalition: our programme for government*, May 2010

progressive.[327] They found that it would mostly be higher income households that would benefit.

This is surprising given that the measure would provide a roughly equal benefit to each person making sufficient earnings to use up the higher personal allowance, and should therefore be worth more to lower earners as a share of their total income. There are two reasons why that is not found in the Horton and Reed analysis:

- The poorest, with earnings below the existing personal allowance or no earnings at all, do not pay Income Tax. That means any cut in income taxes will not benefit them.
- Higher income households are less likely to include an earner – perhaps a secondary earner working part time – who makes less than the existing personal allowance. They are more likely to have two earners both of whom take the full benefit from the increase in the personal allowance.

Looking at individual earners, the picture is very different.[328] While those with very low earnings will not benefit, many low earners will and they will benefit more as a share of their income:

For that reason, while families on middle incomes and above will see the largest increases in their income, the measure will do more to reduce taxes as a share of lower incomes. It will improve incentives, by lowering the marginal rates faced by low earners, and that is likely to improve their economic position over time. To look at it another way, it removes a much greater share of the income tax liability of lower earners:

The alternative objection to increasing the personal allowance is almost that, rather than being regressive, it is too progressive. In the United States, where there are larger exemptions in the tax code for low earners, there have been concerns that, with 47 per cent of the population not paying federal income tax, the result could soon be a "majority paying nothing and voting more spending at the expense of a taxpaying minority."[329]

This concern is overstated though. Even with substantial increases in the personal allowance a heavy majority of earners in Britain will still pay the tax. The personal allowance in 2011–12 is £7,475. If the personal allowance were £14,614, that would still be lower than the income of 70 per cent of earners.[330] And low earners pay other taxes such as VAT. Even in the United States, without consumption taxes, only 18.1 per cent of filers pay neither income nor payroll tax.[331]

The concern is that those who do not pay income taxes will conclude that their interests are best served by higher taxes to pay for increased spending on benefits and services. But, to the extent that is the case, the same logic will apply to all those who receive more in benefits than they pay in taxes. There is no reason to think that the share of the population paying Income Tax has a significant effect on public

327. Horton, T. & Reed, H. *"Think again, Nick!" Why spending £17 billion to raise tax thresholds would not help the poorest*, Left Foot Forward, 13 March 2010
328. Incomes data taken from Office for National Statistics *Annual Survey of Hours and Earnings*
329. Boskin, M. J. The GOP Candidates Square Off on Taxes, *Wall Street Journal*, 3 November 2011
330. Office for National Statistics *Annual Survey of Hours and Earnings 2011*
331. Tax Policy Center *Who Doesn't Pay Federal Taxes?* http://lowtax.es/Hr0rqH

opinion, let alone a decisive one, and little historical evidence for that contention either. Ponnuru has looked at the political history in the United States:[332]

"The number of people who pay no income taxes moved up fast between 2006 and 2010, but voters turned sharply right between the elections of those two years"

> *The U.S. that began the Democrats' 40-year reign in the House of Representatives in 1954 had roughly the same percentage of non-payers of income tax (24.9) as the U.S. that ended it in 1994 (24.4). A relatively large proportion of the citizenry paid income taxes in the early 1960s. It didn't stop the Great Society from being enacted. The number of people who pay no income taxes moved up fast between 2006 and 2010, which has helped set off conservative alarms. But voters turned sharply right between the elections of those two years.*
>
> *[…]*
>
> *The Tax Foundation has calculated the percentage of filers in each state who pay income tax. The ten states with the highest number of non-payers are a strongly Republican bunch: Eight of them went for John McCain in 2008, and nine of them have Republican governors.*

Increasing the personal allowance is a good way of ensuring that a flatter marginal income tax rate schedule does not come at the price of higher taxes for low income families. Hall and Rabushka, for example, included a tax-free allowance of $25,500 for a family of four in their flat tax plan.[333]

It reduces the very high marginal rates that currently apply to many low earners thanks to the combination of taxes on labour income and the withdrawal of benefits. TaxPayers' Alliance research on the potential for welfare reform reported how "for example, a claimant who loses Housing Benefit, Council Tax Benefit and tax credits for each extra pound of income, at the same time as paying Income Tax and National Insurance Contributions on that extra income, has an effective marginal tax and benefit withdrawal rate of 95.5 per cent. For someone working at a minimum wage of £5.80 an hour and facing such a marginal rate, the effective marginal hourly pay would be just 26p."[334]

The 2020 Tax Commission proposals would increase the personal allowance to £10,000 immediately. It is important to note that, with inflation, a personal allowance of £10,000 in 2010–11 (the year used to assess the revenue the proposals would generate, see Section 3.6.4) is worth around £11,000 in 2014–15.

4.1.1.3. The effective corporate tax rate would fall from 20 per cent to 10 per cent

As the 2020 Tax Commission is changing the nature of capital taxation quite fundamentally, it is difficult to apply the findings of the literature looking at the effects of corporate taxes. Simply comparing the two rates would definitely be wrong as our new capital tax does not tax retained earnings and therefore constitutes a less onerous tax for a given rate. It would also constitute a single tax on dividends and interest instead of taxes also being levied on some individuals. That means that a simple comparison of the amount raised in corporate tax and through our combined tax on capital income would overstate the relative amount being charged under the new system. The best available standard – though it severely understates the improvement in competitiveness with our new system as it compares Corporation Tax to a tax that replaces Corporation Tax, taxes on dividends, taxes on interest,

332. Ponnuru, R. The Freeloader Myth, *National Review*, 21 November 2011
333. Hall, R. E. & Rabushka, A. *The Flat Tax*, Hoover Institution, 1995, pg. xiv
334. Taylor, C., Denham, M., Baron, R. & Allum, A. *Welfare reform in tough fiscal times: Creating a better and cheaper benefits system*, The TaxPayers' Alliance, 22 July 2010

Capital Gains Tax and a range of other taxes – is a simple estimate of the effective corporate tax rate. The net operating surplus of financial and non-financial corporations in 2010 was £210.1 billion.[335] Corporation Tax raised £43 billion in 2010–11, or around 20 per cent of that total. Under the new capital income tax that the 2020 Tax Commission is proposing, and at a rate 30 of per cent, the total tax levied on distributed income, as a share of the same net operating surplus, would be 10 per cent. That suggests the effective corporate tax rate would more than halve and should therefore be competitive with the low rates set in countries like Ireland.

4.1.2. Cutting marginal tax rates will deliver a stronger economy

4.1.2.1. Higher marginal income tax rates reduce national income and economic growth

The economic harms produced by high marginal income tax rates are likely to be substantial. Not just because they reflect higher overall taxes and spending, with all of the harms discussed in Section 3.4, but also because particular harms are produced by taxing incomes at high marginal rates.

In a paper for the United States Congressional Joint Economic Committee, Chris Edwards set out six economic effects of changes in income tax rates:[336]

- **Labour supply**. Workers respond to tax rate cuts by substituting more labour for less leisure since labour becomes relatively more attractive (the "substitution effect"). But tax cuts also create an incentive to reduce labour because a higher after-tax income increases the demand for leisure (the "income effect"). Empirical research has found that labour supply substitution effects usually outweigh income effects. As a result, overall labour supply can generally be expected to rise modestly in response to marginal tax rate cuts.
- **Saving**. Income tax systems are often biased against saving and towards current consumption because the returns to saving often face high tax rates whereas current consumption does not. There are often limitations on tax-favoured savings vehicles.
- **Entrepreneurial Activity and Small Business Growth**. Along with Capital Gains Tax, the income tax system has a wide-ranging impact on how businesses are structured and operated. For example, in the United States, cuts in income tax would benefit the "more than 20 million small businesses that are subject to tax under the personal income tax system. This includes 19.4 million non-farm sole proprietorships, 2.1 million farms, 1.9 million partnerships, and 2.6 million S corporations. […] IRS data for 1998 shows that of tax filers with adjusted gross income above $200,000, 27 per cent reported sole proprietor income and 49 per cent reported partnership or S corporation income. By comparison, 14 per cent of all tax filers reported sole proprietor income and five per cent of all filers reported partnership or S corporation income. Similarly, Federal Reserve data shows that 40 per cent of the income of the wealthiest one per cent of families comes from self-employment or entrepreneurship, compared to 14 per cent for the general population."

335. Office for National Statistics *Blue Book 2011*

336. Edwards, C. *Economic benefits of personal income tax rate reductions*, Joint Economic Committee, April 2001

Production and Consumption Efficiency. The income tax code is riddled with incentives and disincentives affecting different industries, investments, and consumption goods.

- **Tax Avoidance**. As tax rates rise, taxpayers have greater incentives to invest more in tax minimisation activities.
- **Tax Evasion**. Tax evasion is tax reduction by illegal means. Like legal tax avoidance, tax evasion rises as tax rates rise, as confirmed by numerous empirical studies.

There have been a number of papers that have found higher marginal income tax rates create serious economic problems. Reinhard and Kormendi found in 1989 that increases in marginal tax rates reduce economic activity, even with average tax rates held constant.[337]

Mullen and Williams studied the same issue in 1994 and found that, holding other factors constant, "lowering marginal tax rates can have a considerable positive impact on growth […] creating a less confiscatory tax structure, while maintaining the same average level of taxation, enabling sub-national governments to spur economic growth."[338]

In 2001, Padovano and Galli found that higher effective marginal income tax rates were associated with lower economic growth, using a panel regression with data for OECD countries from 1951 to 1990.[339]

Johansson et al., in a 2008 study for the OECD, reported that considering "the average OECD country in 2004, which had an average personal income tax rate of 14.3 per cent and a marginal income tax rate of 26.5 per cent. If the marginal tax rate were to decrease by five percentage points in this situation, thus decreasing the progressivity of income taxes, the estimated increase in GDP per capita in the long run would be around one per cent."[340]

More recently Barro and Redlick used a newly constructed data set for average marginal tax rates in the United States.[341] They found that in "2006, the overall AMTR [Average Marginal Tax Rate] was 35.3 per cent, breaking down into 21.7 per cent for the federal individual income tax, 9.3 per cent for the social-security levy (inclusive of employee and employer parts), and 4.3 per cent for state income taxes." That rate varied over time, increasing during wars for example and decreasing with some of the major tax cuts discussed in Section 3.5.3. The AMTR also fell during the Great Depression – from 4.1 per cent in 1928 to 1.7 per cent in 1931 – thanks to "falling incomes within a given tax structure" pushing people into lower brackets. It then rose to 5.2 per cent by 1936 with attempts to balance the federal budget.

They found that a fall in marginal tax rates was associated with a higher national income: "the estimate is that a cut in the AMTR by one percentage point raises next year's per capita GDP by around 0.5 per cent." And that this was primarily the result of a substitution effect – the effect on incentives – rather than income effects:

337. Koester, R. B. & Kormendi, R. C. Taxation, Aggregate Activity and Economic Growth: Cross-Country Evidence on Some Supply-Side Hypotheses, *Economic Inquiry*, Vol. 27 (3), 1989, pgs. 367–86
338. Mullen, J. K. & Williams, M. Marginal tax rates and state economic growth, *Regional Science and Urban Economics*, Vol. 24 (6), 1994, pgs. 687–705
339. Padovano, F. & Galli, E. Tax rates and economic growth in the OECD countries (1950–1990), *Economic Inquiry*, Vol. 39, No. 1, January 2001, pgs. 44–57
340. Johansson, A., Heady, C., Arnold, J., Brys, B. & Vartia, L. *Tax and economic growth*, OECD, Economics Department Working Paper 28, 11 July 2008
341. Barro, R. J. & Redlick, C. J. *Macroeconomic Effects from Government Purchases and Taxes*, NBER Working Paper No. 15369, September 2009, Updated February 2010

Once we hold constant the behaviour of the AMTR, we find no statistically significant effects on GDP in the post-1950 sample from "exogenous" movements in federal revenue (using the Romer-Romer exogenous federal tax change). In contrast, when revenue is held constant, we still find at least marginally significant negative effects on GDP from increases in the AMTR. Thus, changes in taxes seem to influence GDP mainly through substitution effects, rather than wealth effects.

Other studies have found more modest effects. A recent British study was carried out by Blow and Preston for the Institute of Fiscal Studies in 2002.[342] This examined the effect of changes in the marginal tax rate on the taxable income of the self-employed between financial years 1985–86 and 1995–96 and concluded that the response was modest. However, the self-employed only amounted to 4,513,000 people in September 2011 out of a total workforce of 31,271,000 (i.e. 14.4 per cent). It is not clear how large the response of the rest of the workforce is. This depends on how much control people have over their working hours, which clearly varies from sector to sector, and may have increased in recent years with the rise in flexible working. The likelihood that high marginal rates of tax cause a significant withdrawal of labour hours was supported by a study by three ECB economists in 2005, who concluded:[343]

Countries with a relatively high tax wedge (which captures the amount of social security contributions, payroll taxes, personal income tax and consumer taxes that create a wedge between real labour costs for employers and the real take-home pay of employees) tend to record a lower level of annual hours worked per capita. Belgium, France, Italy and the Netherlands, for example, which were at the low end of the annual hours worked per capita scale in the euro area in 2004, have particularly high tax wedges. Countries with high marginal tax rates, for example, Belgium Germany and the Netherlands, also show some tendency towards shorter average annual hours per worker, especially among women. Reductions in labour taxes probably contributed to the increase in average annual hours worked per capita in some countries, such as Ireland, in the second half of the 1990s.

Aaronson and French have argued that many studies underestimate the economic effects of high marginal tax rates as the "failure to account for wage-hours ties within a progressive tax system leads to an hours response to a change in marginal tax rates that may be biased downwards by as much as 10 per cent for men and 17 per cent for women". People tend to supply more hours to the market when their wages are higher – and existing models wrongly underestimate that effect. They explain: "First, in a model where the wage is a function of hours worked, an increase in the post-tax wage resulting from a tax cut potentially leads to an increase in hours worked. This increase in hours worked leads to an increase in the pre-tax wage through the tied wages-hours effect, further escalating hours worked. Therefore, there is a larger labour supply response to a tax change than to an equally sized wage change. Since most models do not account for tied wage-hours

342. Blow, L. & Preston, I. *Deadweight Loss and Taxation of Earned Income: Evidence from Tax Records of the UK Self Employed*, Institute for Fiscal Studies, WP02/15, 23 July 2002
343. Leiner-Killinger,, N., Madaschi, C. & Ward-Warmedinger, M. *Trends and Patterns in Working Time across Euro-area Countries 1970–2004: Causes and Consequences*, ECB Occasional Paper No.41, December 2005

offers, the latter effect (i.e. the effect of increased hours worked on increasing wages, which should in turn further increase hours worked) is ignored. Therefore, this model misspecification problem causes tax analysts to understate the labour supply response to a tax change".[344]

Looking at the evidence across US States, which set their own income taxes, Poulson and Kaplan found that there was a "significant negative impact of higher marginal tax rates on economic growth" and cautioned that their analysis underscored "the importance of controlling for regressivity, convergence, and regional influences in isolating the effect of taxes on economic growth in the states."[345] Becsi found that it was possible to explain more than 60 per cent of the growth variation between the 50 US states in terms of just three variables:[346] The first was the relative tax burden in each state. The second variable was a measure of how regressive the tax system was. This was because progressive systems caused more distortions at the margin. The final variable was the state's relative income at the start. This allowed for the tendency of poorer states to catch up on richer ones, as would be expected in neo-classical growth models.

High marginal tax rates do not just depress aggregate economic growth. They also have specific effects on the behaviour of specific and important groups within the labour market.

Carroll, Holtz-Eakin, Rider and Rosen found that "a five percentage point rise in marginal tax rates would reduce the proportion of entrepreneurs who make new capital investment by 10.4 per cent. Further, such a tax increase would lower mean capital outlays by 9.9 per cent"[347]

Meghir and Phillips summarised a number of studies looking at female labour supply, and particularly the extent to which married women and lone mothers participate in the labour force. They found that the "prevailing consensus annual labour supply elasticity for women is close to 1", though those results "have to be regarded with some caution because they rely almost exclusively on cross-sectional comparisons". This appears to be a result of women dropping out of the labour force in response to higher taxes as "the overall consensus (with the exception of the result by Devereux) is that participation elasticities for married women are quite high and that this margin for adjustment is perhaps more important than weekly hours of work." There may be an even stronger response from lone mothers, as "there is a strong consensus in the literature that the participation elasticity for lone mothers is among the highest of all demographic groups".[348]

Keane has produced another recent survey of the academic literature studying labour supply and reports that for male workers "a simple average of Hicks elasticities across all the studies I examine is 0.30. Several simulation studies have shown that such a value is large enough to generate large welfare costs of income taxation." While many studies have found low estimates of that elasticity, that is driven by the "use of direct vs. ratio wage measures, with studies that use the former tending to find larger elasticities" and many studies fail to "account for human capital returns to work experience". He reports that in a model that includes human capital "even

344. Aaronson, D. & French, E. *The Effects of Progressive Taxation on Labour Supply when Hours and Wages are Jointly Determined*, Federal Reserve Bank of Chicago Working Paper No. 2002–22, 2002
345. Poulson, B. W. & Kaplan, J. G. State Income Taxes and Economic Growth, *Cato Journal*, 28, 1, 2008
346. Becsi, Z. *Do State and Local Taxes Affect Relative State Growth*, Federal Reserve Bank of Atlanta, Economic Review, March/April 1996
347. Carroll, R., Holtz-Eakin, D., Rider, M. & Rosen, H. S. *Entrepreneurs, Income Taxes, and Investment*, NBER Working Paper No. W 6374, 1998
348. Meghir, C. & Phillips, D. *Labour supply and taxes*, Institute for Fiscal Studies, April 2008

modest elasticities – as conventionally measured – can be consistent with large welfare costs of taxation."

For women the picture is far more drastic though, as "most studies find large labor supply elasticities, especially on the participation margin." In particular, estimates that "allow for dynamic effects of wages on fertility, marriage, education and work experience" are "generally quite large."[349]

Marginal tax rates also appear to affect corporate behaviour. For example, high tax rates on dividends lead to less being paid. Chetty and Saez studied the effect of the cuts in the tax on dividends in 2003, from a top rate of 35 per cent to 15 per cent. They found that the share of publicly traded firms paying dividends began to increase precisely from 2003, after having declined continuously for more than two decades. They reported that "nearly 150 firms have initiated dividend payments after the tax cut, adding more than $1.5 trillion to aggregate quarterly dividends. Most of these firms initiated regular, recurrent payments rather than one-time 'special' distributions." They also found that many firms that were already paying dividends increased the amount they paid significantly after the tax cut.[350]

The effects of marginal tax rates on growth and corporate behaviour are sufficient to produce changes in asset prices. Sialm found a statistically significant relationship between asset valuations and personal tax rates. Lower taxes are associated with higher share prices and the "result is consistent with the observation that stock and bond returns tend to be higher in periods when taxes decrease and lower when taxes increase".[351]

As the economic harms created by high marginal tax rates are so severe, tax reform that reduce them can lead to significant economic improvements. Engen and Skinner found that a "major tax reform reducing all marginal rates by five percentage points, and average tax rates by 2.5 percentage points, is predicted to increase long term growth rates by between 0.2 and 0.3 percentage points."[352]

4.1.2.2. Higher corporate tax rates reduce investment, innovation and economic growth

The academic literature strongly suggests that excessively high rates of Corporation Tax lead to declining economic activity and lower tax revenue than might be generated through lower marginal rates. Djankov et al. performed a study on 85 countries (including the developing world) to find that:[353]

> *A 10 percentage point increase in the effective corporate tax rate reduces the investment to GDP ratio by about two percentage points (mean is 21 per cent), and the official entry rate by 1.3 percentage points (mean is eight per cent).*

Felix estimates that, for the US economy, if Corporation Tax is increased by one percentage point, the marginal burden on labour is 4.2 times higher than the additional revenue collected through Corporation Tax. In other words, focusing taxes

349. Keane, M. P. *Labor Supply and Taxes: A Survey*, University of Technology Sydney Working Paper No. 160, July 2010

350. Chetty, R. & Saez, E. *Do Dividend Payments Respond to Taxes? Preliminary Evidence from the 2003 Dividend Tax Cut*, NBER Working Paper No. 10572, 2004

351. Sialm, C. *Tax Changes and Asset Pricing: Time-Series Evidence*, NBER Working Paper No. 11756, 2005

352. Engen, E. M. & Skinner, J. S. *Taxation and Economic Growth*, NBER Working Paper No. W5826, 1996

353. Djankov, S., Ganser, T., McLiesh, C., Ramalho, R. & Shleifer, A. *The effect of corporate taxes on investment and entrepreneurship*, NBER, 2007

on labour directly (rather than indirectly though corporations) could make everyone better off. And since she finds that low-skilled workers face just as high a burden as high-skilled workers, corporate income taxes are not just a concern for high earners or those who own substantial numbers of shares.[354]

OECD research reports how corporate taxes can diminish growth in productivity and income:[355]

"Corporate income taxes can affect the rate of capital accumulation and hence GDP per capita"

> *Corporate income taxes can affect the rate of capital accumulation and hence GDP per capita. Since firms' investment decisions are driven by the cost of and the expected return to investment projects, corporate taxes can have a negative effect on corporate investment by reducing its after-tax return. The extent of this effect can, in turn, be expected to depend on the degree of openness of the economy, with a more open economy likely to suffer more from an excessively high corporate tax than a more closed economy.*

Schwellnus and Arnold found that a reduction in the corporate tax rate from 35 per cent to 30 per cent would increase the annual total factor productivity (TFP) growth rate by 0.4 percentage points for ordinary firms, and given "that trend TFP growth of OECD countries averaged around 1.1 per cent over the period 2000–2005 this is actually a large number".[356] Gemmell et al. have also looked at the impact of corporate taxes on productivity. They found that a five percentage point cut in corporate tax rates would increase total factor productivity by 3.8 per cent in the long run. That effect "occurs relatively quickly (within four to five years rather than over decades)" and firms in "innovation intensive" industries are affected more severely. "Higher corporate tax rates, via their effect on the post-tax user cost of capital, have significant adverse effects on firms' investment levels."[357]

Conefrey and Fitzgerald have found that in Ireland "a reduction in the rate of corporation tax in the 1990s stimulated exports and, even allowing for profit repatriations by foreign firms and replacement of lost tax revenue, it resulted in an increase in domestic output."[358]

It is widely repeated that at 24 per cent from April 2012 the UK has one of the lowest headline rates of taxation in the G7, and that rate is set to fall progressively to 22 per cent by April 2014. But Britain does not only compete with the large developed G7 economies and needs to keep up with the prevailing trend towards lower and more competitive rates. Devereaux, Lockwood and Redoano link the rise in tax competition with the relaxation of capital controls, suggesting that the UK is part of a global environment in which companies make increasingly important choices

354. Felix, R. A. *Passing the Burden: Corporate Tax Incidence in Open Economies*, Federal Reserve Bank of Kansas City Working Paper, October 2007
355. Johansson, A., Heady, C., Arnold, J., Brys, B. & Vartia, L. *Tax and economic growth*, OECD, Economics Department Working Paper 28, 11 July 2008
356. Schwellnus, C. & Arnold, J. *Do Corporate Taxes Reduce Productivity and Investment at the Firm Level?* OECD Economics Department Working Paper No. 641, September 2008
357. Gemmell, N., Kneller, R., Sanz, I. & Sanz-Sanz, J. F. *Corporate Taxation and the Productivity and Investment Performance of Heterogeneous Firms: Evidence from OECD Firm-Level Data*, Documentos de Trabajo FUNCAS, 2010
358. Conefrey, T. & Fitzgerald, J. D. *The Macro-Economic Impact of Changing the Rate of Corporation Tax*, ESRI Working Paper No. 273, January 2009

about their tax environment.[359] Overesch and Rincke estimate that corporate tax rates would have been 12.5 per cent higher without tax competition.[360]

Table 4.1: Effective Corporation Tax rates on new business investment in 83 countries, 2010

Country	Rate (%)	Country	Rate (%)	Country	Rate (%)
Argentina	43.1	Kazakhstan	19.9	Morocco	13.9
Chad	36.3	Tanzania	19.3	Botswana	13.6
Brazil	35.1	Sierra Leone	19.0	Trinidad	13.1
Uzbekistan	34.9	Sweden	18.9	Greece	13.0
USA	34.6	Georgia	18.9	Ghana	12.9
France	34.0	Denmark	18.5	Czech Republic	12.0
India	33.6	Finland	18.3	Vietnam	11.7
Russia	31.9	Malaysia	18.0	Slovenia	11.6
Japan	29.5	Jamaica	17.9	Slovak Republic	11.2
Korea	29.5	Ecuador	17.9	Ireland	10.9
UK	27.9	Jordan	17.6	Taiwan	10.9
Italy	26.9	Switzerland	17.6	Ethiopia	9.8
Australia	26.0	New Zealand	17.6	Croatia	9.5
Spain	25.4	Mexico	17.5	Iceland	8.9
Lesotho	25.3	Zambia	17.2	Romania	8.6
Austria	25.3	Thailand	17.0	Singapore	8.5
Costa Rica	25.2	Rwanda	16.9	Mauritius	7.8
Norway	24.7	Netherlands	16.8	Egypt	7.0
Pakistan	24.1	Luxembourg	16.8	Chile	6.7
Germany	23.8	China	16.6	Turkey	5.6
Peru	23.0	Hungary	15.9	Latvia	5.6
Bolivia	22.9	Uganda	15.4	Bulgaria	4.6
Tunisia	21.9	Nigeria	15.1	Kenya	4.5
Portugal	20.8	Madagascar	14.6	Hong Kong	4.0
Iran	20.6	Israel	14.6	Ukraine	3.1
Fiji	20.6	South Africa	14.5	Belgium	-1.7
Indonesia	20.5	Bangladesh	14.5	Serbia	-5.1
Canada	20.5	Poland	14.3	Average	17.7

Focusing solely on headline rates can cause people to miss the real picture. More important than the headline rate is the effective rate – i.e. the percentage of taxable income that companies actually hand over to the Treasury. The difference between

359. Devereux, M. P., Lockwood, B. & Redoano, M. Do countries compete over corporate tax rates? *Journal of Public Economics*, 92, 2008, pgs. 1210–1235
360. Overesch, M. & Rincke, J. What Drives Corporate Tax Rates Down? A Reassessment of Globalization, Tax Competition and Dynamic Adjustment to Shocks, *Scandinavian Journal of Economics*, 113, 3, 2011, pgs. 579–602

the two is not tax evasion (although this would have an impact), but established and sensible provisions for things such as capital allowances, how previous losses are carried forward, and profits from foreign subsidiaries.

Analysis by the Cato Institute estimates that in 2010 the effective Corporation Tax rate on new investment for the UK was actually 27.9 per cent, compared to an average rate of 17.7 per cent across all countries studied. This also compared to an OECD average of 18.6 per cent.[361]

After Budget 2012, the Office for Budget Responsibility incorporated a 0.1 per cent increase in the level of GDP as a result of cuts in Corporation Tax. Academic research suggests that corporate tax cuts, particularly more ambitious ones than those currently planned in Britain, can deliver much more impressive results than that.[362]

4.1.2.3. Higher taxes particularly deter entrepreneurs, which impedes job creation

It has been well understood for some time that taxes like Capital Gains Tax (CGT) discourage entrepreneurship, in 1963 US President John F. Kennedy said:[363]

> *The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital […] the ease or difficulty experienced by new ventures in obtaining capital, and thereby the strength and potential for growth in the economy.*

Birch in the US, and more recently Trends Business Research in the UK, have shown how new firms create the vast majority of new jobs.[364] Indeed, a relatively small number high-growth “gazelles” – which could be hit particularly hard by CGT – were found to be responsible for creating the vast majority of new jobs. If those firms are not formed, or grow more slowly, because entrepreneurs and investors in these firms are deterred by CGT then that will have significant consequences.

For that reason, successive British governments have aimed to encourage more entrepreneurship. But they appear to have had limited success even before the financial crisis and recession.

The conventional indicator of business creation and closure, VAT registration and deregistration,[365] suggests there has been little progress in improving the rate of new business creation. With 181,530 businesses registering for VAT in 1997 and 182,055 businesses registering in 2006, there has been a 0.3 per cent increase,[366] significantly less than population growth over that period.

---

361. Chen, D. & Mintz, J. New estimates of effective corporate tax rates on business investment, *Cato Institute Tax & Budget Bulletin*, 64, February 2011

362. Office for Budget Responsibility *Economic and fiscal outlook*, March 2012, Box 3.1

363. Moore, S. & Silvia, J. *The ABCs of the Capital Gains Tax*, Cato Institute, Policy Analysis No. 242, 4 October 1995

364. Birch, D. *Job Creation in America: How Our Smallest Companies Put The Most People to Work*, 1987; Trends Business Research *Job Creation by New and Small Firms, 1995–1999*, 2001

365. From the end of 2008 the Office for National Statistics (ONS) and the Department for Business, Enterprise, and Regulatory Reform (BERR) launched a new methodology for measuring the creation and closure of UK businesses: ‘births’ and ‘deaths’. This measure captures those businesses which do not register for VAT, enabling in the future a more accurate analysis of those enterprises opening and closing over a year. However, the data series is potentially misleading. 2007 is the first year in which data was systematically collected for this new method, and totals for previous years were done retrospectively, potentially overstating the rate in 2007 relative to earlier years.

366. BERR *Guide to Business Start-ups and Closures*, 2008, Table 1a, Table 1b

Entrepreneurs assess the risks associated with starting a business. They may be in employment or may be unemployed, and in either case must make a rational economic decision about whether the risk of moving into self-employment is worth taking.

The individual may be a "necessity" entrepreneur who starts a business because of economic need or unemployment[367] or a Kirznerian opportunity entrepreneur, who moves from employment to self-employment to exploit an opportunity that he or she has discovered. Shane identifies that those who are unemployed have "less to lose by becoming entrepreneurs", i.e. "a lower opportunity cost on their time" and he goes as far as saying that "If a place wants more of its population to start businesses, it needs to have more of its population out of work".[368] With high unemployment, many people who are made redundant are inevitably pushed towards entrepreneurship which may increase the effectiveness of policies designed to encourage entrepreneurship.

There are non-economic reasons why people start a business. It may be that the individual would rather be independent or be his or her own boss, or as Shane puts it, "most people start businesses simply because they just don't like working for someone else."

There are also non-economic factors that might put people off starting a business. These will include the potential stigma of failure. Many simply do not become entrepreneurs because they think they could fail and feel they would be ashamed if that happened.

While these non-economic factors may be significant, they are predicated on the perceived chances that a venture will be economically successful. An entrepreneur will not achieve financial independence if their firm is a failure or its success is insufficient to pay them enough that they can maintain their lifestyle. Equally, the social disgrace of failing is tied up in the ability to make a sufficient return from a new venture. The economic risks and rewards of entrepreneurship have to be critical to someone's decision to become an entrepreneur.

Blanchflower and Oswald used surveys to examine the choice between employment and self-employment and concluded that there is a clear preference towards self-employment which leads to higher levels of satisfaction. Potential entrepreneurs are often stymied by a "shortage of capital and money" and "most small businesses were begun not with bank loans but with own or family money […] and that the single biggest concern to potentials was with where to obtain capital". As a result, receiving an inheritance or a gift led to higher levels of self-employment.[369]

There is a wide range of literature which draws similar conclusions about the impact of finance constraints upon entrepreneurship, which are widely thought to be a major barrier to starting up a business. While the tax system can affect the availability of informal sources of finance in a number of ways, inheritances are particularly singled out. Anyone who receives a share of an estate after a death or a gift from someone who died within seven years of making that gift will have to pay Inheritance Tax on any amounts above the threshold. As many estates will exhaust that threshold with the transfer of a family home the amounts left to help finance a new business could be significantly reduced. The Inheritance Tax burden is therefore levied upon funds particularly critical to entrepreneurs hoping to finance new

367. Bögenhold, D. *Der Gründerboom: Realität und Mythos der neuen Selbständigkeit*, 1987
368. Shane, S. A. *The Illusions of Entrepreneurship: The Costly Myths That Entrepreneurs, Investors and Policy Makers Live By*, 2008
369. Blanchflower, D. & Oswald, A. J. What makes an entrepreneur? *Journal of Labour Economics*, 16, 1, 1998, pgs. 26–60

businesses without the risks attached to formal external finance (other property taxes can have similar effects, Section 6.2.4.4).

Douglas and Shepherd found that: "the intention to be an entrepreneur is stronger for those with more positive attitudes to risk and independence. That is, the higher the tolerance for risk, and the more positive the attitude to decision-making autonomy, the stronger is the stated intention to be an entrepreneur. Note that income was not a significant determinant of entrepreneurial intention – people do not appear to start their own businesses to get rich, or to get any richer than they expect to get as employees."[370]

However, other studies suggest that potential financial rewards are important.

Cassar found that a key motivation for becoming an entrepreneur was potential financial success.[371] Henderson and Robertson interviewed students and found that "being one's own boss" and "to make money" were the primary motivations for choosing to start a new business.[372] Evans and Jovanovic found that "he will choose to start a business if and only if his expected net income from doing so exceeds that from waged work".[373]

That controversy extends to the question of whether high tax rates will encourage or discourage entrepreneurship. Some authors suggest that higher income tax levels can increase entrepreneurship. This can happen because entrepreneurs are given particular reliefs or because "high marginal tax rates on unincorporated businesses serve as an insurance policy against business failure because they allow businesses to write off business losses against personal income in the event that they fail." There is some empirical support for these arguments.[374]

But overall we should expect that higher taxes lower the rewards to entrepreneurship and thereby reduce the supply of it. Manzi summarised the issue in the City Journal:[375]

"Higher tax burdens raise the price of entrepreneurship"

> *Some people start companies because they're driven by a dream that transcends rational economic calculation. But most successful entrepreneurs are pretty serious about comparing risks with opportunities. Higher tax burdens raise the price of entrepreneurship. When you raise the price of something, then, all else held equal, you usually get less of it.*

Many new businesses fail. Research in the United States suggests that 66 per cent of new establishments are still in existence two years after their birth and 44 per cent are still in existence four years later.[376] Another study, looking at the venture capital backed businesses, that are the best candidates to become high-growth 'gazelles', suggests that first-time entrepreneurs have a 'success rate' (managing to go public) of 17.7 per cent. Even serial entrepreneurs with successful track records only have

370. Douglas, E. J. & Shepherd, D. A. 'Self-employment as a career choice: attitudes, entrepreneurial intentions and utility maximization' in *Entrepreneurship: Theory and Practice*, 2002, pg. 88
371. Cassar, G. Money, money, money? A longitudinal investigation of entrepreneur career reasons, growth preferences and achieved growth, *Entrepreneurship & Regional Development*, 19, 1, 2007, pgs. 89–107
372. Henderson, R. & Robertson, M. Who wants to be an entrepreneur? Young adult attitudes to entrepreneurship as a career, *Career Development International*, 5, 5, 2000, pgs. 279–287
373. Evans, D. S. & Jovanovic, B. An estimated model of entrepreneurial choice under liquidity constraints, *Journal of Political Economy*, 97, 4, 1989, pgs. 814–815
374. Schuetze, H. J. & Bruce, D. *Tax Policy and Entrepreneurship*, 2004, http://lowtax.es/HFzuFD, Table 1
375. Manzi, J. The Innovation Squelch, *City Journal*, 3 March 2009
376. Knaup, A. E. Survival and longevity in the Business Employment Dynamics data, Bureau of Labour Statistics, *Monthly Labour Review*, May 2005, pg. 51

a 29.6 per cent success rate.[377] When businesses fail, the entrepreneur can often lose substantial amounts of money or their home and risk bankruptcy.

For simplicity, it is possible to think of the earnings for an entrepreneur from a failed business as zero. Leaving aside other factors, this would mean an individual would become an entrepreneur if the following held true:

$$E_e \times P_e > E_c$$

Where,

E_e is the expected return as a successful entrepreneur,

P_e is the probability that the entrepreneur will be a success,

E_c is the expected return the potential entrepreneur would make if they decided not to start a new business.

In this simplified model, if a new business has a one-third chance of being a success then the rewards will need to be three times as large if it does succeed as the entrepreneur could obtain by staying in their existing, secure, employment.

The tax system complicates this, as the decision will be made on the basis of post-tax returns to entrepreneurship or remaining in existing employment.

The following will need to be true for entrepreneurship to be worthwhile (T is a function from pre-tax return to post-tax return):

$$T(E_e) \times P_e > T(E_c)$$

The tax system is not neutral with respect to the choice between entrepreneurship and remaining in existing employment. Successful entrepreneurs are likely to face a greater tax burden as their earnings will be higher – pushing them into a higher tax bracket, which will make it less likely those earnings will be sufficient to outweigh the risk of failure. While relatively low rates of capital gains tax are available to entrepreneurs, the total tax burden on high earnings that are often the reward for entrepreneurial success can be formidable.

This is particularly the case because the high earnings may well be more than the entrepreneur needs to satisfy their own immediate needs. It is no accident that the BBC television programme *Dragons' Den* features a successful entrepreneur who refers to his personal wealth as his "children's inheritance". That money will be taxed repeatedly for an extremely high combined rate as shown in Section 5.2.1.

By so substantially diminishing the rewards to the most successful, and economically important, entrepreneurs, there is good reason to think we will increase the number who decide that it is not worth the risk.

377. Gompers, P. et al. *Skill vs. Luck in Entrepreneurship and Venture Capital: Evidence from Serial Entrepreneurs*, July 2006

A number of empirical studies suggest that taxes impede entrepreneurship:

- Folster draws upon data on OECD countries and particularly in Sweden, and found that "there is a strong negative correlation between the tax burden and the share of self-employment", and that "reducing the tax burden by 10 percentage points (of GDP) increases the share of self-employed by about three per cent of total employment."[378]
- The World Bank's "Doing Business" study found that a "10 percentage point increase in the first year effective corporate tax rate reduces business density by 1.9 firms per 100 people (average is 5), and the average entry rate by 1.4 percentage points (average is 8)".[379]
- Blau found that "self-employment rates fall when tax rates rise for low income groups."[380]
- Bögenhöld and Stabler, and Meager, have found that countries with high welfare payments such as Denmark and Sweden have minuscule levels of self-employment as a result.[381]

There are numerous economic studies showing that CGT in particular discourages entrepreneurship

There are numerous economic studies showing that CGT in particular discourages entrepreneurship. For example, Keuschnigg and Nielsen developed a model of start-up finance where entrepreneurs were willing to start a new business and had the ideas and expertise to do so. Venture capitalists were able to provide finance and business support. The study found that:[382]

> *We found, indeed, that even a small capital gains tax involves a first-order welfare loss, because it exacerbates a pre-existing distortion and further diminishes incentives to provide entrepreneurial effort and managerial support. Therefore, the capital gains tax could indeed be a major impediment to the development of a high quality venture capital industry that significantly adds value to young innovative firms.*

Gentry argues that the disincentive effects created by CGT are arguably more important for entrepreneurs than they are for investors in large corporations. He also discusses how the asymmetric taxation of capital gains – when gains are taxed more heavily than losses are relieved – discourages entrepreneurs:[383]

> *Taxing capital gains creates a tax in addition to the taxes on wage or business income. This additional tax can be particularly burdensome because it tends to fall asymmetrically on successful projects.*

378. Folster, S. Do Lower Taxes Stimulate Self Employment? *Small Business Economics*, 19, 2002, pgs. 135–145
379. Djankov, S., Ganser, T., McLiesh, C., Ramalho R. & Shleifer, A. *The effect of corporate taxes on investment and entrepreneurship*, World Bank: Doing Business, May 2008
380. Blau, D. M. *A time series analysis of self-employment in the United States*, Journal of Political Economy, 95, 3, 1987, pgs. 445–446
381. Bögenhöld, D. and Stabler, U. *Self employment and the institutional-political framework*, Mimeo, 1992. Cited in Storey, D. J. *Understanding the Small Business Sector*, 1994; Meager, N. The characteristics of the self employed: Some Anglo-German comparisons, in Leighton, P. and Felstead, A. (eds) *The New Entrepreneurs: Self Employment in Small Businesses in Europe*, 1992
382. Keuschnigg, C. & Nielsen, S. B. Start-ups, venture capitalists, and the capital gains tax, *Journal of Public Economics*, 88, 2004
383. Gentry, W. *Capital Gains Taxation and entrepreneurship*, 2010

That could mean the proposed alternative minimum tax would discourage them (Section 2.7.2).

Not only does the literature overwhelmingly suggest that tax cuts would increase entrepreneurial activity, it also finds they would increase entrepreneurial longevity. Gurly-Calvez and Bruce used a 12 year panel of tax return data and found "convincing evidence that cutting marginal tax rates faced by wage-and-salary workers can reduce the duration of entrepreneurial activities, while cutting marginal tax rates faced by entrepreneurs can lengthen entrepreneurial spells. The relative magnitudes of these effects suggest that an across-the-board tax cut would increase entrepreneurial longevity."[384]

While the Government does offer Entrepreneurs' Relief, a lower rate of 10 per cent on disposals of up to up to £10 million, the combined rate of tax on that income if it is then saved and invested is still high (Section 5.2.1) and a 10 per cent rate is higher than it sounds given that CGT is a double tax (Section 5.2.2.1). The limitations on that relief can also encourage entrepreneurs to sell their companies and move on earlier than they otherwise might. The substantial effect of CGT on entrepreneurship, and thereby on innovation and jobs, is a high price to pay for the revenue generated by the tax.

4.1.2.4. Introducing a proportionate income tax would increase national income and growth

Many countries have introduced proportionate, or flat, income taxes as a way of keeping marginal income tax rates at a fair and efficient minimum. The plan for such a tax outlined by Hall and Rabushka – originally in 1981 – has been extremely influential, they describe how their plan would function:[385]

> *Under our flat tax, all income would be taxed once and only once, at a uniform low rate of 19 per cent. Our plan is fair to ordinary Americans because it would permit a tax-free allowance of $25,500 for a family of four. The family would pay a tax of 19 per cent on its earnings above that allowance. Millions of U.S. residents would no longer pay any income taxes. All wage earners would pay less tax under our flat tax than under the current system.*
>
> *Our flat tax would eliminate the distortions of the present tax treatment of business. It would replace a hodgepodge of depreciation schedules with an effective investment incentive, a first-year write-off. It would reduce the current corporate tax of 35 per cent to 19 per cent. It would eliminate double taxation of business income by ending taxation of dividends and capital gains.*

Rabushka maintains a list of countries and jurisdictions that have adopted a proportionate tax, and the current rates. At September 2010, he reported the following list:[386]

384. Gurley-Calvez, T. & Bruce, D. Do tax cuts promote entrepreneurial longevity? *National Tax Journal*, 61, 2, 2008, pgs. 225–250

385. Hall, R. E. & Rabushka, A. *The Flat Tax*, 1995

386. Rabushka, A. *Flat Tax Countries and Jurisdictions*, 1 September 2010

Table 4.2: Countries and jurisdictions that have adopted a flat tax

Jurisdiction	Year of implementation	Personal tax rate (%)	Corporate tax rate (%)
Jersey	1940	20	20.00
Hong Kong	1947	16	17.50
Guernsey	1960	20	0.00
Jamaica	1986	25	33.30
Tuvalu	1992	30	30.00
Estonia	1994	21	0.00
Lithuania	1994	15	15.00
Grenada	1994	30	30.00
Latvia	1995	26	15.00
Russia	2001	13	24.00
Serbia	2003	12	10.00
Iraq	2004	15	15.00
Slovakia	2004	19	19.00
Ukraine	2004	15	25.00
Georgia	2005	20	20.00
Romania	2005	16	16.00
Turkmenistan	2005	10	20.00
Trinidad & Tobago	2006	25	25.00
Kyrgyzstan	2006	10	10.00
Albania	2007	10	10.00
Macedonia	2007	10	10.00
Mongolia	2007	10	10.25
Montenegro	2007	9	9.00
Kazakhstan	2007	10	15.00
Pridnestrovie	2007	10	0.00
Mauritius	2007	15	15.00
Bulgaria	2008	10	10.00
Czech Republic	2008	15	19.00
Timor Leste	2008	10	10.00
FBiH	2009	10	10.00
Belarus	2009	12	24.00
Belize	2009	25	25.00
Nagorno Karabakh	–	5	5.00
Seychelles	2010	15	35.00
Paraguay	2010	10	10.00
Hungary	2011	16	10.00
Abkhazia	–	10	18.00

Many of those countries maintain separate payroll taxes though, so the combined rates are not as low relative to the 2020 Tax Commission recommendations – which include abolishing National Insurance – as they might appear.

There have been a number of studies that have looked at the economic results that could be obtained with the introduction of a flat tax.

Boskin estimated that a flat tax would increase national income by 10 per cent by "replacing the current corporate and personal income taxes with a broad-based, low-rate direct, or indirect tax on consumption or consumed income", and that a "conservative estimate" would be five per cent per year, though partly thanks to forgoing some consumption.[387]

Jorgenson and Wilcoxen found that there would be a number of economic improvements if a Hall-Rabushka flat tax were introduced: "Labour supply increases sharply because the consumption tax raises real after-tax wages substantially at the margin. Household capital would decline by about 10 per cent and business capital would increase by about 12 per cent. GDP would increase by almost 3.3 per cent in the first year relative to the base case due to the increase in labour supply."[388]

Auerbach and Kotlikoff found that the introduction of a Hall-Rabushka flat tax would raise the ratio of capital formation to GDP from 5.0 per cent to 6.2 per cent and increase national income by two per cent to four per cent in seven years.[389]

Auerbach, Kotlikoff, Smetters and Walliser looked at the effects of moving to a "unified flat income tax" where "firms can fully expense new capital investment". They found that:[390]

> *In the simulations, labor supply initially increases by 2.5 per cent, which boosts output by 1.2 per cent. At the same time, the removal of the capital income tax and the drop in the value of existing assets leads to an increase in the saving rate from 5.3 per cent to 9.0 per cent in the short run. Labor supply decreases slowly over time and its level in the long run barely exceeds its original level. In the medium and long run, the growth in output is mostly driven by capital accumulation. Four years after the reform, the capital stock is 7.2 per cent larger, and by year 9, it has increased 14 per cent above baseline. Eventually, the capital stock exceeds its initial level by 31.5 per cent. Accordingly, output is 2.4 per cent larger than baseline in year four and 4.0 per cent larger in year 9. In the long run, output increases by 7.5 per cent. In response to the changes in long run factor supply, the interest rate falls from 9.6 per cent to 7.8 per cent and (before-tax) wages increase by 7.1 per cent above the baseline.*

Caucutt, Imrohorglu and Kumar found that:[391]

> *Experiments on a calibrated model indicate that the quantitative effects of moving to a flat rate system are economically significant. The assumption*

387. Boskin, M. J. *Frontiers Of Tax Reform*, Hoover Institution, 1996
388. Jorgensen, D. W. & Wilcoxen, P. J. *The Effects of Fundamental Tax Reform and the Feasibility of Dynamic Revenue Estimation*, Paper prepared for the Joint Committee on Taxation's Symposium on Modeling the Macroeconomic Consequences of Tax Policy, 1997
389. Auerbach, A. J. & Kotlikoff, L. *Dynamic Fiscal Policy*, 1987
390. Auerbach, A. J., Kotlikoff, L. J., Smetters, K. A. & Walliser, J. Fundamental Tax Reform and Macroeconomic Performance in Congressional Budget Office *Two Papers on Fundamental Tax Reform*, October 1997
391. Caucutt, E. M., Imrohorglu, S. & Kumar, K. B. *Does the progressivity of taxes matter for economic growth?* Discussion Paper 138, Institute for Empirical Macroeconomics, Federal Reserve Bank of Minneapolis, 2000

made about the engine of growth has an important effect on the impact of a change in progressivity.

They also found that growth increased by up to 0.52 percentage points in simulations of the effect of the reform.

Altig, Auerbach, Kotlikoff, Smetters and Walliser found that adopting a Hall-Rabushka flat tax in the United States at the revenue neutral rate of 22 per cent initially – and 19.4 per cent in the long term – would increase long-term output by six per cent. They argued that: "The flat tax generates long-run utility gains across-the-board. Interestingly, the highest relative gains are for the richest and poorest lifetime-income groups."[392]

Jorgenson and Yun calculated that if a Hall-Rabushka flat tax were introduced in the United States, it would lead to welfare gains of at least $2.06 trillion, even after the flat tax is adjusted to make up for any revenue shortfall. If there were no revenue shortfalls, or if they were met by a lump sum tax, then the gains would be even greater.[393]

Cassou and Lansing decompose the effect of a flat tax on economic growth into three effects: the flattening of the income tax schedule; the full expensing of physical capital investment; and the elimination of double taxation of corporate dividends. Their model followed an earlier investigation by Stokey and Rebelo, which had suggested the economic effects of the flat tax would be limited. They found that the most important element conducive to economic growth was the flattening of the marginal rate schedule. While they find that a flat tax reform permanently increases per capita growth by up to 0.143 percentage points a year, that estimate is likely to be low thanks to certain assumptions. For example, that the government would impose a "higher average tax rate to pay for the more generous expensing and deduction features."[394]

Bohacek and Kejak found that "Our simulation of the flat-tax reform increases the steady state levels by magnitudes found in the literature: capital stock increases by 30 per cent, output by 10.8 per cent, consumption by 4.6 per cent, and welfare by 3.9 per cent".[395]

Gonzalez & Pijoan-Mas quantify the macroeconomic and distributional effects in Spain of a range of potential flat tax reforms using a dynamic general equilibrium model of individual behaviour. With heterogenous agents, they find "that a revenue neutral reform with a marginal tax equal to 17.42 per cent and a fixed deduction equal to 15 per cent of per capita income will yield increases in aggregate consumption and labour productivity equal to 7.6 per cent and 2.5 per cent respectively." Another revenue-neutral flat tax reform with a marginal tax rate of 23.37 per cent and a fixed deduction of 35 per cent still produces aggregate gains and those in the lowest quintile of the wage distribution pay lower taxes and enjoy higher consumption than under the then current income tax.[396]

392. Altig, D., Auerbach, A., Kotlikoff, L., Smetters, K. & Walliser, J. Simulating Fundamental Tax Reform in the United States, *American Economic Review*, 91, 3, 2001, pgs. 574–595

393. Jorgenson, D. W. & Yun, K-Y. *Lifting the burden: fundamental tax reform and US economic growth, National Bank of Belgium working paper*, 2002

394. Cassou, S. P. & Lansing, K. J. *Growth effects from shifting from a graduated rate tax system to a flat tax, Economic Inquiry*, 42, 2, 2004, pgs. 194–213

395. Bohacek, R. & Kejak, M. *Optimal Government Policies in Models with Heterogenous Agents*, USC FBE Macroeconomics and International Finance Workshop, 2005

396. Gonzalez, M. & Pijoan-Mas, J. *The Flat Tax Reform: a General Equilibrium Evaluation for Spain*, CEMFI Working Paper 0505, 2005

Conesa and Krueger calculate the optimal progressivity of the marginal income tax schedule in a dynamic general equilibrium model with household heterogeneity, in which uninsurable labour productivity risk gives rise to a non-trivial income and wealth distribution. Using a utilitarian steady state social welfare criterion, they find "that the optimal US income tax is well approximated by a flat tax rate of 17.2 per cent and a fixed deduction of about $9,400. The steady state welfare gains from a fundamental tax reform towards this system are equivalent to 1.7 per cent higher consumption in each state of the world."[397]

Introducing a proportionate income tax would be a much simpler way of ensuring everyone paid a fair share and bring increased prosperity, particularly if it were combined with reforms to capital taxation that aimed to ensure that all streams of income – labour or capital – were taxed at the same low rate.

4.1.2.5. Business opinion surveys suggest that many companies are struggling with taxes, particularly when competing in global markets

4.1.2.5.1. Earlier surveys

British business perceives taxation to be too high. When business people are asked about the specific levies raised from business (business rates, or Employers' National Insurance contributions), or more general taxation, current tax rates are seen as a burden to business and an obstacle to growth and enterprise. Similarly, high taxation is seen as having a negative impact on British international competitiveness.

79 per cent of private businesses cited the onerous tax regime as an obstacle to their growth

PwC's 2011 Enterprising UK survey asked private businesses what they considered to be obstacles to growth for their company in the next five years. 79 per cent cited the onerous tax regime, with 34 per cent calling it a major obstacle.[398] This is not just a reference to complexity, but also high taxation – in the same survey 70 per cent thought the 50 per cent tax rate on higher incomes was having a negative impact on their businesses, 75 per cent thought the same about the 20 per cent VAT rate, and 91 per cent about increased Employers' National Insurance contributions.

Different sized businesses feel the pressure of taxation in different ways. Overwhelmingly, small to medium-sized enterprises dislike the current level of business rates, which "are regarded as the biggest taxation impediment".[399] This is felt most strongly by small rural businesses. They cited Business Rate Relief as the single highest priority for an incoming Government in 2010.[400] Small businesses are also most often concerned about the level of Fuel Duty, with 66 per cent saying in April 2010 they would like to see it cut to promote business growth.[401]

There is no evidence that a tax cut for small business would just be used to pay more to directors or managers, or otherwise to take money out of businesses. Polling suggests that money freed up by tax cuts would be used to fund business expansion, confirming concerns that the tax burden is a threat to investment and economic growth. 42 per cent of small business owners would use a tax cut to finance innovation and growth. 35 per cent would spend it on capital investment. 28 per cent would increase wages for workers.[402]

397. Conesa, J. C. & Krueger, D. *On the Optimal Progressivity of the Income Tax Code*, 2005
398. PricewaterhouseCoopers *A voice for private business*, Enterprising UK Survey, 2011
399. Federation of Small Business-ICM *Voice of Small Business*, 2009
400. Forum of Private Business *Referendum* 191, March 2010
401. Federation of Small Business-ICM *Voice of Small Business panel*, April 2010
402. Federation of Small Business-ICM *Voice of Small Business*, 2009

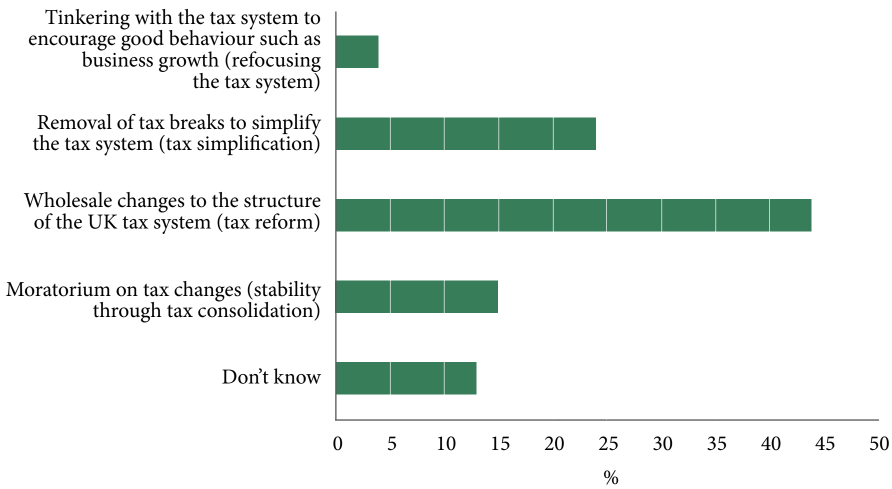
Larger businesses have different but parallel concerns. A survey of FTSE 250 bosses found that their highest priorities were reducing the top level of Income Tax and lowering the corporate tax rate.[403] This is closely linked to business perception of Britain's international competitiveness, with the same survey finding that many company bosses would think twice about basing their companies in Britain, even if they were unwilling to move after they had already established their business here. High taxes are also perceived as undermining the ability to attract highly-qualified and highly-paid employees. Skandia's *Millionaire Monitor* found 55.9 per cent of British-based millionaires were considering leaving the UK – of these 33.3 per cent blamed high taxes. They were disproportionately young millionaires who had not inherited their wealth.[404]

These results cannot be dismissed as an inevitable negative response to any level of taxation. Most businesses want tax cuts because they believe their opportunities for growth are being stymied by excessive tax rates. When businesses complain of increases to National Insurance contributions it is because increased rates prevent them from taking on extra staff. When businesses criticise Fuel Duty, it is because cars and vans are often vital to their livelihoods.

4.1.2.5.2. New survey results

The Forum of Private Business (FPB) surveyed members for its Tax and Budget Panel report in February 2012. The organisation represents small business so respondents represent a specific set of opinions in the private sector. In one of the panel questions, FPB members were offered options for their priorities for the tax system. They included stability (maintaining the status quo), reform (wholesale structural changes), simplification (removing tax breaks), or refocusing (minor tweaks). The results show that wholesale reform was by far the most popular answer, while 68 wanted either reform or simplification. Only 15 per cent wanted to keep things as they are, while just four per cent thought that tinkering with the tax system was the right thing to do.

Figure 4.3: Business opinion on the overall need for tax reform, Forum of Private Business survey



403. PricewaterhouseCoopers *FTSE 250: Realising ambitions for growth*, March 2011
404. Skandia *Millionaire Monitor*, October 2011

The written answers provided to the questions are also very revealing. Many respondents felt the system was just too complicated and there were too many opportunities for larger companies to lower their tax bills, while smaller businesses did not have the same resources. One told the FPB:

Everything is far too complex with too many opportunities to avoid paying it, so find a system that is fair to all and EVERYONE PAYS WHAT THEY OWE!

Another said that:

The tax system has been getting larger and more complicated for many years. All this does is incur accountant fees for companies and employs large numbers of civil servants. The merging of NI and Income Tax would make a great deal of sense.

Respondents also felt that the current system hindered investment and economic growth:

The country needs economic growth; in simplifying the tax system and refocusing it on encouraging business and private sector infrastructure investment will encourage existing companies and entrepreneurs to invest.

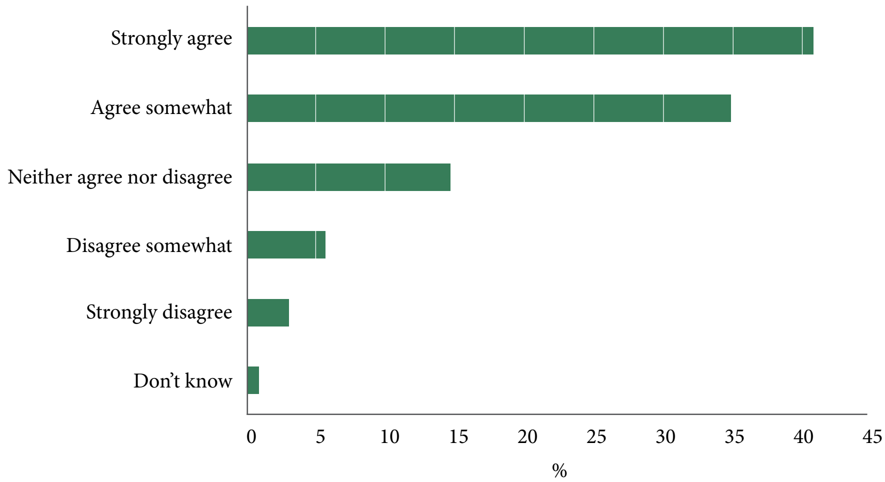
Finally, a simpler system would be harder to defraud:

Simplify the system it makes it easier for everyone to understand their responsibilities and makes a tax inspection more straightforward. A good simple system should highlight fraud far more easily.

The Institute of Directors also surveyed members for their opinions on the tax system for the 2020 Tax Commission. They looked at some more specific issues, including the incidence of taxation and which taxes most hindered economic growth.

For instance, the survey asked members about Fuel Duty, and found that 76 per cent thought that "current rates of fuel duty have an adverse effect on businesses".

Figure 4.4: "Current rates of fuel duty have an adverse effect on businesses," IoD survey



79 per cent agreed that National Insurance and Income Tax should be merged, with just 11 per cent disagreeing.

4.1.3. There is a massive deadweight loss from investments that aren't made and work people don't do because high taxes reduce the return

Taxes create deadweight costs because they drive a wedge between the price signals perceived by consumers and those received by producers. As Christopher J. Conover has explained:[405]

> *In a competitive market, the equilibrium price at which supply matches demand permits many consumers to purchase goods at a cheaper price than they are willing to pay. Imagine you can purchase an apple for 50 cents. If you were willing to pay 50 cents, there would be no net value to you from the transaction: you would give up 50 cents, and receive the equivalent value in the form of an apple. You would be indifferent about keeping your money or buying the apple. But if you were willing to pay 90 cents for the apple, buying an apple for 50 cents increases your net welfare by 40 cents. The amount by which a consumer's willingness to pay exceeds the price is what economists call the 'consumer surplus'. A parallel calculation applies to producers. In a competitive market, some producers may have been willing to supply apples for only 25 cents, but because the price they get in the market is 50 cents, they enjoy a 'producer surplus' of 25 cents.*

More formally, this can be seen from Figure 4.5 which illustrates what happens when a flat rate consumption tax is imposed on a product. The supply of the product falls from Q1 to Q2, the price to the consumer rises from P1 to PC and the price received by the producer falls from P1 to PS. The revenue received by the government corresponds to the area C on the diagram. Both the consumer surplus A and the producer surplus B are smaller than before. The area D represents the deadweight cost of taxation, and represents the utility that has been entirely lost as a result of the tax. This deadweight loss increases at the square of the marginal tax rate concerned. Further tax increases from today's high base are correspondingly likely to be more harmful to social and economic wellbeing than if they had been attempted in the 1950s, for example.[406]

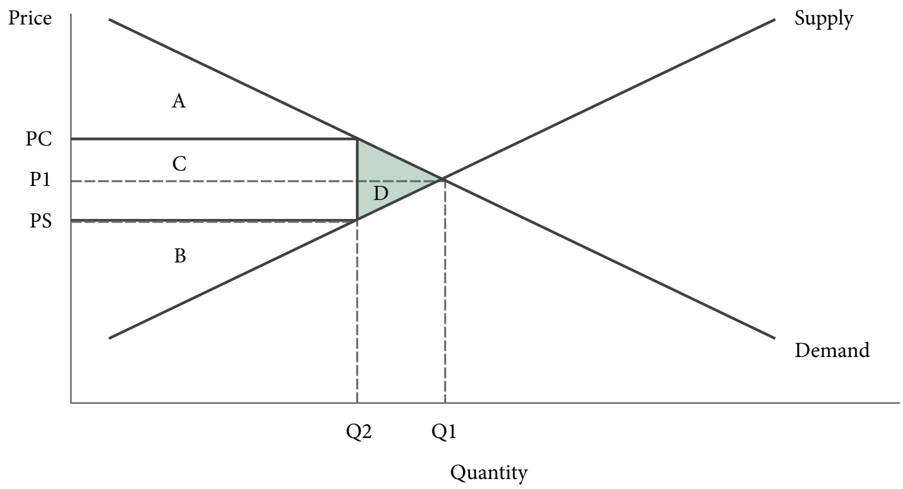
It is because of the deadweight costs of taxation that most economists have argued that proportionate taxes are the least damaging. They cause the least distortion at the margin, where economic decisions are made. These deadweight costs are also frequently referred to as the excess burden of taxation. The practical problem is that the excess burden of taxation cannot be measured directly. This means that it is similar to the value of time or human life employed in cost benefit studies of whether it is worth building a new road, for example. Governments are supposed to take such intangibles into account when deciding how to allocate their budgets to maximise social welfare most effectively. The same consideration suggests that governments should minimise the negative deadweight losses from taxation when setting taxes (Section 3.6.5.2).

---

405. Conover, C. J. *Congress Should Account for the Excess Burden of Taxation, Cato Institute*, Policy Analysis No. 669, 13 October 2010

406. Possibly, one important intellectual advance since the late Victorian public finance literature has been the development of optimal tax theory, which provides a methodology for designing tax systems to achieve the best outcome given the constraints faced by government. The, somewhat complex, issues involved are well explained in Section 2.2.1, in Chapter 2 of the September 2011 Mirlees Report from the Institute of Fiscal Studies.

Figure 4.5: Deadweight cost



There is a detailed discussion of the evidence that higher marginal tax rates reduce labour supply in (Section 4.1.2.1). That represents one type of reduction in producer surplus, but high taxes are also likely to lead to a withdrawal of other productive activities such as capital formation, enterprise, and technical innovation as set out in the rest of Section 4.1.2. There is now a considerable US literature on the issue of deadweight loss, extending back to Lindsay in the 1980s and Feldstein in the 1990s.[407] This research has generally indicated that the deadweight loss (or excess burden) represents at least 25 per cent of each additional US dollar of Federal income tax revenues. This means that if income tax rates were increased by $10 billion, for example, taxpayers would be $12.5 billion worse off because of the extra $2.5 billion of economic distortions that had been created.

The US Office of Management and the Budget (OMB) has incorporated a 25 per cent deadweight loss measure into Federal cost-benefit analyses since 1992. However, the 25 per cent figure is little better than a rule of thumb. There are two particular circumstances under which the excess burden can be significantly higher. The first is when the supply and demand responses concerned are high, in which case the deadweight loss will be far larger. As all such responses tend to be larger in the long run than they are immediately, the implication is that the ultimate damage will be far greater than the initial shock. This is consistent with the results of simulations on macroeconomic forecasting models, which also tend to find that the ultimate adverse effects of taxes on national output are far worse than the initial ones.

The second factor affecting the size of deadweight losses is the marginal tax rate. This is because the excess burden associated with a tax rises more than proportionally to increases in the rate of tax – generally at its square, as suggested earlier. The marginal excess burden (MEB) or marginal deadweight loss caused when taxes are raised from an already high base may correspondingly be twice as large as the average deadweight loss and will vary with the source of tax revenue and marginal tax rates.[408] The paper by Conover already cited reports a range of estimates of the MEB based on recent studies. Conover concluded that the most likely estimates of the

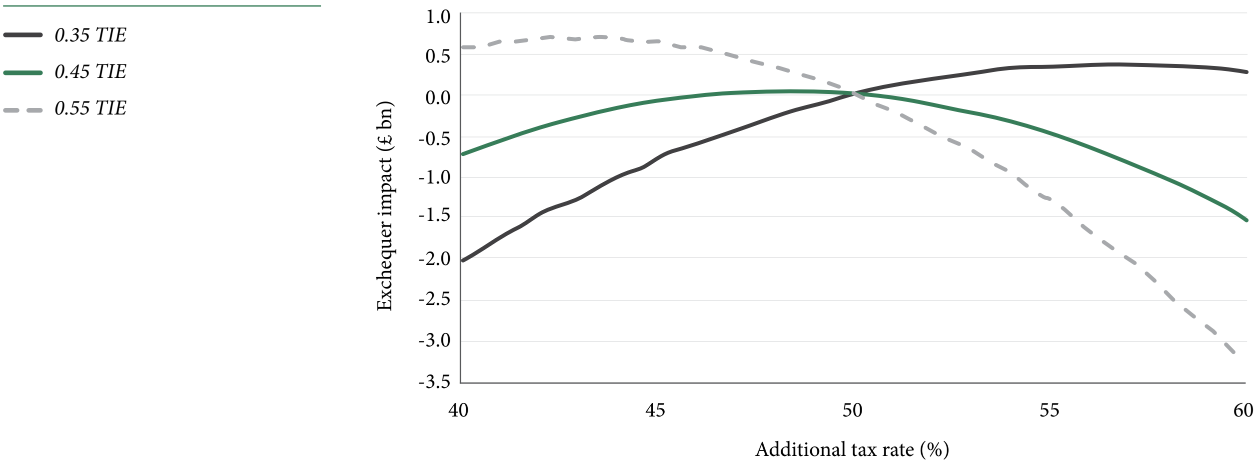
407. Lindsey, L. Individual Taxpayer Response to Tax Cuts, 1982–1984, with Implications for the Revenue Maximising Tax Rate, *Journal of Political Economy*, 33, 1987; Feldstein, M. The Effect of Marginal Tax Rates on Taxable Income: a Panel Study of the 1986 Tax Act, *Journal of Political Economy*, June 1995
408. Jorgenson, D. & Yun, K-Y. The Excess Burden of Taxation in the United States, *Journal of Accounting, Auditing and Finance*, Fall 1991 put the total deadweight loss of US taxation at 18 per cent but the MEB was 39 per cent.

MEB ranged from 14 per cent to 52 per cent of the revenue collected and averaged about 44 per cent for all Federal taxes.

4.2. Higher marginal rates can create sufficient economic disruption that the resulting revenue is underwhelming, or overall revenue actually falls

The economic problems created by high marginal tax rates, and the substantial fiscal churn that takes place as people are taxed and then given the money back in benefits, mean that many cuts in taxes do not reduce revenue anything like as much as a simple static calculation would suggest.

Figure 4.6: Laffer curve for high earners with different Taxable Income Elasticity estimates, HMRC



The simplest and most well-known expression of the idea that higher taxes might not produce the revenue expected is the Laffer Curve produced by Art Laffer. Figure 4.6 shows an example of the concept being applied, in the HMRC estimate of the revenue effect of the 50p rate. He is far from the only economist to have identified that possibility though, in 1933 Keynes wrote:[409]

> *Nor should the argument seem strange that taxation may be so high as to defeat its object, and that, given sufficient time to gather the fruits, a reduction of taxation will run a better chance than an increase of balancing the budget. For to take the opposite view today is to resemble a manufacturer who, running at a loss, decides to raise his price, and when his declining sales increase the loss, wrapping himself in the rectitude of plain arithmetic, decides that prudence requires him to raise the price still more – and who, when at last his account is balanced with nought on both sides, is still found righteously declaring that it would have been the act of a gambler to reduce the price when you are already making a loss.*

"Nor should the argument seem strange that taxation may be so high as to defeat its object…"

John Maynard Keynes

409. The quotation is reproduced in Young, P. & Saltiel, M. *The Revenue and Growth Effects of Britain's High Personal Taxes*, Adam Smith Institute, 2011. The original source was Keynes's 1933 essay "*The Means to Prosperity*".

President Kennedy made a similar argument in 1962 (Section 3.5.3.2.1).

That does not mean we should be preoccupied with identifying a single peak for the Laffer Curve though. Not only are there other priorities besides maximising revenue, there are a number of criteria that will affect the extent to which higher taxes translate into higher or lower revenue:

- Which tax? Corporate taxes appear to be particularly likely to produce lower revenue when they are increased.
- Where? Smaller and more open economies are likely to find that tax rises produce less revenue.
- When? There is good reason to think that the increasing mobility of capital and some labour will reduce tax-maximising tax rates over time.
- Over what period? Taxes may increase revenue in the first year they are introduced but reduce it over time by reducing the extent of economic growth.

This section will look at the extent to which higher or lower rates are likely to translate into higher or lower revenue for three sets of taxes: income taxes (Section 4.2.1); corporate taxes (Section 4.2.2); and capital gains taxes (Section 4.2.3).

4.2.1. Higher marginal tax rates on labour income reduce taxable income, particularly when levied on high earners, meaning that revenue is often underwhelming

Trabandt and Uhlig found that many European economies are now not far from reaching a stage where raising taxes would begin to lose revenue. Their results indicated that Britain had a 73 per cent self-financing rate for capital taxes – in other words, a capital tax cut would recover 73 per cent of the costs to the Exchequer. For labour taxes, the figure is 42 per cent.[410]

Harvard economist Gregory Mankiw also investigated the extent to which tax cuts pay for themselves in a 2005 paper with Matthew Weinzierl. They found that the feedback from tax cuts was large, and that half of a capital tax cut is self-financing.[411] The paper uses models that are iterations of the neoclassical growth model, also considering other assumptions like imperfect competition and positive externalities to capital investment. Their results show that "the dynamic response of the economy to tax changes is too large to be ignored."[412] In almost all cases, tax cuts are partly self-financing.

Aaberge and Flood found that tax cuts for low earners can be largely self-financing. In 2007 the Swedish Government introduced a reform that reduced the marginal tax rate for low earners, and the total effect was to reduce revenues by only one per cent. This is because the loss in Income Tax revenues was minimised by an improvement in labour incentives and offset by an increase in payroll tax and VAT receipts, and a reduction in benefit spending. They found cutting taxes on low earners increased employment, particularly for single mothers.[413]

410. Trabandt, M. & Uhlig, H. *How far are we from the slippery slope? The Laffer curve revisited*, NBER Working Paper No. 15343, 2009

411. Mankiw, G & Weinzierl, M, *Dynamic scoring: A back-of-the-envelope guide*, Harvard University, 2005

412. *Ibid*. pg. 19

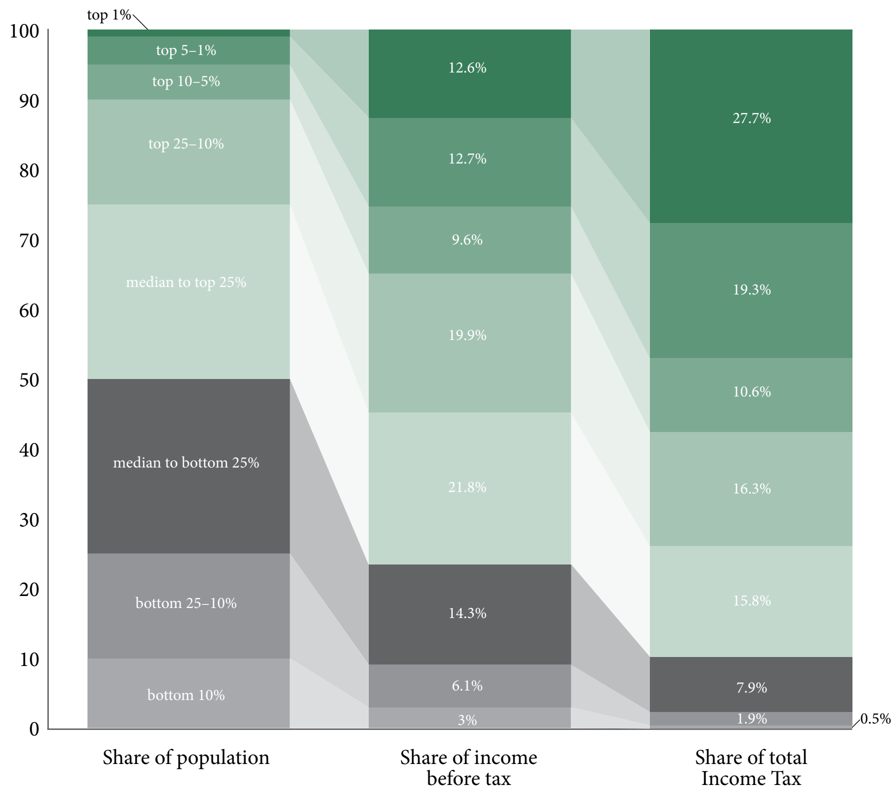
413. Aaberge, R and Flood, L, *Evaluation of an in-work Tax Credit reform in Sweden: Effects on labor supply and welfare participation of single mothers*, School of Business, Economics and Law at the University of Gothenburg, 2008

Feldstein and Feenberg looked at the effects of tax hikes introduced in the United States during the 1990s. The top rate had been 31 per cent, but that rate was increased to 36 per cent and a new top rate of 39.6 per cent was introduced, on income above $250,000. They reported that taxable income would have been 7.8 per cent higher without the higher rates, and as a result the US government lost more than half the revenue that would have been generated without behavioural changes. As a result, they argued that the overall loss in efficiency was twice the amount raised in revenue.

Research in Norway suggests that an estimate of the revenue cost of major cuts in personal taxes in 2006 is reduced from around NOK9.3 billion ($1.44 billion) to NOK6.5 billion ($1 billion) when labour supply model simulations are included. In other words, those dynamic effects offset the effects on revenue by around a third. The authors point out that is similar to results reported by Feldstein for an increase in labour taxes in the United States.[414]

High earners are expected to be the most responsive to higher rates of tax, and therefore higher top marginal rates are thought to be the most likely to produce underwhelming returns or reduce revenue. In Britain the top one per cent of earners paid nearly 28 per cent of total tax in 2011–12, while they earned a 13 per cent share of total before-tax income (this falls to nine per cent after taxes). For those in the lower 50 per cent of earners, their share of total tax paid was 10 per cent, with a 23 per cent share of before-tax income (which rises to 26 per cent after taxes).

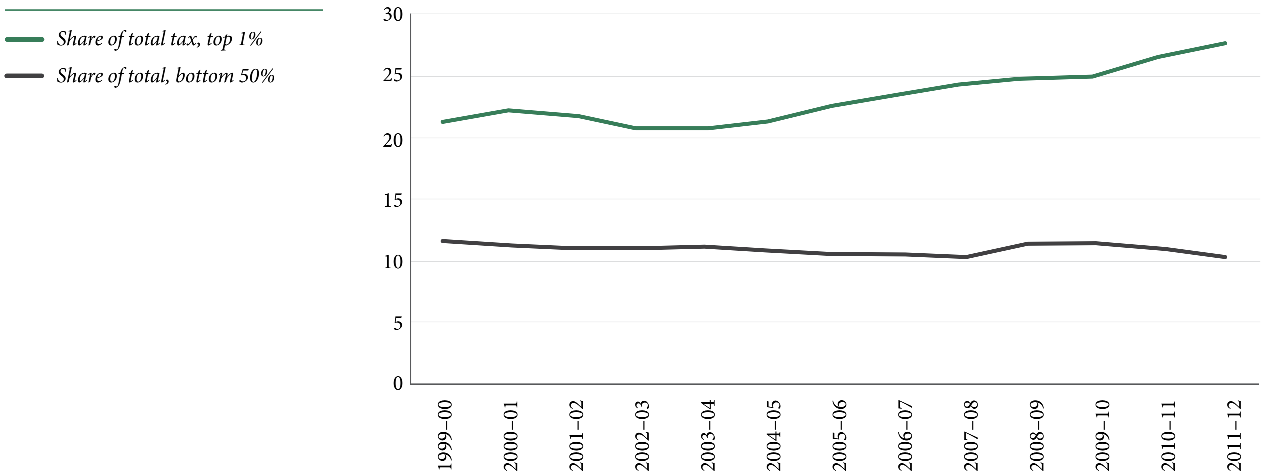
Figure 4.7: Share of income and tax paid, sections of the income distribution



414. Thoresen, T. O., Assness, J. & Jia, Z. The Short-Term Ratio of Self-Financing of Tax Cuts: An Estimate for Norway's 2006 Reform, *National Tax Journal*, 63, 1, March 2010, pgs. 93–120

The share of total tax paid by the top one per cent of earners has increased over the last decade too, with the trend starting before the introduction of the new top rate. It has fallen for the bottom 50 per cent of earners over the same period of time.

Figure 4.8: Share of total tax paid, top one per cent and bottom 50 per cent



That is in part evidence of the successful legacy of the tax cuts implemented by Nigel Lawson in 1988 (Section 3.5.3.1.3), which reduced marginal Income Tax rates and built up strong revenue from high earners over time. But at the same time it means that the tax system is highly dependent on a relatively small number of high earners and select industries, as less productive workers and struggling industries and regions are squeezed by rising taxes and onerous regulation. As Nick Pearce, Director of the IPPR, put it: the "over-reliance of the UK on revenues from financial services, the housing market and wealthy individuals was brutally exposed in the financial crisis".[415]

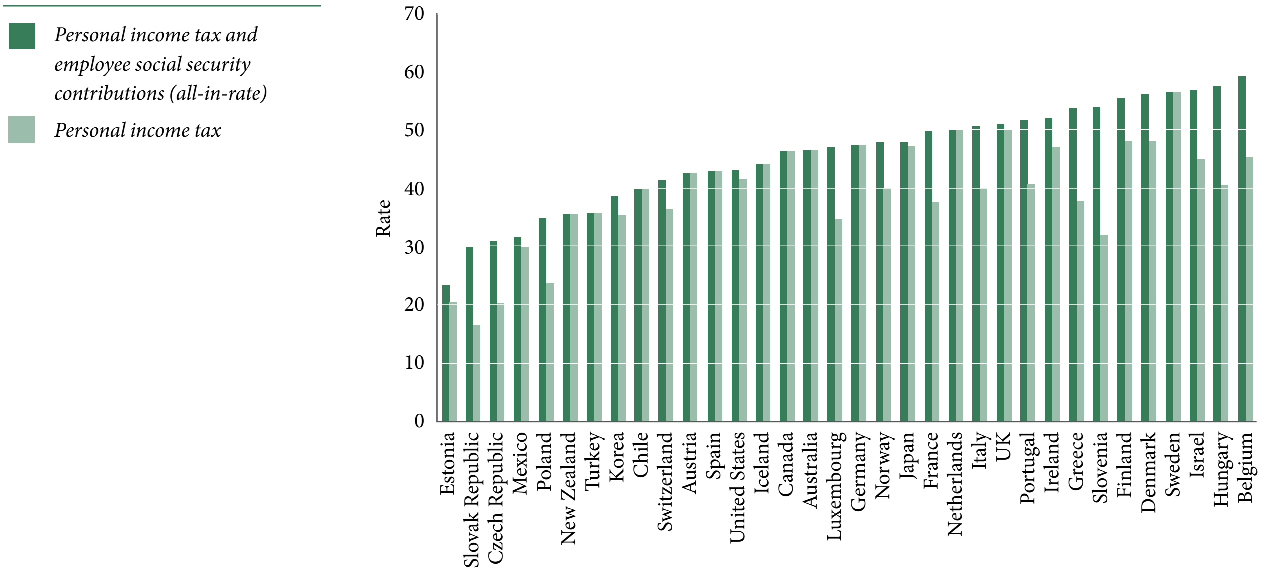
A similar pattern exists in the United States. The rich pay a higher share of their income in federal taxes, as Moore has pointed out in the *Wall Street Journal*:[416]

> *According to the Congressional Budget Office (CBO), middle-class families in 2007 (earning between $34,000 and $50,000) paid an effective 14.3 per cent of their income in all federal taxes. The top five per cent of income earners paid 27.9 per cent and the top one per cent paid 29.5 per cent. And what about the highest earners? Americans with annual incomes above $2 million paid an average 32 per cent of their income in federal taxes in 2005 (the most recent year for which data are available)*

Britain has one of the highest top marginal tax rates, and one of the highest combined top marginal income tax and employee social security contributions rates, in the developed world and the highest of the major developed economies. It is likely to remain relatively high when it falls to 45p in 2013–14.[417]

415. Pearce, N. *UK taxbase: weak and getting weaker*, Institute for Public Policy Research, 19 July 2011, http://lowtax.es/HOlWl5
416. Moore, S. Warren Buffett Is Wrong On Taxes, *Wall Street Journal*, 28 July 2011
417. OECD *Tax Database*, B. Personal Taxes, 1. Personal income tax rates, Table I.7: Top marginal combined personal income tax rates on gross wage for a single individual, www.oecd.org/ctp/taxdatabase

Figure 4.9: Top income tax and employee social security contribution rates, OECD, 2010



Those who pay that tax are certainly very high earners compared to the general population, but most do not fit with the popular conception of the "super rich". The Institute for Fiscal Studies reports that "half have incomes between £150,000 and just over £200,000". And many more than one in a hundred people will attain such an income at some point in their lives.[418] The top one per cent of earners is also not dominated by those working in financial services to the extent that has been portrayed. Jo Johnson MP has written that, in a letter to the Public Accounts Committee, the head of the Treasury has revealed that out of "275,000 affected, only 63,000 – 23 per cent – work in 'financial intermediation'".[419]

In the same way, while the top one per cent of earners paying the additional rate are concentrated in London, 63,000 people in the North and Midlands will also be affected in 2011–12.[420]

Table 4.3: Number of additional rate taxpayers by region and country, 2011–12

Region/country	Number paying additional rate
North East	5,000
North West	18,000
Yorkshire & the Humber	13,000
East Midlands	12,000
West Midlands	15,000
East of England	34,000

418. Brewer, M., Browne, J. & Johnson, P. The 50p income tax rate: what is known and what will be known? in Emmerson, C., Johnson, P. & Miller, H. (eds) *The Institute for Fiscal Studies Green Budget*, February 2012
419. Johnson, J. Why a high-tax London is a disaster for Britain, *Financial Times*, 16 March 2011
420. HMRC *Income Tax Statistics*, Table 2.2: Number of individual income taxpayers by marginal rate, gender and age, by country and region, 1999–2000 to 2011–12

Region/country	Number paying additional rate
London	94,000
South East	67,000
South West	17,000
Wales	4,000
Scotland	16,000
Northern Ireland	4,000

The economic effects of taxes can be particularly pronounced when they are levied on high earners because, as the Mirrlees Review put it, "they may find other ways to minimise the amount of tax they pay: by reducing their effort per hour worked, or by, for example, changing the form of their remuneration, contributing more to a pension or to charity, converting income into capital gains, setting themselves up as a company, investing in tax avoidance, illegally hiding their income, or even leaving the country altogether (or not coming here when they otherwise would have)." Leaving or not coming here in the first place is the avoidance strategy of last resort which cannot practically be controlled by government policy. Richard Longdon, Chief Executive of software company Aveva, told the *Sunday Telegraph*:[421]

"[If] we ask overseas employees whether they want to come and work in the UK they say: 'No thanks. I don't want to pay 50pc tax'"

Richard Longdon

> *The UK is already an expensive place to live and work and if we ask overseas employees whether they want to come to work in the UK they say: 'No thanks. I don't want to pay 50pc tax'.*
>
> *We've got colleagues who pay 50pc tax in the UK but are sitting in meetings next to guys doing similar jobs for a similar salary in South Korea but paying half the tax. It makes a big dent in their salary.*
>
> *There's nowhere that our employees want to be less than the UK. The people who live in Asia really don't like coming here and I can't think of any scenario where we would be able to entice an Asian employee to come and work in the UK. No way.*
>
> *Nothing could get them here.*

That can mean that higher taxes fail to raise revenue even in the short term. The 50 per cent additional rate was introduced in Budget 2009, and the Treasury expected it to raise £2.5 billion by 2011–12.[422] That was later revised up to £3.1 billion in Budget 2010.[423] Independent forecasts of the revenue that would be raised were far more pessimistic.

The Institute for Fiscal Studies has studied this issue looking at the highest earning one per cent of the population, and the central estimate used in the Mirrlees Review was that "the taxable income elasticity for the group is 0.46, which implies a revenue-maximising tax rate on earned income of 56 per cent. This in turn (accounting for National Insurance contributions and indirect taxes) corresponds to an income tax rate of 40 per cent." And after that analysis increases "in rates of National Insurance contributions and VAT" were announced that would "further reduce the income tax rate that corresponds to a given overall tax rate on earnings."[424]

421. Cave, A. Aveva boss threatens to leave UK over 50p tax, *Sunday Telegraph*, 2 October 2011
422. HM Treasury *Budget 2009*, pgs. 153–154
423. HM Treasury *Budget 2010*, pg. 140
424. J. Mirrlees, S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles, and J. Poterba (eds), *Tax by Design: The Mirrlees Review*, September 2011, Chapter 4

As a result, at the time that the 45p top marginal rate – which George Osborne announced Britain would return to in 2013–14 at Budget 2012 – was first announced in 2008, they argued that it would raise "approximately nothing".[425]

It would be reasonable to assume that taxable income had become more elastic since the 1980s evidence base used by the Institute for Fiscal Studies, given the rising international mobility of capital and labour. But the Treasury initially put the Taxable Income Elasticity at 0.35 in their estimate of the effect of the new top rate of tax.

A number of different estimates of the Taxable Income Elasticity have been produced by academics in Britain and in the United States, using the example of the tax cuts implemented in both countries during the 1980s.[426] There are substantial disparities but that is partly explained by the different studies looking at different parts of the income distribution. Higher earners tend to respond more strongly to higher tax rates.

Cheety, for example, produced an estimate for all income groups. Those disparities may also be the result of studying different countries. Brewer, Saez and Shephard and the Centre for Economics and Business Research looked primarily at evidence from the United Kingdom whereas many of the earlier studies looked at the evidence in the United States, where there may be "more opportunities to reduce taxable income" in the tax code.[427] Sillama and Veall looked at the results of Canadian reforms in 1988 and the response of high earners, those with incomes over $75,000. Hansson looked at the effects of the 1990–91 tax reform in Sweden and found results "comparable with recent estimates for the U.S."

Table 4.4: Estimates of taxable income elasticities

Author of estimate	Year of estimate	Country	Taxable income elasticity
Lindsey	1987	United States	1.07 to 2.75 with a central estimate of 1.75
Feldstein	1995	United States	"At least one and could be substantially higher"
Long	1999	United States	From 0.1–0.8 for those earning less than $50,000 to 0.7–0.8 for those earning more than $150,000
Goolsbee	2000	United States	Corporate executives, in the short term: 1; in the long term: 0.1–0.33. High earners (over $1 million): 0.56

425. Nelson, F. Why squeezing the rich doesn't produce much juice, *The Spectator*, 25 November 2008
426. Some sources drawn from HMRC *The Exchequer effect of the 50 per cent additional rate of income tax*, March 2012; Feldstein, M. The Effect of Marginal Tax Rates on Taxable Income: A Panel Study of the 1986 Tax Act, *Journal of Political Economy*, June 1995; Sillamaa, M-A & Veall, M. R. *The Effect of Marginal Tax Rates on Taxable Income: A Panel Study of the 1988 Tax Flattening in Canada*, Quantitative Studies in Economics and Population Research No. 354, August 2000; Hansson, A. *Taxpayers' responsiveness to tax rate changes and implications for the cost of taxation in Sweden*, 2007
427. Brewer, M., Saez, E., and Shephard, A. Means-Testing and Tax Rates on Earnings in J. Mirrlees, S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles, and J. Poterba (eds), *Dimensions of Tax Design: The Mirrlees Review*, 2010

Author of estimate	Year of estimate	Country	Taxable income elasticity
Sillamaa & Veall	2000	Canada	1.3
Aarbu & Thoresen	2002	United States	Minimum of -0.6; Maximum of 0.2
Gruber & Saez	2002	United States	0.4 overall. 0.57 for those with incomes above $100,000 a year
Selén	2002	Sweden	Central estimate: 0.4–05
Blow & Preston	2002	United Kingdom	Range of results: 1.4–2.8, self-employed more responsive
Saez	2004	United States	Top 1%: 0.5– 0.71
Kopczuk	2005	United States	0.21. Includes lower earners in Gruber and Saez analysis. High earners still 0.57
Hansson	2006	Sweden	0.4–0.5
Brewer, Saez & Shephard	2010	United Kingdom	0.46
Cheety	2011	Denmark	Lower bound: 0.34
Centre for Economics and Business Research	2011	United Kingdom	0.5

At Budget 2012, a new official estimate of the revenue raised was released by HMRC which found a Taxable Income Elasticity of 0.48, though with substantial uncertainty "suggesting that the true TIE for the model is likely to lie anywhere in the range of 0.14 to 0.81".[428]

While those results vary they all point to a substantial reduction in taxable income with a rise in rates, particularly for high earners. Gruber and Saez have gone as far as arguing that "optimal tax structures may feature tightly targeted transfers to lower income taxpayers and a flat or even declining marginal rate structure for middle and high income taxpayers."[429]

The Institute for Fiscal Studies has produced a table setting out how even quite low estimates of the Taxable Income Elasticity imply that measures like a 50p rate would raise substantially less than expected:[430]

428. HMRC *The Exchequer effect of the 50 per cent additional rate of income tax*, March 2012
429. Gruber, J. & Saez, E. The elasticity of taxable income: evidence and implications, *Journal of Public Economics*, 84, 2002
430. Brewer, M., Browne, J. & Johnson, P. The 50p income tax rate: what is known and what will be known? in Emmerson, C., Johnson, P. & Miller, H. (eds) *The Institute for Fiscal Studies Green Budget*, February 2012

Table 4.5: Revenue raised by the 50p rate under different assumptions about taxable income elasticity and revenues affected

Taxable income elasticity	Revenue raised by the 50p rate assuming	
	Indirect tax revenues unaffected (£bn)	Expenditure falls as much as income (£bn)
0.20	4.1	2.9
0.25	3.5	2.2
0.30	3.0	1.6
0.35 (HMT)	2.4	0.9
0.40	1.8	0.3
0.45	1.3	-0.4
0.46	1.1	-0.5
0.50	0.7	-1.0

Despite a central estimate of the Taxable Income Elasticity at 0.48, the HMRC research looking at the introduction of the 50p suggests it could have increased revenue. However the amount the tax raises was estimated to be "£1 billion at most", much less than the earlier Treasury estimate, and – with lower economic growth over time; other potential ways of estimating the behavioural response; and potential reductions in indirect tax revenue – it appears to be more likely that the real effect of the 50p rate on revenue is lower than that or even negative.

As mentioned earlier, research for the Institute for Fiscal Studies has suggested that the revenue maximising rate for high earners is well below 50 per cent. In November 2011, the CEBR released a report looking at Britain's 50p tax. They concluded that their "calculation shows that the combination of higher VAT, higher National Insurance contributions and increased labour and capital mobility mean that the 50 per cent rate of Income Tax is likely to lead to a loss of tax revenue." On the basis of their estimate that the TIE for those subject to the 50p rate is 0.5, they argue that the "revenue maximising top rate of Income Tax is likely to be less than 40 per cent".[431]

As a result of the behavioural response of high earners, Fraser Nelson has argued that lower tax rates actually lead to more redistribution, as tax yields from those higher earners increase. In figures obtained from the Treasury, he showed that following Nigel Lawson's reductions in marginal rates, higher earners have shouldered an increasingly large share of the Income Tax burden. That has been updated to 2011–12 with HMRC figures to produce Table 4.6.[432]

431. CEBR *The 50p tax – good intentions, bad outcomes: The impact of high rate marginal tax on Government revenues in a world with no borders*, November 2011
432. Treasury figures supplied to *The Spectator*, 2008; the figure for 2011–12 was obtained from HMRC *Income Tax Statistics,* Table 2.4: Shares of total income (before and after tax) and income tax for percentile groups, 1999–00 to 2011–12

Table 4.6: Share of total Income Tax liability 1976–77 to 2011–12 (%)

	1976–77	1978–79	1981–82	1986–87	1999–00	2008–09	2011–12
Top 1%	11.0	11.0	11.0	14.0	21.3	23.0	27.7
Top 5%	25.0	24.0	25.0	29.0	39.8	42.3	47.0
Top 10%	35.0	35.0	35.0	39.0	50.3	53.1	57.6
Next 40%	45.0	47.0	46.0	42.0	–	–	–
Lower 50%	20.0	18.0	19.0	16.0	11.6	11.5	10.3

Even if we only consider the objective of maximising revenue, the merits of high marginal tax rates on high earners are dubious. But there are wider economic problems created by high taxes on high earners. Edwards gave a simple explanation of the potential consequences:[433]

> *Higher-income taxpayers generally have the largest responses to tax changes and face the highest tax rates. Society in general also loses when higher-income taxpayers react to high tax rates because those with high incomes often have unique talents. For example, if high taxes cause highly skilled surgeons to take fewer patients, the welfare of many potential patients will suffer.*

High earners may also increase the productivity of other workers. Without that surgeon, the work of nurses and other doctors who can diagnose a patient and prepare them for surgery would be less valuable. Even if they only have a small effect on overall firm performance, senior executives can make a sufficient difference to justify substantial pay (Section 4.3.4).

Entrepreneurs in particular may be deterred by high taxes and that will reduce innovation. Johansson et al. report that "[industry-level] evidence covering a sub-set of OECD countries suggests that there is a negative relationship between top marginal personal income tax rates and the long-run level of [total factor productivity]."[434] If high taxes on high earners reduce productivity growth then that will, over time, tend to mean lower wages across the economy.

4.2.2. Lower corporate taxes attract international investment and often increase revenue

Brill and Hassett present evidence that over time the revenue maximising point is falling and the fall off in revenues after that point is becoming sharper

A number of studies have found that revenues from higher corporate taxes can be underwhelming, and that they can reduce revenue. Brill and Hassett present evidence that over time the revenue-maximising point is falling and the fall-off in revenues after that point is becoming sharper.[435] A Conservative Way Forward report looks at 13 countries that have increased Corporation Tax revenue following rate cuts, and four who reduced revenue following rate rises.[436] Looking at corporate tax revenues in OECD countries between 1979 and 2002, Clausing found that small

433. Edwards, C. *Economic benefits of personal income tax rate reductions*, Joint Economic Committee, April 2001

434. Johansson, A., Heady, C., Arnold, J., Brys, B. & Vartia, L. *Tax and economic growth*, OECD, Economics Department Working Paper 28, 11 July 2008

435. Brill, A. & Hassett, K. A. *Revenue-Maximizing Corporate Income Taxes: The Laffer Curve in OECD Countries*, American Enterprise Institute Working Paper No. 137, July 2007

436. Elliott, M., Sinclair, M. & Taylor, C. *How cutting corporation tax would boost revenue*, Conservative Way Forward, 2008

open economies have lower maximising rates than larger, closed economies. On the revenues analysed in the study, she found that: "At high tax rates, the elasticity of reported taxable income with respect to the tax rate may exceed one, implying that an increase in the tax rate will reduce tax revenues."[437] Riedl and Rocha-Akis found a weaker result, but still found that an increase in the tax rate would lead to a substantial reduction in the base, with an elasticity of -0.7.[438]

Stinespring found the existence of a Laffer curve in corporate tax revenues in American states from 1996–2007. Furthermore, he found that its revenue-maximising rate had declined over time, with rates ranging from 8.52 per cent to 9.32 per cent for the period 1996 to 2002 and 6.03 per cent to 7.47 per cent over the period 2003 to 2007. This suggests that only eight states were taxing at revenue-maximising rates or lower in 2002, improving to 22 states in 2007. The author concludes that a number of states could therefore have actually received higher revenues with lower rates.[439]

In a 2007 study for the TaxPayers' Alliance, the Centre for Economics and Business Research "modelled the impact of a TaxPayers' Alliance plan for pre-announced, phased Corporation Tax cuts of two per cent each year until the Irish level of 12.5 per cent was reached." It estimated that if such cuts were made, by 2021, relative to the baseline forecast:[440]

- GDP would be 8.7 per cent higher;
- Total fixed investment would be 60.9 per cent higher;
- Total employment would be 8.7 per cent higher while manufacturing employment would be 10.1 per cent higher;
- Disposable income would be nine per cent higher largely due to a 13.5 per cent boost to wages and salaries;
- Consumer spending would be boosted by 2.3 per cent;
- The savings ratio would be 13.1 per cent higher.
- Although this plan would cost £3.8 billion initially, by 2021 revenue would be £28.7 billion higher in that year than in the base case, largely due to higher Income Tax and VAT receipts. Within eight years, revenue would be higher than without Corporation Tax cuts.

4.2.2.1. Rising taxes on North Sea oil deter investment and reduce taxable production

There have been studies that suggest the most efficient way of maximising revenues from the North Sea, as well as protecting jobs and minimising imports of oil and gas, is actually to set more competitive rates. Nakhle found that:[441]

437. Clausing, K. Corporate tax revenues in OECD countries, *International Tax and Public Finance*, 14, 2, April 2007, pgs. 115–133
438. Riedl, A. & Rocha-Akis, S. *Testing the Tax Competition Theory: How Elastic are National Tax Bases in OECD Countries?* CESIFO Working Paper No. 2669, June 2009
439. Stinespring, J. *Are State Corporate Income Tax Rates Too High? A Panel Study of Statewide Laffer Curves*, Social Science Research Network, 2009
440. Centre for Economics and Business Research *The dynamic impact of the 2007 Budget and a comparison with the impact of gradually introducing an Irish level of corporation tax*, TaxPayers' Alliance, April 2007
441. Nakhle, C. *Do High Oil Prices Justify an Increase in Taxation in a Mature Oil Province? The Case of the UK Continental Shelf*, Surrey Energy Economics Discussion Paper Series, February 2007

In the late 1970s and early 1980s, the UK Government leant towards generating high revenues from the oil industry. From 1983 to 2002 the emphasis was on encouraging new developments and growing production thereby extending a period of UK self-sufficiency. Then, after 2002, squeezing out more revenues from the UKCS became once again a high priority given the need to fund a rapid growth in public expenditure. However, this came at the wrong time in the life of the UKCS, since the Government's concern should have been to encourage more oil production from its declining province, especially in the light of the rising concern surrounding the security of supply (Nakhle, 2005).

[…]

Finally, a high level of Government take is not recommended in cases of high-risk exploration and high-cost development, or for those provinces with remaining modest petroleum potential, as is the case in the UKCS. The cost of producing oil can overwhelm any price incentive. Large price incentives are needed to increase production while the costs of production are rising. In the UKCS, there are still substantial volumes to come. But this requires very large investment, given the rising costs and the shrinking of fields' size. Besides, the UK Government's priority should be to extend the life of its oil province (Nakhle, 2005). Even at lower oil price, the Government can generate higher revenues if production is sustained. The rapid increase in production during the 1990s resulted in a sharp increase in tax revenues despite the static oil price, which averaged under $20/bbl.

After the announcement of a rise in the rates at Budget 2011, reports suggested that it would deter investment needed to maintain production in the North Sea:[442]

Despite the chancellor building in a mechanism to reverse the tax hike should oil fall back below $75, the proposal comes at the wrong time for the industry. North Sea firms will incur rising costs just as the industry faces "a compelling need for serious investment", according to Jim Hannon of North Sea consultants Hannon Westwood.

The North Sea has witnessed increased, and successful, drilling activity over the past decade. But Mr Hannon points to a rising stock of discoveries that smaller, cash-strapped companies haven't been able to develop, particularly given looming decommissioning liabilities and ageing pipelines. He estimates that the industry needs to invest $35bn (£21.5bn) over the next five years to exploit these undeveloped discoveries. Without this finance, the industry could end up leaving in the ground a substantial proportion of the estimated 4.4bn barrels of oil and gas that the small and medium-sized firms are looking to develop.

Those warnings seem to have been borne out in practice. Oil & Gas UK reported in its 2012 Activity Survey that "there was an 18 per cent fall in production, 50 per cent collapse in exploration activity and an acute decline in capital efficiency" and it was "apparent that this trend will continue in 2012 and activity will be dominated by the few large projects which were commercially committed before Budget 2011."[443] The 2020 Tax Commission does not make specific proposals for taxes on the North

442. Davies, G. & Li, M. Tax blow to North Sea oil and gas, Investors Chronicle, 23 March 2011
443. Oil & Gas UK *2012 Activity Survey*

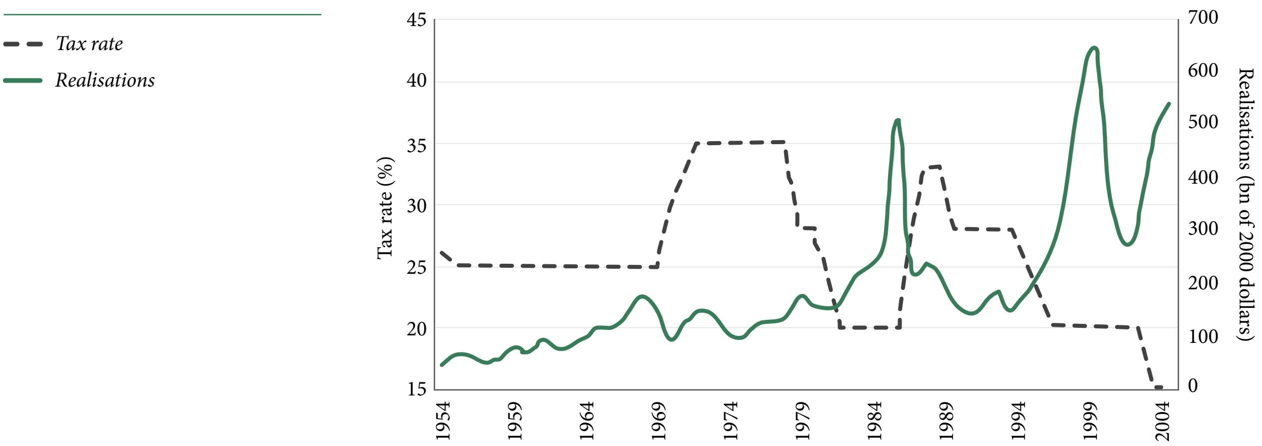
Sea but the regime should be competitive and this is a broader illustration of how high and uncertain corporate tax rates can discourage investment and reduce the size of the tax base.

4.2.3. Higher capital gains taxes do not appear to generate higher revenues

In 2010–11, the income from Capital Gains Tax (CGT) was just £3.2 billion, a small part of the £447.2 billion total tax take. That means it makes up less than one per cent of overall tax receipts. While proponents for the tax argue that it also increases Income Tax receipts, research suggests that the effect of higher CGT rates may be to lower revenue overall, or not increase it sufficiently to justify the economic disruption the tax causes.

Researchers at the Adam Smith Institute used data from the Congressional Budget Office to show revenues from CGT have often fallen when it has been increased in the United States, and vice-versa, as shown in Figure 4.10.[444]

Figure 4.10: Capital gains realisations and tax rates, United States, 1954 to 2004



The same paper by the Adam Smith Institute found that in Australia, reforms from the Ralph Review meant that revenues from capital gains from individuals increased relative to companies, when tax rates on individuals' capital gains were cut.

During the Democrats' Presidential Debate in Philadelphia in April 2008, then Senator Barack Obama did not defend the view that capital gains tax rate hikes increase federal revenues:[445]

> *Charlie Gibson: And in each instance, when the rate dropped, revenues from the tax increased. The government took in more money. And in the 1980s, when the tax was increased to 28 per cent, the revenues went down. So why raise it at all, especially given the fact that 100 million people in this country own stock and would be affected?*
>
> *Senator Obama: Well, Charlie, what I've said is that I would look at raising the capital gains tax for purposes of fairness.*

444. Adam Smith Institute, *The effects of Capital Gains Tax rises on revenues*, 2010
445. Republican Study Committee, *RSC Policy Brief: The effect of Capital Gains Tax Cuts on revenue*, 2008, pg. 1

But that argument that a higher CGT would be fairer ignores that it is effectively a double tax (Section 5.2.2.1) and is also hard to sustain if the tax reduces revenue. The Republican Study Committee reports similar findings to the Adam Smith Institute:[446]

> *In 1977, the top capital gains tax rate was 35 per cent. After five changes between 1978 and 2003, four that lowered the capital gains rate, the top capital gains tax rate is currently 15 per cent. This 57 per cent reduction in the top capital gains tax rate over the last thirty years has coincided with a fifteen-fold increase in capital gains revenue. From 1977 to 2007, capital gains revenue increased from $8 billion to $127 billion.*

In 1987, Lindsey looked at a proposed increase in the rate of CGT in the United States. He found that the change could lead to a long term and substantial reduction in CGT revenue, and that as a result the measure would be regressive.[447]

The obvious objection to these findings is that, while a rise in CGT rates reduces CGT revenue, it increases Income Tax revenue. Investors will put less effort into shifting income into capital gains in order to avoid tax. However more comprehensive research suggests that, even with a broader set of potential behavioural changes accounted for, a cut in CGT may still increase revenue.

Table 4.7: Fiscal effects of changes in the Capital Gains Tax rate, Entin

Federal budget	Changes to revenue and budget effects of changes in the capital gains tax rate ($bn)		
	20%	24%	28%
Static capital gain tax increase	30.7	54.7	77.5
Loss in personal income tax from weaker economy	-28.3	-51.8	-73.5
Net change in personal income tax	2.5	2.9	4.0
Loss in other taxes from weaker economy	-15.3	-27.7	-39.0
Dynamic change in total federal revenue (before portfolio adjustments)	-12.8	-24.8	-35.0
Change in federal outlays due to lower wages	-7.4	-13.4	-18.8
Change in federal budget surplus (- indicates smaller surplus or larger deficit)	-5.4	-11.4	-16.2
Portfolio adjustment			
Further reduction in capital gains tax revenue from reduction in capital stock	-12.0	-21.4	-29.8
Dynamic revenue change with portfolio adjustment	-24.9	-46.2	-64.8
Change in federal surplus with portfolio adjustment	-17.4	-32.8	-46.0

Entin modelled the effects of raising CGT to 20 per cent, 24 per cent and 28 per cent. The first row of Table 4.7 shows that with static increases to the CGT rate, assuming no change in capital formation and employment, revenues can indeed

446. *Ibid*
447. Lindsey, L, *Capital Gains Taxes under the Tax Reform Act of 1986: Revenue estimates under various assumptions*, NBER Working Paper No. w2215, 1987

increase. And a higher CGT will also increase personal income tax receipts. But the losses from a weaker economy and portfolio adjustments outweigh more than 180 per cent of the expected static revenue gains, leading to a substantial overall reduction in tax revenue.[448]

While the effect of a very large change in CGT rates may not match the findings of this literature, the effect of increasing or decreasing the rate on revenues is at least ambiguous.

As CGT also effectively taxes inflation, since indexation was removed, the Government has not felt comfortable increasing it to match the Income Tax rate. That may mean we are currently facing both problems: there is still a substantial incentive to try and disguise income as capital gains; and we have a double tax on genuine capital gains for those investing in business assets. Keeping CGT, and all of the economic problems it creates, purely as a revenue protection measure is hard to justify, particularly given its effect on entrepreneurship and the allocation of resources. The mechanism to abolish and merge it into a wider capital income tax is considered in Section 5.2.2.1.

4.2.4. Taxes on the creation of wealth should be as efficient and neutral between different taxpayers as possible

Taxes on the creation of wealth are generally proportions of income or gains, so that taxpayers in similar circumstances suffer similar burdens. The burdens may, however, differ for reasons that one might not expect. Different types of income may be taxed at different rates, even though all are simply money in the hands of the recipients. Thus an individual's income from employment is taxed more heavily than income from investments, on account of National Insurance, and profits made in industries that require heavy investment in machinery may be taxed more lightly than those that require less machinery but more premises, on account of capital allowances.

Taxes that are proportions of income or gains recognise differences in circumstances in a way that is *prima facie* appropriate. We must, however, pose the question of the extent to which a tax of this nature should be progressive. Exactly how different should the tax burdens on different levels of income and gains be?

Income Tax (in 2012–13) has rates of 20, 40 and 50 per cent (and a 10 per cent rate that applies in very limited circumstances), and Capital Gains Tax has rates of 18 and 28 per cent. One could have less progressive scales, down as far as a single rate on all income (and the same, or a different, single rate on all gains), or more progressive scales, rising to higher rates or rising more rapidly.

Ethical theory is not able to offer any clear response to the question, but it can identify some relevant considerations. A utilitarian would oppose a scale of rates that deterred people from working (Section 4.1.2.1), or from taking entrepreneurial risks (Section 4.1.2.3), in a way that would reduce total utility. And a virtue ethicist would be equally concerned at any scale of rates that would limit people's opportunities to develop and use their talents, for example by limiting economic growth. If we reject the mere achievement of equality as a legitimate purpose of taxation (Section 4.3.6) there would seem to be scant ethical support for a steeply progressive scale of rates.

Taxes are not levied for the sake of imposing burdens. If we reject the mere achievement of equality, there is no point in levying taxes, apart from raising money that can be spent on useful things and pricing in externalities. It therefore makes no

448. Entin, S. *The effect of the Capital Gains Tax rate on economic activity and total tax revenue*, Institute for Research on the Economics of Taxation, 2009, pg. 11

sense to impose taxes at high rates, when the same amount of money could be raised with lower rates. The lower rates would support the public sector to the same extent, while leaving more wealth in the private sector – a result that utilitarians would prefer.

We should also have ethical concerns about the effects of specific taxes. National Insurance, for example, is specific to income from labour. It therefore deters work (Section 5.2.3.2.1), and the productive use of people's talents. The question of which taxes do the greatest damage is an economic question, but ethical thought can make one contribution: it can identify reasons to be particularly concerned about some economic effects. The virtue ethicist can point out that productive work should not be deterred, and the utilitarian can point out that a tax that reduces the availability of reasonably-remunerated work has the potential to do serious damage to the life chances of individuals, which in turn greatly diminishes levels of satisfaction.

4.3. Cutting marginal tax rates would not endanger efforts to tackle the real causes of undesirable inequality

Taxes should be fair, and for any tax system to last it needs to be seen to be fair

Taxes should be fair, and for any tax system to last it needs to be seen to be fair. Whether or not a tax system is fair ultimately depends upon whether or not it is just, and is therefore a philosophical question (Section 4.3.6).

However fairness is often understood in terms of the distributional impact of a tax system, or a change in taxes or spending, and the extent to which taxes promote equality. As well as the ethical considerations of whether that is the right objective, there are also more practical ones about how we assess whether a particular measure is progressive or regressive (Section 4.3.2).

There is an argument that making a society more equal makes it better in a wide range of ways, for example healthier and more innovative, and therefore that it should be an overriding social priority. That case was stated most comprehensively in the influential book *The Spirit Level* but it does not stand up to scrutiny (Section 4.3.3). Equally, Rajan, and Kumhof and Rancière, argue that rising inequality led to a credit boom, and thereby was responsible for the resulting financial crisis in 2008,[449] but – using data "from 14 advanced countries between 1920 and 2000" – Bordo and Meissner find "no evidence that a rise in top income shares leads to credit booms. Instead, low interest rates and economic expansions are the only two robust determinants of credit booms" in their dataset.[450]

There is also the simpler case that the marginal utility of income diminishes as a person's income rises. An additional pound of income means more to someone earning £25,000 a year than it does to someone earning £50,000 a year. That effect is not necessarily as strong as it might seem. Someone earning a high salary but with high costs such as a big mortgage may feel a fall in their income keenly, and there is a limit to the extent to which it is really possible to draw meaningful comparisons. There is evidence that subjective wellbeing rises with the log of income. Sacks, Stevenson and Wolfers found that "going from \$500 to \$600 of income per year yields the same impact on wellbeing as going from \$50,000 to \$60,000".[451]

449. Rajan, R. Fault Lines, 2010; Kumhof, M. & Rancière, R. *Inequality, Leverage and Crises*, IMF Working Paper 10/268, 2011

450. Bordo, M. D. & Meissner, C. M. *Does inequality lead to a financial crisis?* NBER Working Paper No. 17896, March 2012

451. Sacks, D. W., Stevenson, B. & Wolfers, J. Subjective wellbeing, income, economic development and growth in Booth, P (ed) *… and the Pursuit of Happiness: Wellbeing and the Role of Government*, Institute of Economic Affairs, January 2012

The argument that there is a somewhat diminishing marginal utility to income is plausible, but it still leaves the question of why income is distributed unequally. Two particular causes undermine the case for a strongly redistributive tax system (Section 4.3.4). First, someone is much more likely to become rich if they want to be rich. If one person becomes an artist, because they value being able to work at their art, and another becomes a banker because they want to make money, then the artist is already being compensated for their lower income and there is no need for the tax system to step in. Second, it appears that a recent rise in inequality is largely the result of an increased premium being placed on education and skills. In the face of global competition the value of unskilled labour has fallen sharply. That should create an incentive for people to learn new skills, thereby both improving their earnings and correcting the imbalance between supply and demand for skilled labour. Diminishing the incentive through redistribution will slow that process.

Finally, high taxes can often stand in the way of family formation (Section 4.3.5). That is likely to hurt the prospects of people on low incomes in particular, as they tend to be the ones who suffer the most from family breakdown.

The 2020 Tax Commission recommends a proportionate income tax. There is good evidence that is an effective way of creating the conditions for stronger economic growth (Section 4.1.2.4). Overall the proposals will benefit taxpayers across the income spectrum, with a particularly pronounced reduction in the income liabilities of those earning low incomes (Section 4.3.1).

4.3.1. All income taxpayers would see a substantial reduction in their tax burden under the 2020 Tax Commission proposals

While some smaller taxes may matter a lot for some families in some years, the static distributional impact of the measures proposed by the 2020 Tax Commission for most families in most years is dominated by three measures:

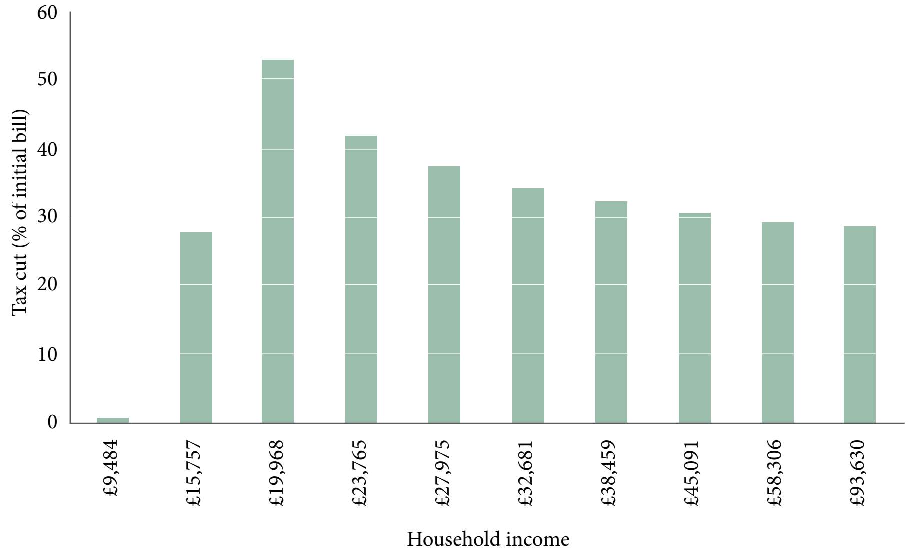
- The increase in the personal allowance and the abolition of National Insurance. Those changes particularly benefit low and middle earners as the rise in the personal allowance is more valuable as a share of their incomes, and Employees' National Insurance has an upper limit beyond which the rate of contributions falls sharply.
- The cut in the marginal rate of Income Tax for those paying the higher and additional rates particularly benefits high earners.
- The cut in Fuel Duty affects all income groups but is most significant for middle earners.

No group by income will pay more in taxes as a result of the proposals. The personal finances of those who already earn too little to pay direct taxes will enjoy the least significant immediate benefits from the changes because that is where they are focused. However, their incentive to earn more will be improved, because their marginal rates of tax as they earn more should be cut substantially (as they will start paying Income Tax later and not have to pay National Insurance). As a result, there is good reason to think that they will particularly benefit from the dynamic impacts of the 2020 Tax Commission proposals.

In order to avoid some, though not all, of the limits of distributional analysis of tax changes discussed in Section 4.3.2, the modelling work done for the 2020 Tax Commission only attempts to look at one dimension in each graph: the income distribution. It does not aggregate different types of household, such as those with one and two earners, and assumes that in two earner families income is split equally between the two partners.

First, couples, both employed, by decile of household income are shown in Figure 4.11.

Figure 4.11: Distributional impact of 2020 Tax Commission proposals, by decile, couple with both employed



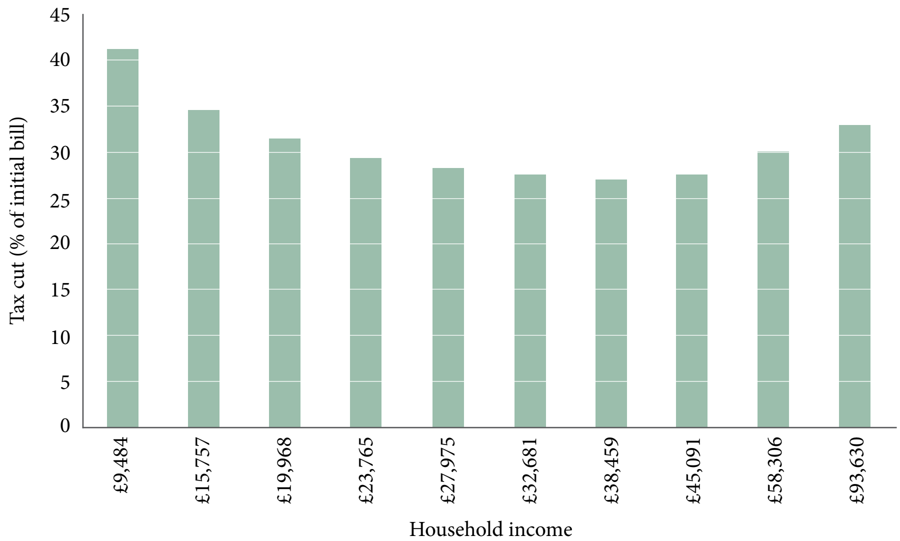
That distribution does not show very high earners, those who make significantly more than necessary to be a part of the top decile, or very low earners, those who do not make enough to be represented by the bottom decile shown in Figure 4.11. So a selected percentile distribution, including those on the lowest one and five per cent of incomes, and the highest earning one and five per cent of households, is shown in Figure 4.12.

Figure 4.12: Distributional impact of 2020 Tax Commission proposals, by percentile, couple with both employed

High earners will, thanks to the cut from the current very high top marginal rate, see a substantial tax cut. However they will still not benefit as much, as a share of their income, as those on middle incomes, and they will still pay the largest share of their income in direct taxes thanks to the higher personal allowance, which affects their overall tax bill less in proportionate terms.

Next we consider families with only one person employed, shown in Figure 4.13. Low earners in this distribution would benefit quite a lot, as they currently earn enough to pay Income Tax and National Insurance but would have almost their entire direct tax liability removed. Otherwise the distribution is similar to that for the two earner families with a similar cut in the income liability for middle earners. The increase in the personal allowance is only counted once but, on the other hand, the higher single incomes will see a larger cut in their average rate.

Figure 4.13: Distributional impact of 2020 Tax Commission proposals, by decile, couple with one employed



The self-employed pay less in National Insurance, which is being abolished. And pensioners pay less in National Insurance and have a higher personal allowance. As a result both groups will not benefit to the same extent from the tax cuts proposed. To some extent this is the result of levelling down existing inequities in the tax system.

However it also reflects that some of the gains to pensioners in particular would accrue through other taxes that affect their income. Most workers in the private sector have defined contributions rather than defined benefits pensions.[452] They are likely to take a part of the benefit from a rise in asset prices and the yield from business assets that would almost certainly follow the merger of taxes on capital into a single capital income tax, at a low effective rate (Section 5.1.5). Those more fortunate workers with defined benefit pensions, for example those in the public sector, would benefit less.

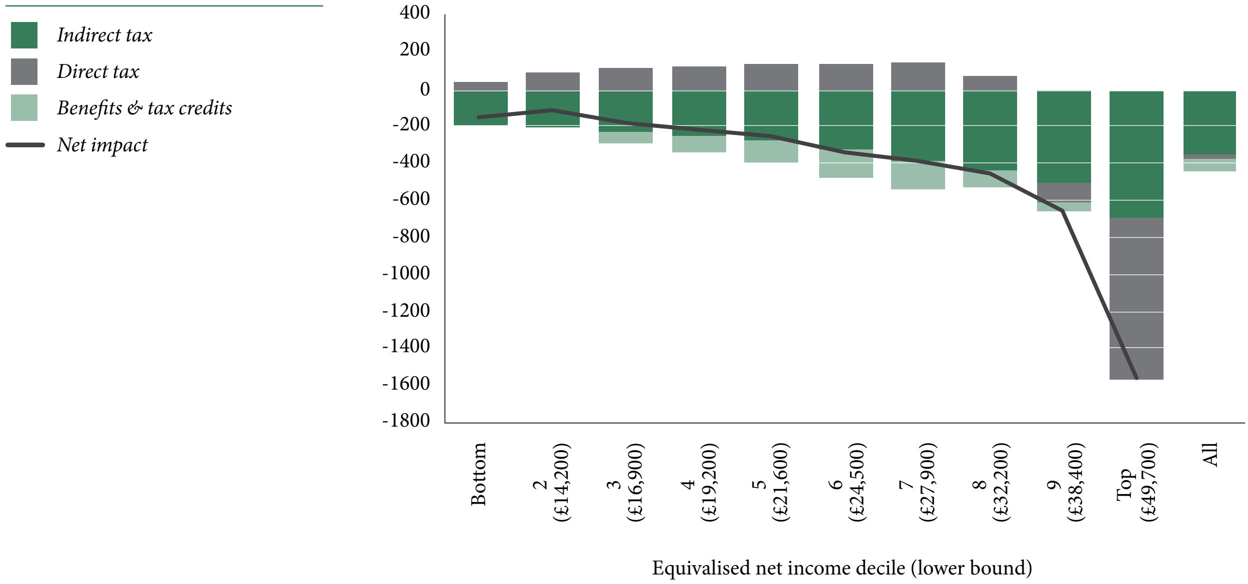
452. Arthur, T. & Taylor, C. *The UK Pensions Crisis*, TaxPayers' Alliance, 3 November 2008; Taylor, C. *The Pensions Apartheid: The problem, the cost and the tough choices that need to be made*, Institute of Directors, 29 January 2009

4.3.2. Policies promoted on the basis of simplistic distributional analysis will often not address the real needs of the least fortunate

There are four ways the distributional impact of a tax policy change can be understood: by looking at a static direct snapshot; the static direct permanent income effect; the static incidence effect and finally the dynamic effect. The most frequent way that is measured is looking at a **static direct snapshot** of the extent to which a measure increases or decreases the taxes certain households will pay, or will receive in spending. That is the kind of analysis shown in Section 4.3.1. Households are normally divided up by decile or quintile and then the impact of a certain policy on each group is studied.

The Government set itself that standard with Chart A1 from the Budget Report in June 2010, shown in Figure 4.14.

Figure 4.14: Budget 2010 distributional analysis



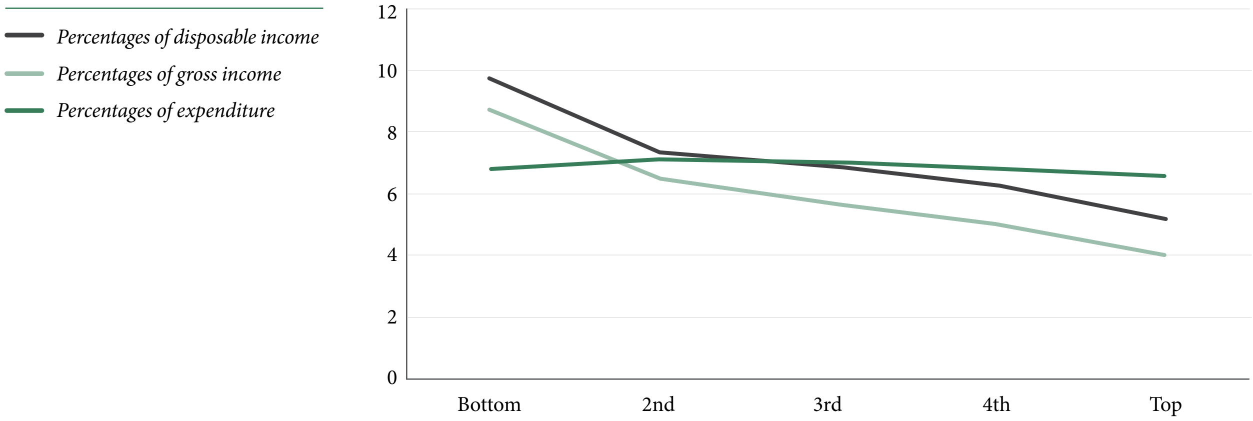
The Institute for Fiscal Studies frequently performs similar distributional analyses and has argued that Chart A1 was misleading as "many of the progressive tax rises that will be introduced over the next two years were announced by the previous Government, and that the Budget measures scheduled to come in between 2012 and 2014 are generally regressive. Moreover, the distributional analysis in the Budget documentation did not include the effects of some cuts to Housing Benefit, Disability Living Allowance and tax credits that are likely to affect the poorer half of the income distribution more than the richer half."[453]

Though it is important to hold the Government to account for the accuracy of its statistical claims, whether these measures are genuinely progressive or regressive on that standard may be less significant than has been portrayed. There are other ways of understanding who a given set of measures affect that can be far more meaningful.

453. Browne, J. & Levell, P. *The distributional effect of tax and benefit reforms to be introduced between June 2010 and April 2014: a revised assessment*, Institute for Fiscal Studies, Briefing Note 108, October 2010

With the kind of methodology used to produce Chart A1 in Budget 2010, an increase in the Value Added Tax (VAT) rate clearly be regressive. The impact of the tax by household is shown in Figure 4.15.

Figure 4.15: VAT impact for households by income quintile



However the Institute for Fiscal Studies instead came to the conclusion that the Value Added Tax is not regressive, as the graph above shows the tax is almost proportionate when considered as a percentage of expenditure:[454]

> *However, looking at a snapshot of the patterns of spending, VAT paid and income in the population at any given moment is misleading, because incomes are volatile and spending can be smoothed through borrowing and saving. Consider a student or a retiree: their current income is likely to be quite low but their lifetime earnings could be relatively high. The student may borrow to fund spending, whilst the retiree may be running down savings. Similarly, many people in the lowest income decile will be temporarily not in paid work and able to maintain relatively high spending in the short period they are out of the labour market. Because their spending is higher than their current income, these people will be paying a high fraction of their current income in VAT. Similarly, those with high current incomes tend to have high saving, and so appear to escape the tax, but they will face it when they come to spend the accumulated savings. Because of this 'consumption smoothing', expenditure is probably a better measure of living standards (and households' perceptions of the level of spending they can sustain).*

In this case, the researchers are looking at the **static direct permanent income** effect. They are looking at the effect on someone's permanent income in order to assess how the truly fortunate are affected, as opposed to simply those with the highest income that year.

The first limitation of that approach is that permanent income is not the only measure of how fortunate someone is that differs from a snapshot of income. There are other ways in which taxes can affect people differently. To look at hypothetical examples – on the basis of Britain's Income Tax schedule (as for 2012–13) at rates of 20 per cent, 40 per cent and 50 per cent to provide a simple approximate result

454. Crossley, T. F., Phillips, D. & Wakefield, M. Chapter 10: Value Added Tax in *Green Budget 2009*, Institute for Fiscal Studies, January 2009

– people in similar circumstances can face very different bills with a progressive income tax:[455]

- A household with two earners both making £25,000 will pay £7,410 in income tax (£3,705 each). By contrast, a single parent earning £50,000 will pay £9,930 in income tax. The single parent pays 34 per cent more despite having the same household income.
- Someone who earns £30,000 a year but spends £10,000 a year on housing – around the average for a family of two adults with children – will pay £4,705, nearly 25 per cent of their income minus housing costs. By contrast, if someone earns the same amount of money but spends £5,500 on housing – around the average for a one-person non-retired household – income tax will be less than 20 per cent of his income minus housing costs.
- Someone who earns £100,000 a year for ten years, £1,000,000 in total, would pay £299,300 in income tax. By contrast, someone who earned nothing for nine years but then earned £1,000,000 in a single year would pay £471,693 in income tax, well over 50 per cent more despite earning the same amount.

Special allowances can be put in place, and to some extent have been, to correct for these inequities. And they are not necessarily inequities in the first place. Perhaps two people with the same income as one should pay less tax, as their combined costs will be higher so they are really worse off. Perhaps someone who chooses to support a family inevitably accepts pressures on their finances and the tax system shouldn't be adjusted to ameliorate that. A potential partially transferable personal allowance is discussed in Section 4.3.5. Perhaps someone who earns a large amount all at once has normally enjoyed a pleasant windfall and can afford to pay more.

Even if you have an accurate understanding of who is genuinely more or less fortunate, your understanding of whether a tax is being borne by the more or less fortunate is still limited if it only looks at the amount people pay directly. For example these analyses almost always exclude corporate taxes. However that tax may reduce the wages of some and the return on shares held by others. It is critical to at least look at the **static incidence** of taxes.

The same goes for Financial Transaction Taxes. In that case, the interesting question is both the incidence of the tax – who pays initially – and the **dynamic effect** – who pays over time as the economic effects of the tax play out. Financial Transaction Taxes are understood to affect savers initially but may affect workers over time as they increase the cost of capital, lower investment and thereby lower wages. The incidence changes over time and a tax may therefore start out progressive and then turn regressive.

A more extreme example is the additional rate of income tax. A direct static snapshot of the impact of the tax would suggest it is highly progressive, falling as intended on the richest one per cent of the population. But if the measure actually reduces revenue from the richest, as a number of estimates suggest it might (Section 4.2.1), and the shortfall has to be made up with taxes on other people or cuts in spending, then a large part of the burden could actually fall on the poorest.

455. Originally calculated for the TaxPayers' Alliance research note *"Fair" taxes*, 28 January 2011, http://lowtax.es/nCMQOt

In this report, a static analysis suggests that the 2020 Tax Commission proposals would benefit many families across the income distribution (Section 4.3.1), but those families would also benefit from the substantial increase in national income that dynamic modelling suggests would follow the proposals' implementation (Section 1.1).

Those examples are concerned with the dynamic economic results of a given tax or spending decision. However the same logic could equally apply to social impacts. If effective cuts in certain benefits led to a reduction in dependency, for example, then the dynamic effect could be to improve the situation of the poorest. Or if extremely high public spending ratios in large regions of the United Kingdom choke off enterprise, that might lead to stagnation relative to the rest of the country, to the detriment of the people living in those regions (Section 3.6.1).

A simple thought experiment shows why a static account of the direct effects of a change in taxes and benefits cannot provide a reliable or complete account of the true distributional impact:

Suppose you invented a policy, some kind of economic miracle, which doubled the incomes of the poorest ten per cent of families without the government spending a pound. That would reduce benefit spending. It would also increase tax revenues from the poorest. It would be easy to look at the raw taxation and spending totals and see the effects of that policy as horribly regressive, cutting spending on the poor and shifting the fiscal scales against them.

There is a deeper debate over the nature of fairness. Lilico argues that it should be seen as a form of being proportionate, but even that objective is not always desirable. There are situations where other duties normally trump the duty to treat everyone fairly:[456]

> *Once I make a promise (or contract – a contract is a special kind of promise), the promise-holder is not to be treated equally or in proportion to desert with others – the promise "trumps" the obligation to be fair. Similarly, it is not that I give my own children Christmas presents and not the children of strangers because my own children deserve presents more. Nor am I obliged to buy my chocolate bars equally from each corner shop, or from the most deserving one. One might conclude that this meant there was a natural role for government action to "correct" for the unfairness automatically generated by promises/contracts, familial obligation and private property. But since these are the three classical foundations of human society, an alternative implication is that any society must (and ought to) contain a certain level of unfairness upon which policy should be reluctant to encroach.*

The critical test should be whether tax reforms increase the capacity for those on low, middle and high incomes to prosper; not an overly simplistic understanding of whether a measure is "progressive" or "regressive"

The Single Income Tax should be as fair as they can be between different taxpayers. But the critical test should be whether they increase the capacity for those on low, middle and high incomes to prosper; not a single overly simplistic understanding of whether a measure is "progressive" or "regressive".

4.3.3. The evidence in *The Spirit Level* that increased income equality is responsible for an extremely wide range of social goods is not credible

In *The Spirit Level: Why More Equal Societies Almost Always Do Better* Wilkinson and Pickett claimed to have finally resolved the debate over redistributive policies. The book argued that science had proven that more income redistribution is a solution to virtually every social problem. Higher taxes and more wealth redistribution

456. Lilico, A. *On Fairness*, Policy Exchange, pg. 1

would – amongst other things – lengthen life spans, lower crime, reduce obesity, cure mental illness, cut teenage births, improve educational performance and boost national innovativeness.

The authors did not claim that the problem to be solved was absolute poverty or deprivation. Rather, relative income differences were the problem to be solved. These income differences caused stress, which in turn had negative social consequences. In short, they believe that people are driven to overeat, commit crimes etc. because they are stressed about their (relatively) low income. If it were indeed true that income redistribution benefited the rich and the poor alike, while improving most social outcomes, who would not opt for more income redistribution in a heartbeat?

But the central claims in *The Spirit Level* do not hold up at all when scrutinised. The authors put their ideology before both the mainstream academic literature and an objective reporting of facts.

4.3.3.1. Representation of the literature

The basic argument in *The Spirit Level* is not new. For a century and a half, a lot of research has promised that more income redistribution would cure social ills. But what makes *The Spirit Level* remarkable is the claim that differences in income in themselves, not deprivation or absolute poverty, constitute the core social problem of modern societies. The claim of *The Spirit Level* is certainly bold: not only have the authors shown once and for all that there is no meaningful trade-off between income redistribution and growth, but also that the root cause of most social ills is to be found in income disparities.

The authors hence further argue that policies such as sharp increases in tax rates would not only help those who might benefit from the spending they would afford, but that such policies would also be good for those being taxed. Opposition to increases in tax rates could best be explained by false consciousness, as *The Spirit Level* scientifically proved that everyone in society gained from even drastically redistributive policies.

The book was initially received enthusiastically. *The Guardian* wrote that it was "a thorough-going attempt to demonstrate scientifically the benefits of a smaller gap between rich and poor". *The Independent* wrote that it was "an intellectual flagship of post-crisis compassion, this reader-friendly fusion of number-crunching and moral uplift has helped steer a debate about the route to a kinder, fairer nation". *The Observer* called it "a remarkable new book", while *The New Statesman* swiftly named it one of the top ten books of the decade.

The book was also well received in Scandinavian Social Democracies. The most important Social Democratic editorial page in Sweden, *Aftonbladet*, wrote that *The Spirit Level* was "the story the left had been lacking". The leader of the Social Democratic opposition, Mona Sahlin, made the claims made in *The Spirit Level* one of the central themes in the party's campaign at the Swedish election in 2010.

Wilkinson and Pickett are academics at institutions in Britain. Since the book's publication, both authors have maintained that *The Spirit Level* is not a political tract, but a work of science, based on the latest research.

When it was pointed out to the authors that some of their results could not be replicated, Wilkinson and Pickett made the extraordinary statement that, as *The Spirit Level* was science, the authors would not respond to any criticism that did not appear in a "peer reviewed" scientific journal. This unusual statement is particularly remarkable given that *The Spirit Level* (along with most of the claims contained therein) was itself never peer reviewed.

Social scientists do not generally restrict criticism of their work in this way. Nobel Prize winners to the left and right such as Paul Krugman, Milton Friedman, Linus Pauling, Joseph Stiglitz and others who have written books with policy implications have never demanded that critics keep all discussion in the peer-reviewed literature.

A layperson is not likely to be able to contribute a great deal to the discussion of issues regarding the latest evolutionary biology or nuclear physics. But Wilkinson and Pickett's field of research is hardly so specialised as to close off public debate and discourse on their findings, let alone exclude economists or other social scientists from the discussion. The 'social epidemiology' employed by the authors may sound to an outsider like a hard science, but is best described as a subfield of sociology, relating to income inequality and public health.

The methodologies employed in *The Spirit Level* and the studies it cites are not controlled scientific studies conducted by medical researchers, but simple correlational studies of individuals and countries of the kind long used in the social sciences. In the last two decades experts in statistical methods have increasingly convinced economists and political scientists to rely less on this particular methodology for purposes of assigning causality, as correlational studies have been shown to be extremely unreliable as a way to determine cause and effect between two variables. There is no reason these claims should not be subject to scrutiny in the public, as well as the academic, sphere.

An obvious question that arises from the purported strength and simplicity of the link between inequality and such a broad range of social ills is why that link had not been studied and identified before *The Spirit Level*. If inequality causes most social problems and poor health, and if the evidence is as strong as the authors claim, the facts should have been obvious decades ago. Wilkinson and Pickett rely on correlational studies, a statistical methodology which has existed for over a century. No one could possibly argue that inequality was an unimportant subject in the policy debate, and in research, over the last one hundred years.

Other researchers had already come to the opposite conclusion, and did not believe that inequality was the underlying cause of most social and health problems

If overwhelming scientific evidence that income redistribution was good for both the rich and the poor existed, why had advocates of greater redistribution deprived themselves of these powerful arguments for so long? Why had social science waited so long, for example, to measure the relationship between inequality and life expectancy?

There is a simple explanation: they had measured this relationship and didn't find persuasive evidence that income inequality caused lower life expectancy. Other researchers had already come to the opposite conclusion on the broader claims of the book, and did not believe that inequality was the underlying cause of most social and health problems. Trusting readers of *The Spirit Level* would not be aware of this. Wilkinson and Pickett omitted – or ignored – all research that contradicted their claims.

While it might make for a simpler book, *The Spirit Level* is misleading because it never acknowledges that other researchers – using more rigorous methods – have come to the opposite conclusion about income inequality causing lower life expectancy through increased stress, for example. In a review for respected journal *Nature*, Michael Sargent noted that:[457]

457. Sargent, M. Book Review, The Spirit Level: Why more equal societies almost always do better, *Nature*, April 2009

The idea that income inequality within a society is more unsettling to health and welfare than income differences between societies has been hotly debated for more than two decades. In the past year alone [2009], six academic analyses have been published in peer-reviewed journals, four of which contradict the hypothesis on statistical grounds. Yet Wilkinson and Pickett do not address these criticisms in their book.

Wilkinson and Pickett give readers the impression that they are reading novel research results. In fact, they are reading claims that were debunked years ago.

Princeton Professor Angus Deaton is among the most highly ranked and widely respected health economists in the world. He is an expert in health economics, statistical methods and one of the foremost authorities when it comes to determining causality – when one event can be seen to explicitly cause another – in the social sciences. Deaton, no ideologue, has been mentioned as a potential Nobel Prize winner. In 2003, Angus Deaton reviewed the research on income inequality and life expectancy for the *Journal of Economic Literature*, in an article based on work performed for a World Health Organisation report. He in particular evaluated the empirical evidence for the claims of Wilkinson and Pickett. Deaton concluded:[458]

[I]t is not true that income inequality itself is a major determinant of public health. There is no robust relationship between life expectancy and income inequality among the rich countries, and the correlation across the states and cities of the United States is almost certainly the result of something that is correlated with income inequality, but is not income inequality itself.

The Spirit Level claims that income inequality causes poor health outcomes in American states and cities. This was examined by Deaton and a co-author in 2003. They analysed the link between income inequality and mortality, controlling for demographic differences. They found that:

Conditional on the fraction black, neither city nor state mortality rates are correlated with income inequality.

Despite the significance of these results, they are ignored or discussed only in an unrecognisable form in *The Spirit Level*. But ignoring inconvenient scientific findings does not make them go away.

In introductory classes in statistical methods, students are taught that the presence of correlation in itself does not imply causation. While Wilkinson and Pickett pay lip service to this, they violate the principle repeatedly. The problem is not the use of correlational data as a piece of the puzzle *per se* (such data is often useful when complemented by other research), but the manner in which it is employed.

A good example is given by the primary relationship used by Wilkinson and Pickett in order to defend their methodology: smoking and life expectancy. People who smoke more die earlier. Therefore, it is OK to interpret correlations in general as being causal.

However, smoking is sufficiently random in the population and the effect on health strong enough that the correlation does indeed give you the correct answer: that those who smoke more die earlier because they smoke more. It is however

458. Deaton A. S. Health, Inequality, and Economic Development, *Journal of Economic Literature*, March 2003

preposterous to argue, as Wilkinson and Pickett do explicitly, that this example implies that correlational studies in general can be used as evidence for causal links.

The core problem is that the variable that we are most interested in (differences in income between individuals and groups), is a particularly complex phenomenon prone to relate to other variables in far more intricate ways than smoking does to cancer. For instance, there is a direct problem of reverse causality, since poor health tends to depress income (for obvious reasons), and hence cause poverty (and thus inequality).

Correlations between variables such as inequality and life expectancy can be spurious for several other reasons. One factor is what statisticians refer to as "confounding variables". In the example with American states and mortality, the confounding variable is related to the history of the United States, particularly slavery and subsequent racial discrimination. In the United States, African Americans tend to experience worse social outcomes. There are many potential reasons and their relative importance has been the topic of countless debates in social science.

African Americans earn less, have worse health and have worse educational outcomes than the population average. Notwithstanding the exact interaction of the different factors, the history of racial discrimination *simultaneously* causes states with a large African American population to have lower life expectancy and higher income inequality, which is why the history of slavery and discrimination in the United States is a strong confounding factor.

Once these social differences are even crudely accounted for, Deaton and his co-author find that the correlation between inequality and mortality disappears. If Wilkinson and Pickett were right to believe that inequality in itself causes mortality through stress (or through some other mechanism), the result should not vanish once simple demographic factors are controlled for. But it does. Wilkinson and Pickett's response is to merely avoid this inconvenient fact.

This is not an isolated problem for only some of the variables in *The Spirit Level*. Relating inequality to social outcomes is a task invariably prone to problems of reverse causality and confounding factors. The reason is that virtually all social problems depress the incomes of those who are impacted. Examples include unemployment, poor family environment, drug use, a lack of education, ethnic fragmentation and discrimination. Countries, states and cities with high levels of drug abuse are, for example, almost certain to have more income inequality and poorer health when compared to countries with smaller drug problems. This cannot be interpreted – as Wilkinson and Pickett do – to show that relative income inequality was causing the poor health, and that income redistribution (without fixing drug abuse) will solve the health problem.

Generally, the link between inequality and mortality vanishes, or is greatly diminished, in more sophisticated studies that control for more confounding variables. That is why the survey of the scientific literature in the *Journal of Economic Literature* concluded that no robust link between life expectancy and inequality could be found. Wilkinson and Pickett responded by simply saying that this 2004 study, perhaps the most authoritative comprehensive survey conducted regarding inequality and life expectancy, was out of date.

Professor Deaton in turn wrote about this issue in a 2011 paper, where he responded to Wilkinson and Pickett and to the claim that his 2004 study was out of date. It is worth citing the professor at length:[459]

---

459. Deaton, A. *What does the empirical evidence tell us about the injustice of health inequalities?* Center for Health and Wellbeing, Princeton University, January 2011

The evidence for the income inequality hypothesis [e.g Wilkinson and Pickett 2010], which has taken different forms over time, typically rests on correlations across countries, or across American states, of various health measures with various measures of income inequalities. I have argued elsewhere that these contentions are incorrect, Deaton (2003), and similar conclusions have been reached in the epidemiological literature, Lynch, Davey Smith, Harper, Hillemeier, Ross, Kaplan and Wolfson (2004), Lynch, Davey Smith, Harper, and Hillemeier (2004); nothing in the more recent literature invalidates these conclusions. Yet there are other arguments about inequality, injustice, and health that are quite different from those advanced by Wilkinson, and that are at risk of being undermined or ignored because of the weakness of Wilkinson's evidence and the controversy that surrounds it.

The fact that Wilkinson and Pickett represent the minority opinion within the social sciences does not in itself prove that they are wrong. Sometimes the minority report is the correct one. But it seems to be so important for the authors of *The Spirit Level* to convince the reader about their opinion that they falsely give the impression their views represent established and nigh-unassailable science. Too many readers of the book were simply fooled into believing that the book represents the majority or even the only view in the scientific community.

Wilkinson and Pickett rely on two meta-studies to create the impression of massive external scientific support for their view. The larger study, with close to 200 papers, was written by Wilkinson and Pickett themselves. These 200 papers actually contain a large number of papers that are not about health, but violence. It would be more appropriate to refer to the 169 findings (from 155 studies) which only discuss health.

In the paper Wilkinson and Pickett explain their criteria for determining if a paper is evidence for their hypothesis (inequality causes poor health):[460]

We classified them as wholly supportive if they reported only statistically significant associations between greater income inequality and poorer population health

The key word here is "association". In terms of causality, "association" is roughly equivalent to "correlation". The term "association" is generally what researchers use when they have failed to establish causality.

Wilkinson and Pickett gather a number of articles (87 have a statistically significant relationship) where there is some form of correlation or association between inequality and health. But of course, poor health can cause poverty (and hence contribute to inequality), and other underlying factors (say, drug use or unemployment) can cause both poverty and poor health.

Overall, Wilkinson and Pickett have proven remarkably unreliable when citing other researchers. One example is their citation of Nobel laureate James Heckman. When pushed into a corner regarding their refusal to cite Deaton, Wilkinson and Pickett responded to a TaxPayers' Alliance research paper by saying that a study by James Heckman instead lent support to their claims regarding relative inequality and health.

460. Wilkinson, R. & Pickett, K. Income inequality and population health: a review and explanation of the evidence, *Social Science Medicine*, 62, 7, 2006

This was puzzling, since the work in question is well known and does not deal with relative income differences. The authors of the study therefore asked Professor Heckman directly. Heckman responded bluntly, in one sentence: "This is a misrepresentation of my work".

4.3.3.2. Selection of data

The second major problem with *The Spirit Level* is with the selection of data used in the book. There are plenty of convincing-looking graphs in the book but they are to a large extent based on cherry-picking across datasets and countries. For instance Wilkinson and Pickett admitted in *The Wall Street Journal* that they had established no statistically significant relationship between life expectancy and income inequality across countries existed if the OECD's inequality figures were used in preference to a Luxembourg study they used. But this was the signature claim used to pitch the book in Sweden, under the slogan "inequality kills".

The process that led to this admission was somewhat arduous. At first, Wilkinson refused to acknowledge the criticisms in TaxPayers' Alliance research. Later, the authors engaged in what can be most charitably be described as obfuscation, by discussing the details of the measures of inequality used by the OECD and the UN, and various countries, in order to give the public the impression that this was a debate about details, not substance.

But there is no statistically significant relationship between income inequality and life expectancy regardless of whether the current OECD or the UN dataset was used, for a number of different sets of countries, including the set used by Wilkinson and Pickett themselves.

Finally, Wilkinson and Pickett admitted in *The Wall Street Journal* that no such relationship between income inequality and life expectancy existed if the OECD's inequality figures were used in preference to the Luxembourg study. At this point they claimed that life expectancy was unimportant, since they found correlations in other health variables. This is largely untrue as well. Of the 19 available standardised variables from the OECD health data (OECD Selected Health Indicators) that were examined in research for the TaxPayers' Alliance, only one (infant mortality) had a strong and significant association across countries with income inequality.

Most importantly however, life expectancy is hardly a minor detail in the health literature. It is one of the most important variables to summarise differences in health outcomes across countries. Life expectancy naturally captures many other subcategories of health outcomes. That no robust link between inequality and life expectancy can be observed among industrialised nations is a major problem for Wilkinson and Pickett's preferred selling point ("inequality kills"), not merely one variable among many.

After the publication of *The Spirit Level*, the authors later claimed while promoting the book that income inequality even lowers innovativeness (as shown by the usual cross-country regression).

Their claim that the United States was one of the least innovative countries in the developed world, roughly as innovative as Portugal, was particularly suspicious. After some debate, it turned out the two scientists got their innovation data from the Internet site "Nationmaster". Their claims, however, were not substantiated using official patent data from the World Intellectual Property Organization. It is telling that the authors did not think to check such a remarkable result, accepting obviously suspicious evidence as it fitted with their conclusions.

The Spirit Level makes ambitious but unsupported claims while engaging in the cherry-picking of data

The primary methodology used in *The Spirit Level* (comparisons of countries) is, as noted above, rather weak when it comes to finding actual causal effects. But critical relationships claimed in the book do not survive scrutiny anyway.

The Spirit Level makes ambitious but unsupported claims while engaging in the cherry-picking of data. Meanwhile, it carefully ignores a significant number of studies that contradict it. It is simply bad science. The authors' attempt to avoid open debate further strengthens the sense that the income-stress hypothesis, upon which the whole book is based, is a dead end.

However, the fact that Wilkinson and Pickett have written a shoddy book does not prove that social or economic inequality is unimportant. It has certainly not been proven that stress-induced inequality is unimportant for health, simply that the evidence Wilkinson and Pickett have put forward for this case was wrong. Future, scientific work might well show that relative inequality does lead to poor health and social outcomes.

It is more plausible that it is the underlying social problems that in turn cause inequality between individuals and groups. Inequality is often a sign of deeper social problems. Hence, Wilkinson and Pickett's handling of the topic should not be used to dismiss the relevance of paying attention to inequality and poverty in affluent societies. But the claims in their book should absolutely be dismissed.

4.3.4. Principal causes of inequality such as preference heterogeneity, a growing premium on education and skills and failures of corporate governance cannot be effectively addressed with redistribution

The origin of inequality can be important to the question of whether or not redistribution is an appropriate response.

An argument that has been made recently for redistributive taxes is that the money made by high earners is in some sense illegitimate, and not justified by their performance. Those earnings are supposedly instead either the result of failures of corporate governance, some kind of stitch up at the top. Harris Collingwood wrote for *The Atlantic* about how the role of a chief executive in corporate performance is overrated:[461]

> *But how strong is this power – or any executive power? In their groundbreaking "Leadership and Organizational Performance: A Study of Large Corporations," first published in 1972 in American Sociological Review, Stanley Lieberson and James O'Connor argued that it's weak indeed. Perhaps reflecting the anti-authoritarian spirit of the times, the authors asserted that the CEO's influence was seldom decisive in a company's performance. They had the numbers to back up this view. Working with a database of 167 companies, they teased out the effects that various factors had on corporate profitability, from the competitive state of the industry to the size and structure of an individual company to the CEO's managerial decisions. "Industry effects," such as the amount of available capital and the stability of the market, accounted for almost 30 per cent of the variance in corporate profits. "Company effects," such as the firm's historical place in the corporate pecking order, explained about 23 per cent. "CEO effects" explained just 14.5 per cent. And even this impact should be viewed skeptically: it unavoidably bundles CEO actions that were genuinely smart and skillful with those that were merely lucky.*

461. Collingwood, H. Do CEOs Matter? *The Atlantic*, June 2009

Other scholars have attempted to replicate and extend Lieberson and O'Connor's findings, and many have likewise concluded that external forces influence corporate performance far more than CEOs do. Indeed, more-recent studies have tended to find a smaller CEO effect than Lieberson and O'Connor did – ranging from 4.5 per cent to 12.8 per cent of profit variance. (The scholar Alison Mackey, at Ohio State University, is a prominent dissenter. In a recent paper, she criticises the number-crunching methods of Lieberson and O'Connor and, using a different methodology, concludes that CEOs have a dominant influence on performance that may well justify their high pay.)

That still leaves chief executives making a considerable contribution to corporate performance though. Even if other factors are more important, a good chief executive can still be valuable enough to justify substantial remuneration. Jim Manzi pointed to some of the problems with those studies – which struggle to isolate the importance of chief executive performance from a number of other variables – but pointed out that even small changes in overall corporate results could justify substantial executive remuneration anyway:[462]

Here's some simple illustrative math. I picked the median company on the most recent Fortune 500 (i.e., number 250), Smith International. It has about $11 billion in sales and $1.6 billion in operating income. A one per cent swing in $1.6 billion is $16 million. As context the median Fortune 500 CEO recently had total annual comp of about $6 million. So as a shareholder of Smith International going into the market to hire a CEO, the question I would ask myself if presented with the choice of paying $6 million per year or, say, doubling this to $12 million per year, is not "Will the CEO I get for $12 million fundamentally transform my business?" or whatever; instead, I'd rationally ask myself, "Can the $12 million dollar CEO drive about 0.6 per cent more operating profit than the person I would hire at $6 million?".

The evidence over whether corporate executives can justify their pay is limited. But there is no reason to think that they can't justify very high pay packages if they deliver real results. Some executives almost certainly are overpaid. But the question of who they are should be left in the hands of shareholders at those companies, the ones who actually pick up the bill. Instead of high taxes that make it harder for British firms to hire the best executives, reforms should be aimed at giving shareholders greater control to decide on whether they think those rewards are good value.

In some cases higher taxes could even increase remuneration, as a firm would need to pay more to attract the right executive competing with rivals in other countries where the remuneration paid was not subject to the same tax bill. That would mean the incidence of those income taxes was on shareholders. Or the incidence could fall on other, lower paid workers if a less effective executive was accepted and worse decisions resulted in lower productivity.

Recent research by Piketty, Saez and Stantcheva argues that the incomes of the top one per cent respond to taxes in three ways: (1) the standard supply-side channel through reduced economic activity, (2) the tax avoidance channel, (3) the compensation bargaining channel through efforts in influencing own pay setting. In other words, high earners will either respond to lower taxes by doing more productive

462. Manzi, J. Do CEOs Matter? Absolutely. *The Atlantic Business*, 5 June 2009

work, by putting less effort into avoiding taxes or by putting more effort into negotiating for higher pay, as the post-tax rewards for all three are now higher.

They go on to argue that the right tax code should try to minimise avoidance through "tax enforcement and tax neutrality across income forms" and that then simply leaves the empirical question of whether low taxes lead to more productive work or more bargaining for higher pay. If it is negotiating for higher pay then that is a zero sum game and all we are doing is giving executives a bigger incentive to lobby for our money. If it is more productive work then that will be to everyone's benefit.

The researchers argue that they have found the former as the incomes of the top one per cent are associated with their tax rates, but not overall growth in national income since 1975. But the empirical evidence is unpersuasive. They have a very small number of data points and there have been lots of other things going on in those countries that have affected national income over three decades besides top tax rates. The absence of a statistically significant result does not mean that there is no relationship there. By contrast, the amount earned by high earners is much more directly affected by the taxes they pay, which affects the incentive to work to earn more or less.

If good executives are building strong firms that deliver returns for shareholders then that will be productive for the wider economy. To the extent they are not doing that, it is a failure of corporate governance and we need to try to remedy the situation, not just accept it and tax the results. The same goes for other causes of inequality where the empirical evidence is more robust.

Increasing income inequality appears to be, in large part, the result of an increased return to education and other skills. Becker and Murphy have written about how the premium for higher education has grown substantially in recent years:[463]

> *In 1980, an American with a college degree earned about 30 per cent more than an American who stopped education at high school. But, in recent years, a person with a college education earned roughly 70 per cent more. Meanwhile, the premium for having a graduate degree increased from roughly 50 per cent in 1980 to well over 100 per cent today. The labor market is placing a greater emphasis on education, dispensing rapidly rising rewards to those who stay in school the longest.*

They go on to argue that can be seen as a positive development:

> *Should an increase in earnings inequality due primarily to higher rates of return on education and other skills be considered a favourable rather than an unfavourable development? We think so. Higher rates of return on capital are a sign of greater productivity in the economy, and that inference is fully applicable to human capital as well as to physical capital. The initial impact of higher returns to human capital is wider inequality in earnings (the same as the initial effect of higher returns on physical capital), but that impact becomes more muted and may be reversed over time as young men and women invest more in their human capital.*

Inequality will persist, and there is a serious problem, if people are not able to respond to that incentive to invest in their human capital. But the best response is to ensure people can respond to that incentive, for example by improving educational

463. Becker, G. S. & Murphy, K. M. The Upside of Income Inequality, *The American*, May/June 2007

standards, rather than diminishing it. Otherwise fewer people will develop those skills and the problem will be exacerbated over time.

Inequality can also be caused by substantial variation in people's tastes. Some people may prioritise leisure time or a certain kind of work over their income, and the consumption it allows. Examples would be people who work less in order to spend more time enjoying hobbies or those who choose to work as artists knowing they will normally earn less than those who choose to work as lawyers. The artist is not worse off but just enjoys substantial non-pecuniary rewards not captured by the tax system. This is known as preference heterogeneity and it appears to have substantial effects. Kahneman has noted that:[464]

> *A large-scale study of the impact of higher education [...] revealed striking evidence of the lifelong effects of the goals that young people set for themselves. The relevant data were drawn from questionnaires collected in 1995–1997 from approximately 12,000 people who had started their higher education in elite schools in 1976. When they were 17 or 18, the participants had filled out a questionnaire in which they rated the goal of "being very well-off financially" on a 4-point scale ranging from "not important" to "essential."*
>
> *[...]*
>
> *Goals make a large difference. Nineteen years after they stated their financial aspirations, many of the people who wanted a high income had achieved it. Among the 597 physicians and other medical professionals in the sample, for example, each additional point on the money-importance scale was associated with an increment of over $14,000 of job income in 1995 dollars!*

Many studies of optimal taxation assume entirely homogenous preferences, and economic theory suggests that less redistribution is appropriate with greater preference heterogeneity.

Many studies of optimal taxation assume entirely homogenous preferences, and economic theory suggests that less redistribution is appropriate with greater preference heterogeneity

Preference heterogeneity also appears to affect the extent to which different areas act to redistribute income in practice. Lockwood and Weinzierl have studied the issue and found that "controlling for the pre-tax income distribution and the correlation of income to preferences, regions with more heterogeneous preferences have less redistributive policies."[465]

Before attempting to redistribute income in order to address inequality, it is important to understand the cause. Otherwise treating the symptoms could exacerbate the problem or simply be unfair.

4.3.5. Family formation is critical to inequality and often deterred by high taxes

Traditionally, the tax system treated the income of a married woman as belonging to her husband, but individuals have been taxed separately since 1990. The government also introduced a Married Couples Allowance at the same time, which was an extra allowance on top of the individual personal allowances. The Married Couples Allowance was removed in 2000 for couples under 65 years of age, and it is currently being phased out. It is only available today if one spouse is over 65. The residual marriage allowance reduces a couple's tax bill by 10 per cent of the entitlement,

464. Kahneman, D. *Thinking, Fast and Slow*, 3 November 2011
465. Lockwood, B. & Weinzierl, M. *Preference Heterogeneity and Redistribution: Theory and Evidence, Harvard Business School*, 24 December 2011

dependent on income. So there is no explicit recognition of marriage in the tax system for the majority of families at present.[466]

The tax system can actually affect family formation itself. The pioneering work in this area was performed by the sociologist Patricia Morgan,[467] but the most detailed recent work on family formation in the UK has been done by the Centre for Social Justice (CSJ). In 2007, it published their *Breakthrough Britain* series of research papers.

Family Breakdown found that the decision to treat individuals separately in the tax system has had negative consequences. The tax system discriminates against married couples and that contributed to significant social problems. In a later paper assessing the progress of the Coalition Government on a series of criteria, the CSJ reported:[468]

> *Family breakdown is a root cause of poverty and drives social breakdown in Britain's deprived communities. Its impact is devastating on a personal, social and economic level. 48 per cent of all children born today will experience the breakdown of their parents' relationship and our research has found that a child not growing up in a two-parent family is 75 per cent more likely to fail at school, 70 per cent more likely to be a drug addict, 50 per cent more likely to have an alcohol problem and 35 per cent more likely to experience worklessness. Furthermore, family breakdown costs society almost £42 billion a year.*

The report also found that most European tax systems recognise spousal obligations. The most common system is some form of joint taxation, although separate taxation is available in most cases as an option for those who want it. The charity CARE says that the UK's tax system discriminates against many families, and is "one of the least generous towards middle income families with one earner."[469]

The CSJ was also critical of the tax credit system:[470]

> *The reason why so many children in two parent families are still in poverty is that, while tax credits are based on family income, they do not take account of the living costs of all family members. No allowance is made for a second adult. The inevitable result is that a two-parent family will be poorer than a directly comparable lone-parent family.*

In fact, *Family Breakdown* found that the tax and benefit system discriminates against couples more generally, not just married couples. This is particularly true of couples on lower incomes, where in many cases a couple is worse off financially than if they lived apart.

CARE produces an annual study comparing the tax burden on Britain's families with other OECD countries. The latest study looks at the 2010–11 financial year, and finds that a one-earner married couple with two children pays 74.5 per cent the

---

466. A more comprehensive review of the history of the UK's treatment of marriage in the tax system is available in a House of Commons Library research briefing note: Seely, A. *Tax, Marriage and Transferable Allowances*, House of Commons Library, July 2011

467. Morgan, P. *Farewell to the Family?* Institute of Economic Affairs, 1998; Morgan, P. *The War Between the State and the Family*, Institute of Economic Affairs, March 2007

468. Centre for Social Justice, *Building a social recovery? A first year report card on the Coalition Government*, May 2011, pg. 2

469. Draper, D., Beighton, L. & Pearson, A. *The taxation of families 2010/11*, CARE, March 2012

470. Centre for Social Justice *Family Breakdown*, July 2007, pg. 111

amount of tax a single person on the same income would in the UK, whereas the OECD average is 51.4 per cent. The report also finds that the disproportionate tax burden on one-earner married couples means that, on the average wage, they are in the sixth decile. A single person with the same average wage is in the ninth decile.[471]

Family Breakdown explores two different proposals to encourage stable relationships and marriage in the tax system. One is the reintroduction of the Married Couples Allowance. The other is a transferable personal allowance, which the CSJ argue would have a very positive impact on child poverty:[472]

> *Although a TPA [transferable personal allowance] would not be targeted at child poverty or at reducing the couple penalty, it would reduce both. 570,000 of the 3.9 children in poverty (AHC) are in single earner households – the main beneficiaries of a TPA. The parents of 78 per cent (445,000) of these children are married.*

Other empirical studies have shown that taxation influences a couple's decision to get married. Sjoquist and Walker found evidence that the marriage tax causes couples to postpone marriage for periods of time.[473] However, they did not find the rate of marriage itself was affected. Alm and Whittington produced a counter study, building on earlier influential work, which found a much stronger relationship between taxes and the rate of marriage. They produced additional evidence, including a more robust longitudinal analysis of household data, and found that when the marriage tax increases the probability of marriage falls and the probability of divorce rises. Furthermore, they confirm Sjoquist and Walker's findings that the timing of marriage is also affected.[474]

However, a Commons motion on introducing tax breaks for married couples was defeated in June 2011. It remains a manifesto pledge of the Conservative Party, and Treasury Minister David Gauke has indicated some form of tax incentive is likely to be introduced in the future:[475]

> *Although the Government supports the principle behind it, now is not the appropriate time to bring forward such a measure. This is not an issue about which we have forgotten, but rather it is a commitment we will keep.*

The 2020 Tax Commission proposals prioritise maximising the improvement on incentives for individual earners with lower marginal tax rates, which should reduce the extent of the problems identified in this section. The proportionate income tax will also remove the problem where a family with a single earner is charged a higher tax rate than one with two earners despite earning the same or a lower total amount. Entirely removing penalties for couples in tax and benefit systems is difficult, research for the Institute for Fiscal Studies has called it "almost impossible",[476] but the

471. Draper, D., Beighton, L. & Pearson, A. *The taxation of families 2010/11*, CARE, March 2012
472. Centre for Social Justice *Family Breakdown*, July 2007, pg. 114
473. Sjoquist, D. and Walker, M. B. The marriage tax and the rate and timing of marriage, *National Tax Journal*, 48, 4, December 1995; The 'marriage tax' refers to the extra tax a married couple pays by filing a joint return, as opposed to returns as single individuals on the same income.
474. Alm, J. & Whittington, L. Does the income tax affect marital decisions? *National Tax Journal*, 48, 4, 1995
475. *Parliamentary Debates*, House of Commons, Vol 530, col 877, 28 June 2011
476. Adam, S. & Brewer, M. *Couple Penalties and Premiums in the UK Tax and Benefit System, Institute for Fiscal Studies*, April 2010

proposals that have been included in the revenue estimates and distributional analysis (Section 4.3.1) should partly mitigate the problem.

In addition to those proposals though, the 2020 Tax Commission also proposes the introduction of a Family Transferable Allowance. That could also address problems with the withdrawal of Child Benefit, which creates very high marginal withdrawal rates for some taxpayers.

Anyone, of any age, would have a personal allowance, and they would be able to transfer a share of that to another member of the family

Under the proposed Family Transferable Allowance anyone, of any age, would have a personal allowance they could set against Income Tax, but they would be able to transfer a share of that allowance to another member of the family. The share they could transfer would be determined by the OECD equivalence scale used to adjust household incomes for the differing needs of households of differing sizes (1.0 for the first household member; 0.5 for each additional adult member; and 0.3 for each child).

Based on a personal allowance of £10,000, and the current OECD equivalence scale, that would mean:

- An adult could transfer up to 50 per cent of their personal allowance. At a personal allowance of £10,000, that would mean they could transfer up to £5,000 of personal allowance, worth £1,500 at the 30 per cent tax rate on labour income
- Each child could transfer up to 30 per cent of their personal allowance. At a personal allowance of £10,000, that would mean they could transfer up to £3,000 of personal allowance, worth £900 at the 30 per cent tax rate on labour income

If further support were felt to be necessary for low-earning families with children, with the abolition of Child Benefit – particularly those earning too little to benefit from any change in Income Tax rates and allowances – that could be provided by increasing the Child Element of the Child Tax Credit, as the TaxPayers' Alliance and Institute of Directors have argued in earlier research.[477] If further support was felt to be necessary for single-earner families, or families with children, then the equivalence scale could also be changed, an earlier OECD equivalence scale assigned values of one for the first household member; 0.7 for each additional adult and 0.5 for each child.[478]

Those couples who are both in employment could continue to receive a full personal allowance each. This proposal would benefit low-earning families; maintain a strong incentive to work; not interfere in decisions about family structure – merely evening out existing inequities; and provide a far more efficient alternative to extremely distorting proposals for the reform of Child Benefit in Budget 2012.

The cost to the Exchequer would depend on the level of the personal allowance and the extent of any complementary support for families with children but should not be excessive, after accounting for the existing Child Benefit system it is intended to at least partially replace. Given the proposal's direct interaction with changes to the benefit system it has not been included in the revenue or distributional analysis.

477. Taylor, C., Farrugia, B., O'Connell, J., Denham, M. & Sinclair, M. *How to save £50 billion: reducing spending for sustainable public finances*, TaxPayers' Alliance & Institute of Directors, 11 September 2009
478. OECD *What are equivalence scales?* Available from: http://lowtax.es/HkTO9i

4.3.6. There is not a credible ethical case for trying to achieve equality of outcome by redistribution

Taxation can very easily be used to promote greater equality of wealth or of income – that is, equality of economic outcome rather than of opportunity. A progressive income tax, for example, can have that effect, as can an inheritance tax that only applies to estates above a certain size. But is equality a legitimate objective?

It is tempting to think that all, or nearly all, tax reductions should be aimed directly at reducing the tax on the poor, and reductions for the better-off should be a very low priority. But utilitarians should disagree. They should attach high priority to improving the lot of all, and therefore to economic growth. If the expert view of economists is that more could be done for the poor by encouraging the rich to work more, invest more and take more business risks, and if the way to do that was to reduce tax burdens on the better-off, then a utilitarian would endorse that policy. A thinker like John Rawls, with his difference principle (Section 4.3.6.2), would agree. That is, utilitarianism and Rawlsian thought both create a space within which the recommendations of economists can be implemented without their being condemned as unethical, even if they do not appear at first glance to be the most progressive recommendations.

There is no obvious reason to promote equality in itself, based on virtue ethics or on deontological ethics. The arguments for equality as an objective come from two sources. The first is utilitarian ethics. The argument is that greater equality increases the overall level of utility. The second is an argument from political philosophy, to the effect that a reasonable degree of equality is required by considerations of justice. We examine these arguments here.

4.3.6.1. Utilitarian arguments for equality

A range of possible adverse consequences of inequality might be cited by a utilitarian in favour of the promotion of equality. But utilitarian arguments for doing things depend on likely consequences, so far as they can be determined, not on merely possible consequences. We therefore need to survey the possible consequences of inequality, and ask whether there is good evidence that they are likely.

Inequality might conceivably have extreme adverse consequences, for example when the excesses of the rich provoked civil unrest, or when wealth corrupted the political process.

There is no evidence that the former possibility is, in the UK, a pressing concern that could usefully be addressed through the tax system. The distribution of income is reasonably smooth, with the number of people at each income level falling steadily as income rises. Extensive empirical research in the United States provides "little support for the popular notion that poverty is a major determinant of which cities riot". And higher government spending and taxes will not help, as the "size of government is somewhat positively correlated with rioting, perhaps because community level gains from rioting are higher when there is a greater amount of government expenditures to divide." The critical determinants of the likelihood of a riot in a given city are the probability and extent of punishment, ethnic heterogeneity and unemployment.[479]

Unemployment can be increased by dysfunctional tax and benefit policies. Some spending may be needed to increase the probability and extent of punishment. But redistributive taxes will not in themselves help address any of those causes of riots.

---

479. DiPasquale, D. & Glaeser, E. L. *The Los Angeles Riot and the Economics of Urban Unrest*, November 1996

Inequality might be a more plausible cause of unrest if there were a small group with very high incomes, few people with medium incomes and then the great majority of the population on very low incomes. But that is not the situation in Britain or any other mature developed economy.

Concerns about the corruption of the political process are not going to be resolved by the imposition of greater equality of income

Concerns about the corruption of the political process are not going to be resolved by the imposition of greater equality of income. There will be plenty of other means of obtaining improper influence. Political corruption should be tackled directly, though transparency and other controls may help. We may also note that lower taxes can contribute to reducing the corruption of the political process. Politicians will happily promise spending where they think it will buy them votes, especially when the beneficiaries will not suffer the corresponding tax burdens. A limit on the extent of taxation could do something to restrain that practice.

If *The Spirit Level* was credible, it might provide a utilitarian case for redistribution, but the evidence underlying the book's radical hypothesis that a wide range of social problems are the result of inequality is weak (Section 4.3.3).

4.3.6.2. Political arguments for equality as required for justice

The standard way to argue for equality on political grounds is to start with the notion of justice. If there is no positive justification for people receiving unequal shares, then they should receive equal shares, otherwise an injustice is done to those who get less than they would under an equal distribution. Several thinkers have made this argument, in different ways. We first consider two of the most powerfully argued positions that have been taken, and then assess them.

The starting-point for exploration of this type of argument is the work of John Rawls, and in particular his book *A Theory of Justice*.[480] He asked what principles of justice we would accept, if we were designing a society but had no idea what our places in that society would be. One of the principles he identified, and the relevant one here, was the difference principle: inequalities are to be arranged "to the greatest benefit of the least advantaged".[481] Thus, for example, inequalities of income would be perfectly acceptable if they were a necessary consequence of the incentives that were needed to encourage skilled people to work hard and entrepreneurial people to take risks, so long as the result was that those with the fewest advantages were made better off. It is perfectly possible that they should be made better off. Those who have exercised their talents to develop and implement new technology, and those who have taken commercial risks to build up businesses, have improved the lives of the population at large enormously. Rawls' approach therefore does not require equality. A strict interpretation of the difference principle could be quite limiting, because it would require that the one person with the fewest advantages should benefit from inequalities. But if the principle is interpreted in a practical way, without a requirement to identify that one person but only a requirement that people who have very few advantages should benefit, then it clearly permits incentives that work, and the resulting inequalities.

480. Rawls, J. A *Theory of Justice*, revised edition, 1999
481. Rawls, J. A *Theory of Justice*, revised edition, 1999, pg. 266. Note that this is meant as a general principle that is to be incorporated into the design of a society, not a specific regulation to be written into the society's legislation on income and on taxation. There is, however, a serious question as to the extent to which such a general principle could be incorporated without its dictating that only members of a small subset of the possible laws on income and on taxation would be acceptable.

Incentives, behaviour and justice

Deborah, a computer programmer, is asked by her employer to produce a new stock management system for the company. This will reduce both storage costs, and consumption of the fuel that is used by trucks that deliver the company's products to shops. She is offered a bonus of one per cent of the reduction that is achieved in logistics costs. All staff receive an annual bonus that reflects the results of the whole company anyway, but this will be an additional bonus, just for her.

If Deborah does a good job, both she and everyone else in the company will benefit, but she will benefit more than her colleagues. The shareholders will also benefit. Furthermore, society as a whole will benefit, because the company's increased profits will lead to increased tax revenue and because energy consumption and road traffic will be reduced. Doing a good job will not require her to work extra hours, but it will require her to think very hard about the project, and to apply all the skill that she has accumulated over the years.

Without the extra bonus, she would not be so inclined to do the best job she could. Is it likely that she could be persuaded to do the best possible job if there were no bonus, or if most of the bonus would be taken in tax rather than reaching her pocket? More interestingly, should she be persuaded to do the best possible job in those circumstances? That is, should she be motivated to do so by considerations of the benefit to colleagues, to shareholders or to society? It is not at all obvious that she should. Her relationship with her employer is a commercial one. Time and skills are exchanged for money. If the company wants something above and beyond the normal call of duty, why shouldn't Deborah be allowed to insist on an additional reward for that extra effort – and a reward that she actually gets to enjoy?

This approach reflects a manifestly sensible attitude that it is worth improving people's lot, even if doing so improves other people's lot more, at least so long as no-one is made worse off. The attitude that lies behind the difference principle is, however, not as permissive as the attitude that all Pareto improvements should be pursued: the attitude that it is worth pursuing an improvement in anyone's position so long as no-one else would be made worse off. It is different because the difference principle does not endorse inequalities that only benefit those who are already advantaged.[482] But despite the fact that only certain forms of pursuit of Pareto improvement would be endorsed by the difference principle, forms that would specifically serve the interests of the disadvantaged, others have argued that Rawls was far too permissive of inequality.

Gerald Cohen makes the case most strongly, in his book *Rescuing Justice and Equality*.[483] He relies on the fact that how a human being responds to the presence

482. It should however be noted that in Rawls' system, the difference principle is not the sole regulator of social arrangements that impinge on economic welfare. He explicitly subordinated it to a requirement that all should enjoy the most extensive basic liberties that are compatible with similar liberties for others, and to a requirement of equal opportunity to achieve whatever unequal incomes might be on offer: *A Theory of Justice*, pg. 266. The principle of liberty, in particular, would permit actions that could lead to more inequality than one might expect on the basis of the difference principle alone.

483. Cohen, G. A. *Rescuing Justice and Equality*, 2008

or absence of an incentive, for example an incentive to work harder or to take commercial risks, is a matter of the individual's choice. If someone would act in a certain way given the right incentive, she could decide to act in the same way without the incentive. That much is clearly true. Cohen goes on to argue that inequalities are not justifiable. If we could move from a situation of relative equality to one of relative inequality and, in so doing, improve the position of the disadvantaged, the individuals whose actions had improved the position of the disadvantaged could act in the same ways, regardless of incentives. It follows that there would be a third position to which we could move, in which everyone acted the same as in the second position, but equality was restored. Those who would otherwise be incentivised would give up their incentives, but would still act as if they had received them. For Cohen, this third position is the best one of all. People's lot is improved, but equality is preserved.[484]

There are two ways in which Cohen's argument could be taken. The first one, which is implausible, is to say that it would be practical to achieve the third position.[485] That is, if we were to ask the skilled and the entrepreneurial to do the things they would do with incentives, but to do so while not actually receiving the incentives, they would be good enough to comply. Not only is human nature not always that charitable – although it is that charitable in some individuals. The price mechanism, which relies upon inequalities, is also by far the most efficient mechanism we have found for directing resources to their most productive uses, and that mechanism in itself generates inequality, as some people take advantage of the opportunities that it indicates more efficiently than others. It is no answer to either of these concerns to say that we could have any gross salaries, or any pre-tax profits, but then achieve equality of net income through taxation. People would see that they were being offered no incentive to act in the desired ways, and those who were not particularly charitable would therefore decline to act as required. And the price mechanism would be hopelessly blunted if prices were decoupled from rewards by the imposition of taxation that enforced equality of net income. People would not take market signals seriously, any more than they take seriously a notional gambling game in which they have no actual stake.

The second, more plausible, way to take Cohen's argument is to accept that it would only be theoretically possible to move from the second position to the third, from one in which economic conditions have been improved by the effects of incentives to one in which the improvement is preserved but the incentives are abolished and relative equality (or at the extreme, complete equality) is restored. That mere theoretical possibility is enough for anyone who accepts Cohen's view to claim that while the second position may be practical, it is less than just. It follows that we cannot take Rawls' difference principle to be a good guide to justice. Correspondingly, the inequalities that the difference principle would permit are not really justified.

4.3.6.3. Assessing the political case for equality

Both Rawls and Cohen take it that equality is the presumptively just position. Under inequality, those with less than the average can demand to know why they should

484. Cohen, G. A. *Rescuing Justice and Equality*, pgs. 97–106
485. Cohen recognises that the third position may be impractical: Cohen, G. A. *Rescuing Justice and Equality*, pgs. 102–104

have less, and it is not at all clear that there is any good answer to this.[486] For Rawls, there can be a good answer in the form of a claim that inequalities actually improve the lot of the disadvantaged. For Cohen, even that answer is no good, because the advantaged could have chosen the same actions without special incentives.

We should, however, challenge the view that equality is the presumptively just position. Rawls is the one who provides the key argument for this view. In his view, the way to establish what is just is to imagine what people would want if they were designing a society in which they would live, but with no idea of what family, talents or other circumstances they would have in that society. He called this the original position. It is Rawls' way of getting to fairness, which was essential because he saw justice as amounting to fairness. The original position induces fairness in a similar way to that in which the usual method of division of a cake between two children induces fairness. One cuts the cake and the other then chooses her piece, so the one who cuts is ignorant of which piece he will get, until it is too late.

According to Rawls, people in the original position could expect nothing better than an average share, and would have no reason to accept anything worse. They would therefore choose equality, subject to the allowances for inequality that we have already discussed.[487]

Nozick's response was a general one against any predetermined pattern of distribution. Free exchange would soon disrupt any pattern, so continual intervention would be needed to preserve it. That in turn would require great interference with the distribution that would arise by free exchange, the distribution that would in his view be just.[488]

We can also challenge Rawls' argument for equality at an earlier point. Is it true that people in his original position would want equality, subject to the difference principle? Is it true that they would simply be concerned with the position of the least advantaged person? It is not at all clear that this would be so. Suppose that they had a choice between two societies, X and Y. In both societies, everyone would have at least a tolerable standard of living: no-one would be in abject poverty. In society X, the worst-off person would have income of £15,000 a year, a few people would have incomes of £20,000, and the great majority would have incomes of £25,000. In society Y, the worst-off person would have income of £14,000 a year, a few people would have incomes of £19,000 a year, and the great majority would have incomes of £27,000. It is not at all clear that someone who might turn out to be anyone in the society in question would prefer society X to society Y. One could reasonably take a chance on being someone with the income of the majority, and prefer society Y. Even if one did turn out to be the poorest person in society Y, one would be in a society in which there would be likely to be more interesting things going on, and more

486. The idea that the disadvantaged might object is used in Scanlon, T. M. *What We Owe to Each Other*, 1998. Scanlon, like Rawls, takes a contractualist approach, and he ends up supporting principles (weaker than Rawls' difference principle) that require us to pay attention to the needs of others. But rather than thinking in terms of the principles we would choose if we were designing a society, while not knowing who we would be within that society, Scanlon seeks principles that could not reasonably be rejected by people who sought principles for the regulation of behaviour that others with the same motive could not reasonably reject. Barry, B. *Justice as Impartiality*, 1995, uses a similar starting-point of principles to which people would not object, and argues for equal consideration of people, at least at the level of establishing general principles.

487. Rawls, J. *A Theory of Justice*, revised edition, 1999, pg. 130

488. Nozick, R. *Anarchy, State, and Utopia*, pgs. 160–164

opportunities for members of one's family, because of the generally higher income levels than in society X. But Rawls takes it that one would prefer society X.[489]

A further argument against Rawls' position is that the narrowness of the exceptions to equality that are permitted by his difference principle leads to results that are very hard to justify. An improvement in someone's position that increases inequality is ruled out by that principle, unless it would benefit the least advantaged. But that would rule out a great range of improvements that would make some people better off without making anyone worse off. Looked at the other way, assuming the improvements were already in place, it would require the elimination of benefits gained by some, because those benefits did nothing positively to help the least advantaged, but merely left the position of the least advantaged unchanged. Such elimination would amount to making some people worse off without making anyone else better off. That is a distinctly counter-intuitive position to take. One might defend Rawls' whole system against this charge, by arguing that the exercise of the basic liberties that Rawls requires us all to have could permit actions that would benefit only the better-off and, in so doing, increase inequality. But the difference principle itself looks decidedly shaky. And that is the principle on which any Rawlsian argument for equality of outcome rests.

Turning to Cohen, his concern is to demolish justifications for inequality, rather than to provide fresh positive arguments for equality. His main argument is the one already discussed, that if people respond in certain ways to incentives, they could equally well act in the same ways without incentives. So the efficacy of incentives gives no reason to say that inequality is just, only that it is practically useful.

There are two main lines of response to Cohen's line of thought. The first one is to say that a positive case for setting out to achieve equality cannot be made simply by undermining justifications for inequality. There also needs to be a presumption in favour of equality. As we have seen in reviewing Rawls' argument, it is not at all clear that such a presumption can be adequately supported. The second one is to say that even if Cohen's arguments did work, they would not be a sensible basis on which to formulate policy. We need policy for the real world, in which people do respond to incentives and often cannot be persuaded to act in the same ways without those incentives. If Cohen were right, the result of allowing the incentives, while it might be the best result that was obtainable in practice, would nonetheless be unjust. That would mean that the cost of prosperity was a modicum of injustice (although not injustice of the sort that would outrage most people, such as a biased judiciary or a loss of freedom of expression). That may well be so. The world is not guaranteed to be satisfactory in every respect.

No good case has been made that equality is in itself an objective that should be actively pursued. It is therefore not legitimate to use taxation to promote equality, given that the use of taxation involves coercion and can damage economic growth. The use of taxation to promote other objectives may incidentally promote equality, and equality may happen to arise naturally through the operation of the economy. There is nothing wrong with either of those possibilities.

489. Theoretical arguments, as well as common sense, cast doubt on Rawls' view. The work of John Harsanyi indicates that one should prefer the maximisation of total utility, even at the cost of inequality. For a contemporary consideration of this work and its implications, see Gibbard, A. *Reconciling Our Aims: In Search of Bases for Ethics*, 2008, pgs. 41–44

Chapter five

Taxes on capital and labour income disguised as business taxes should be abolished and replaced with a tax on distributed income

5. Taxes on capital and labour income disguised as business taxes should be abolished and replaced with a tax on distributed income

5.1. Businesses don't pay taxes, people do

Corporations are legal fictions – in the same way that your television does not pay the licence fee, and your house does not pay Stamp Duty, companies cannot ever pay tax: people do. Corporation Tax appears to fall particularly on workers, in the form of lower wages (Section 5.1.1). And Employers' National Insurance also falls on workers in the form of lower wages except to the extent that it increases unemployment instead (Section 5.1.2).

The opacity of taxes also undermines their legitimacy. Complex corporate taxes lead to accusations that large businesses are avoiding tax. These accusations are, in some cases, misguided (Section 5.1.4). That creates a sense of unfairness that legitimises real abuse of the tax system.

Taxes that purport to tax business should be abolished. Labour income will still be taxed through Income Tax. Capital income should instead be taxed through a new tax on capital income itself, collected at the level of the corporation (Section 5.1.5).

5.1.1. Corporate taxes depress shareholder returns, increase prices and reduce wages; but the effect on wages appears to be the largest

One of the popular allures of Corporation Tax is that it is seen to shift the tax burden from ordinary people onto businesses. From an economic perspective, however, this is impossible and Corporation Tax can only be paid by investors (through lower returns on investment), customers (through higher prices), or employees (through lower wages).

The incidence of taxation (i.e. upon whom the burden falls) is a result of relative elasticities.[490] Early attempts to measure this focused on capital,[491] and other studies suggest that the burden can be exported. However, if labour is less mobile than capital, it is relatively easier for investors to escape the burden by investing in more favourable conditions, meaning the lion's share of the Corporation Tax bill is paid for by employees. Feldstein shows that, once you relax assumptions about a fixed capital stock, for "a wide range of plausible parameter values, a substantial fraction of the burden of a general profits tax is borne by labour".[492]

This process is not deliberate. It is the inevitable consequence of the fact that wages are driven by productivity, and by confiscating company profits you reduce

490. Fullerton, D. & Metcalf, G. E. Tax incidence, *Handbook of Public Economics*, 4, 2002

491. The classic study is Harberger, A. C. The incidence of the corporation income tax, *Journal of Political Economy*, 70, 3; also see Auerbach, A. J. *Who bears the corporate tax? A review of what we know*, NBER Working Paper No. 11686, 2005

492. Feldstein, M. S. Incidence of a Capital Income Tax in a Growing Economy with Variable Savings Rates, *Review of Economic Studies*, 41, 4, 1974

investment and the types of productivity gain that can increase wages. This mechanism has been observed by Gentry:[493]

> *Evidence on the degree of capital mobility across countries and the sensitivity of corporate investment to changes in tax policy also corroborate the possibility that the corporate income tax lowers wages by reducing the productivity of the work force*

Indeed there is overwhelming evidence to support the view that "a significant portion of the burden from a country's corporate tax increases falls on its workers".[494]

Numerous empirical studies show that higher rates of Corporation Tax lead to lower wages

Numerous empirical studies show that higher rates of Corporation Tax lead to lower wages. A 2006 Congressional Budget Office report found that "domestic labour bears slightly more than 70 per cent of the burden of the corporation income tax".[495] A 2006 report for the American Enterprise Institute looked at the responsiveness of wages to Corporation Tax in 72 countries and over 22 years, finding "a one per cent increase in Corporation Tax rates is associated with nearly a one per cent drop in wage rates."[496] Arulampalam, Devereux and Maffini found that "an exogenous rise of $1 in tax would reduce the wage bill by 75 cents",[497] though they have reported other values from 49 cents to over $1. Another American Enterprise Institute study in 2010 found that, in the long run, "elasticity of wages w.r.t. the effective marginal or average corporate tax rate varies from 0.4 to 0.6, suggesting that a $1 increase in the tax revenue leads to a nearly $3 or $4 decrease in the real wage".[498]

Moore and Kasten looked at the results of the German Business Tax Reform in 2000, which reduced corporate tax rates from 40 per cent for retained profits and 30 per cent for distributed profits, with a single uniform rate of 25 per cent. They found a highly significant coefficient which implies that wages in the manufacturing sector rose 1.21 per cent due to that cut.[499]

Using data from the Luxembourg Income Study, Felix found that an increase in the rate by one percentage point led to a fall in annual gross wages of 0.52 per cent between 1992 and 2005.[500] That would imply that a five per cent cut in Corporation Tax would have increased the median UK wage in 2009 of £21,221 by £552.

In a separate paper Felix and Hines controlled for difficulties in comparing counterfactual wage estimates by focusing on union vs. non-union wages in comparable jobs, and across US states with varying rates of Corporation Tax.[501] They found that union wage premiums were $1.88 per hour higher in low tax states, and that a one percentage point lower corporate tax rate was associated with a 0.36 percentage point increase in union wages. It makes intuitive sense that collective bargaining

---

493. Gentry, W. M. *A Review of the Evidence on the Incidence of the Corporate Income Tax*, Department of the Treasury – Office of Tax Analysis, 2007

494. Viard, A. D. Three cheers for the decline of the corporate income tax, *American Enterprise Institute Tax Policy Outlook*, 2, April 2008

495. Randolph, W. C. *International Burdens of the Corporate Income Tax*, August 2006

496. Hassett, K. A. & Mathur, A. *Taxes and Wages*, American Enterprise Institute, June 2006

497. Arulampalam, W., Devereux, M. P. & Maffini, G. *The Direct Incidence of Corporate Income Tax on Wages*, Oxford University Centre for Business Taxation Working Paper 09/17, August 2009

498. Hassett, K. A. & Mathur, A. *Spatial Tax Competition and Domestic Wages*, American Enterprise Institute, December 2010

499. Moore, N. & Kasten, T. *Do wages rise when corporate tax rates fall? Difference-in-differences Analyses of the German Business Tax Reform 2000*, February 2009

500. Felix, R. A. Do state corporate income taxes reduce wages? *Federal Reserve Bank of Kansas City Economic Review*, 94, 2009

501. Felix, R. A. & Hines, J. R. *Corporate Taxes and Union Wages in the US*, NBER Working Paper No. 15263, August 2009

power will influence the extent to which reductions in Corporation Tax are passed on to employees, and around 54 per cent of what might be paid as Corporation Tax might otherwise be enjoyed as higher wages.

In a 2007 study, Desai, Foley and Hines concluded that:[502]

> *"The results consistently indicate that corporate taxes depress both real wages and returns to capital, with most of the burden of corporate taxes borne by labor. The baseline estimate for the share of the burden borne by labor is 57 per cent, and estimates vary between 45 and 75 per cent, depending on the sample period and specification."*

5.1.2. The incidence of Employers' National Insurance is on labour, either through lower wages or higher unemployment

Academic opinion varies as to the precise degree to which employees pay the economic cost of the charge but the range of opinion extends between mostly and completely on employees in the form of lower wages and salaries, higher prices (effectively lower incomes for consumers, including workers) and higher unemployment.

Looking at Social Security Payroll Taxes, the closest American equivalent of Employers' National Insurance, Brittain found results "consistent with the hypothesis that 100 per cent of the tax is borne by labor."[503] Gruber used evidence following a "sharp exogenous reduction in the payroll tax burden on Chilean firms" and estimated that "the incidence of payroll taxation is fully on wages, with no effect on employment.[504]

Because consumers are likely to reduce their overall spending and transfer more of it to goods and services produced where Employers' National Insurance is not chargeable, organisations are limited in the extent to which they can raise prices. Labour, however, is less mobile and for most employees reducing wages by an amount equivalent to the charge will simply reduce the net economic benefit they capture from their employment. This is why most, if not all, of the charge works its way through to workers through lower wages rather than to consumers through higher prices or capital through lower profits.

A small number of employees, however, will not simply accept a lower net income as a result of National Insurance because, for this group, the financial and other benefits of being in employment already only just outweigh the costs in terms of the time and effort involved. For them, Employers' National Insurance means the difference between work being financially worth the time and effort required and it not being so in the same way that Income Tax can. Some of these people will give up work altogether, while others will simply reduce their employment to part time.

In other words, they are unemployed or underemployed and it is in this manner that they carry the burden of Employers' National Insurance. While its execution differs from Income Tax and Employees' National Insurance, the effect of Employers' National Insurance is, if not wholly, then almost identical: overwhelmingly paid for by workers in the form of lower net incomes for the majority who stay in work and underemployment and unemployment for the minority who do not.

---

502. Desai, M. A., Foley, C. F. & Hines, J. R. *Labour and Capital Shares of the Corporate Tax Burden: International Evidence*, Harvard University Working Paper, December 2007

503. Brittain, J. A. The Incidence of Social Security Payroll Taxes, *American Economic Review*, 1972

504. Gruber, J. The Incidence of Payroll Taxation: Evidence from Chile, *Journal of Labour Economics*, 15, 1997

5.1.3. Financial Transaction Taxes are not taxes on bankers; they will initially affect savers then over time reduce wages for workers

Recently the Tobin Tax – initially seen as a mechanism to reduce exchange rate volatility though likely to be counterproductive in that regard (Section 6.1.3) – has been revived as a means of raising revenue to pay for a variety of objectives. There is an activist campaign which wants to spend the money raised by what they call the Robin Hood Tax on mitigating potential global warming and supporting international development.[505] The tax has also been promoted by French President Nicolas Sarkozy.[506]

The problem is that the Tobin Tax, as it was designed to change behaviour, is an incredibly inefficient way of raising revenue. The basic problem is set out by Charles Goodhart:[507]

> *The Tobin tax – a tax on financial transactions – is not efficient as exchange operations can be easily done anywhere in the world.*

Campaigners claim that the measure is a "tax on the financial sector" and "has the power to raise hundreds of billions every year globally" and "give a vital boost to the NHS, our schools, and the fight against child poverty in the UK – as well as tackling poverty and climate change around the world." In reality, savers struggling to afford a comfortable retirement would pay this tax. Already struggling with high inflation, they would be hit again as the share prices that underlie the performance of most pension funds would be depressed. In the longer term, particularly if the tax is not applied globally, workers would suffer too with fewer opportunities and lower wages as investment went elsewhere.

In an article for *The Guardian*, Bill Nighy – a film star and campaigner for the Robin Hood Tax – attempted to avoid that problem with the misleading statement that "according to the IMF it would be paid predominantly by the richest", which he then translated for the rest of his article into the suggestion it would be paid by "bankers".[508] The reality is that the IMF paper to which he is referring says that the burden would "fall on owners of traded securities, at the time the tax was introduced, as the value of stocks, bonds and derivatives subject to" the new tax fell. That means savers.[509]

People with savings are generally significantly better off than those without them. For example, people on benefits are not saving and their retirement income will depend on the level of state pension entitlements rather than investment returns. The other group this would not affect as much – though they are actually relatively well off – are public sector workers, whose unfunded, defined benefit pensions also aren't dependent on investment returns.

But, while savers are on average significantly better off than people who aren't saving, many are not very high earners and are struggling to save and build a pension to provide for themselves in retirement. Extensive efforts are made to encourage people to save, by allowing tax-free ISAs for example. That effort would

505. The campaign's website is here: http://lowtax.es/HbJber
506. Viscusi, G. *Sarkozy Wins Merkel Backing for Transaction Tax*, Bloomberg, 9 January 2012
507. Goodhart, C. An Alternative to a Tobin Tax, *EuroIntelligence*, 26 November 2009
508. Nighy, B. A Robin Hood tax could turn the banks from villains to heroes, *Guardian*, 28 September 2011
509. Matheson, T. *Taxing Financial Transactions: Issues and Evidence*, IMF Working Paper, WP/11/54, March 2011

be undermined by a new tax on savers and it would, in time, make it more difficult to maintain stable public finances with an ageing population.

In the longer term, by making it more expensive for companies to raise finance this measure would depress investment. Particularly in an open economy like Britain's, and if the tax wasn't truly global, capital would "flow out until its after-tax return was restored to the world market level." Less investment means fewer jobs and lower wages. As the IMF says: "In the long run, capital owners would therefore not bear the burden of the STT (Securities Transaction Tax); it would fall on workers, who as a result of the smaller capital stock would be less productive and receive lower wages."

Research by Oliver Wyman for the Global Financial Markets Association found that proposals for a European Financial Transaction Tax would cost more than €1 for every €1 raised in tax and that around 70 to 75 per cent of eligible foreign exchange trading would migrate outside the EU's jurisdiction. Institutions like pension funds would be particularly hard hit as they are "less able to relocate volumes outside of the EU than banks or hedge funds."[510] A group of Dutch pensions associations has warned that the tax could lead to a five to 10 per cent reduction in individual pension savings and cost institutional investors up to €4.1 billion a year.[511]

Other countries have seen that these taxes do not work. Australia abolished a stamp duty on shares in 2001, for example. The IMF reported that these taxes have been in steady decline internationally in recent years.

In a report for the Canadian Parliamentary Research Branch, Wrobel looked at the results of the Swedish wealth tax and found that "revenues from the tax on fixed-income securities were initially expected to amount to 1,500 million Swedish kroner per year. They did not amount to more than 80 million Swedish kroner in any year and the average was closer to 50 million."[512]

He goes on to describe other consequences of the tax:

> *As taxable trading volumes fell, so did revenues from capital gains taxes, almost entirely offsetting revenues from the equity transactions tax*
>
> *[…]*
>
> *On the day that the tax was announced, share prices fell by 2.2 per cent. But there was leakage of information prior to the announcement, which might explain the 5.35 per cent price decline in the 30 days prior to the announcement. When the tax was doubled, prices again fell by another one per cent. These declines were in line with the capitalised value of future tax payments resulting from expected trades. It was further felt that the taxes on fixed-income securities only served to increase the cost of government borrowing, providing another argument against the tax.*
>
> *[…]*
>
> *With the 1986 announcement that the equity tax would double, 60 per cent of the trading volume of the 11 most actively traded Swedish share classes, accounting for one-half of all Swedish equity trading, moved to London; thus 30 per cent of all Swedish equity trading moved offshore. By 1990, more than 50 per cent of all Swedish trading had moved to London.*

510. Wagner, M., Smith, B. & Rigby, C. *Proposed EU Commission Financial Transaction Tax impact analysis on foreign exchange markets*, Oliver Wyman, January 2012

511. Preesman, L. Financial Transaction Tax could slash pensions by 10 per cent, Dutch schemes warn, *Investment & Pensions Europe*, 12 January 2012

512. Wrobel, M. G. *Financial transactions taxes: the international experience and the lessons for Canada*, Parliamentary Research Branch, BP-419E, 1996

[…]

Even though the tax on fixed-income securities was much lower than that on equities, the impact on market trading was much more dramatic. During the first week of the tax, the volume of bond trading fell by 85 per cent, even though the tax rate on five-year bonds was only three basis points. The volume of futures trading fell by 98 per cent and the options trading market disappeared. Trading in money market securities, which faced a tax as low as 0.2 basis points, fell by 20 per cent. This reaction was due in large part to the existence of a wide variety of non-taxed substitutes. Once the taxes were eliminated, trading volumes returned and grew substantially in the 1990s.

Wrobel has also looked at the consequences of financial transaction taxes in Switzerland and Germany:

Switzerland, a world banking centre, also suffered from financial migration. Its relatively high transactions on money market funds hindered the development of such an internal market. Its stamp duty also caused the mutual fund business to migrate to Luxembourg and the Eurobond and equity business to go to London. By 1993, 22 per cent of trading in Swiss companies was taking place in London, up from 16 per cent only two years earlier. In 1993, the Swiss government abolished the 15 per cent stamp duty on a wide variety of securities to stem such migration.

The FTT's impact on the location of financial transactions was also felt in Germany and France. In 1989, before the elimination of Germany's taxes, 30 per cent of trading in German government bonds and 50 per cent of trades in other DM-denominated bonds took place in London, as did 80–90 per cent of trades in floating rate DM-denominated bonds. Moreover, about one-third of the trading in French and German public companies took place in London, where almost one-half of the daily volume of trades is in shares of foreign companies.

There is a stamp duty on shares in Britain but it is a disastrously inefficient tax

There is a stamp duty on shares in Britain but it is a disastrously inefficient tax, despite some differences in the conditions making it much less onerous than a full financial transactions tax (there is more detail in Section 6.1.3). In 1999, researchers at the London School of Economics found that other transaction costs for UK equities had more than halved while Stamp Duty had remained constant. As the Forsyth Commission reported, those higher transaction costs depress share prices by up to 10 per cent. One study suggests that if it were abolished the increase in the market capitalisation of the FTSE All Share could be in the region of £150 billion. That suggests the around £4 billion a year the tax raises is poor value.[513] If a Financial Transaction Tax is supposed to raise much more money than that, then it will do even more to reduce share prices.

And Stamp Duty on shares also makes it more expensive for companies to raise the finance they need to grow and compete with rivals abroad. Oxera found that abolishing the tax would reduce the cost of equity by seven to 8.5 per cent on average, but technology companies for example might pay up to 12 per cent less.[514] That means abolishing the tax would increase investment, and bring more jobs

513. Forsyth, M. et al. *Tax Matters: Reforming the Tax System*, October 2006
514. Oxera *Stamp duty on share trading: what is the effect on UK listed companies?* Agenda, June 2007

and higher wages for British workers. Introducing a new financial transactions tax would take us in the opposite direction.

A global financial transactions tax would be economically disastrous and particularly bad for Britain, with a successful financial sector in the City of London. If the tax were not global it would just give a big competitive advantage to other jurisdictions. It would be completely unworkable if a major financial centre weren't included, and any global agreement would be extremely difficult to agree and enforce.

5.1.4. The opacity of corporate taxes undermines the legitimacy of the tax system by suggesting greater avoidance by large companies than actually takes place

As an example of both the controversy and confusion surrounding Corporation Tax consider the furore over Barclays Bank's 2009 bill. In an article in *The Guardian*, it was revealed:[515]

> *Barclays Bank has been forced to admit it paid just £113m in* UK corporation tax *in 2009 – a year when it rang up a record £11.6bn of profits*

It goes on to state that Barclays paid tax of "just one per cent of its 2009 profits", and contrasted this with the 28 per cent rate of Corporation Tax. A firestorm of internet debate ensued, and several errors and misrepresentations were discovered.[516]

Firstly, the pre-tax profit figure of £11.6 billion incorrectly includes around £7 billion of discontinued items that relate to the sale of Barclays Global Investors. A gain on the disposal of a "substantial shareholding" is exempt from Corporation Tax, so that tax on capital gains does not distort decisions to restructure. Barclays' 2009 Annual Report draws attention to this in the "Income Statement Highlights", and clearly provides the actual pre-tax profit of £4.6 billion.[517]

Secondly, *The Guardian* compares the (inaccurate) pre-tax profits of Barclays Group (the global company) with the Corporation Tax bill for the UK. This is highly misleading because companies only pay Corporation Tax in countries where the profits were made – the £4.6 billion profits are not taxable income for HMRC. Provided you believe that subsidiaries of Barclays that operate in Ghana should pay their taxes in Ghana, this is not controversial. Indeed, the relevant total tax liabilities for Barclays in 2009 were in fact £1.07 billion,[518] which means an effective tax rate of 23.4 per cent. As John Band points out, the consolidated cash flow shows that in 2009 Barclays actually paid £1.18 billion in taxes – a rate of 26 per cent.

These two adjustments practically get us from a supposed Corporation Tax rate of one per cent to the headline 28 per cent that might be expected. However there are some additional factors that are worth considering.

515. Treanor, J. Barclays bank forced to admit it paid just £113m in corporation tax in 2009, *Guardian*, 18 February 2011

516. What follows is analysis that derives from Tim Worstall, commenters at his blog, Christie Malry and John Band. In particular, see TimWorstall.com *Does Richard actually read his own blog?* 19 February 2011, http://lowtax.es/HRh3JO ; FCA Blog *The five howlers made by The Guardian in reporting tax paid by Barclays*, 20 February 2011, http://lowtax.es/HJzyj6 ; TimWorstall.com UKUncut: blithering idiots once again, 20 February 2011, http://lowtax.es/HbFgND ; Barclays paid a billion quid in tax – but not to us, 1 March 2011, http://lowtax.es/HdDpGv

517. Note 38 shows that the profit before tax from the discontinued operations was £762 million, and the profit on disposal of the discontinued operation was £6,331 million. The sum of these figures (£7,057 million) is the adjustment that needs to be made to the pre-tax figure of £11,642 million used by *The Guardian* to get the more accurate figure of £4,585 million.

518. Note 10

The Economist recently showed the theoretical accounting charge vs. the actual cash tax paid by HSBC, RBS, HBOS, Lloyds Group, and Barclays.[519] As would be expected, from 2001 to 2006 the big British banks paid slightly less in tax than the theoretical accounting charge. However in 2007 they paid more, and in 2008 they made significant losses and yet still paid almost £8 billion in Corporation Tax due to the previous year's activity. A lower bill in 2009 merely reflects the lag due to previous losses.

Indeed all companies receive tax relief on losses. If a company suffers a loss it is allowed to carry it forward to offset taxes on future profits. This is because Corporation Tax is supposed to reflect, as Tim Worstall puts it, "cumulative profits over time, not just the profits in any one arbitrary time period". Christie Malry points out that Barclays offset £859 million worth of losses in 2008, and "the utilisation of those losses will have reduced the amount of tax it handed over to HMRC in 2009".

Another example of public confusion about taxation can be found in the response to an ActionAid report on tax havens.[520] Its main finding was that 98 per cent of the FTSE 100 utilise tax havens, however its list of the three largest tax havens includes the American state of Delaware, the Netherlands, and Ireland. There are two major methodological problems with this study.

The first is that they do not explain why they use a state (in the case of Delaware) but countries elsewhere. They do not define the economic entities that they are analysing.

Secondly, when they define the term "tax haven" they follow the US Congress's Government Accountability Office. However – as they acknowledge on page five – Delaware and the Netherlands do not appear on this list. There may well be good reasons to augment or modify the Government Accountability Office's definition, but it seems highly dubious to jettison the conventional definition in the case of their two biggest examples. Indeed it seems odd to argue that the largest tax haven in the world lies within a G7 country and that the second and third largest are both EU members – Ireland and the Netherlands. There are obviously very legitimate reasons for FTSE100 companies to operate in those jurisdictions.

Aside from problems with the analysis itself, there are also problems with the interpretation. The report claims that:

> *The roaring trade undertaken by tax havens leads to the tax burden being shifted from the companies and rich individuals who use their services, on to ordinary people and businesses who comply with their tax obligations.*

Even if the premises were correct, that passage implies that the "companies" and the "ordinary people and businesses" are two different economic entities. However, only individuals pay tax. Neither "companies" nor "ordinary businesses" pay a penny of taxation – it all comes from individuals. The passage appears oblivious to the fact that it is the ordinary people already paying the Corporation Tax, and that a change in tax policy from a specific company will change the relative burden between people but not shift the burden from companies to people.

The report implies that the greater the degree of tax efficiency from larger companies, the greater the burden must fall on smaller ones. Even if we take this as given, it is important to understand why this might occur. One reason is that SMEs cannot afford the fixed costs of taxation advice, and only large companies will invest the

519. The Economist *No squeaks from these pips*, 24 February 2011
520. ActionAid *Addicted to tax havens: The secret life of the FTSE 100*, 11 October 2011

time and resources in hiring experts to alter their legal arrangements to minimise their tax obligations. But there are two possible solutions to this problem. One is to further increase the costs of compliance, but this has the unintended consequence of increasing the economies of scale and making the position even more favourable to large companies. The second solution is simply to reduce the costs of compliance and thus give SMEs a more level playing field.

As an example of how such reports can mislead people, consider the following meme. Firstly, ActionAid releases the report claiming that 98 per cent of FTSE 100 companies have subsidiaries that operate in a tax haven. Sky News reported this as "98 out of the 100 companies on the FTSE 100 base their operations in territories where there is low or no tax."[521] This is then understood to mean, in the words of one blogger, "98 of the top 100 grossing businesses in the UK DO NOT PAY ANY CORPORATE TAX!!!!". A report showing that 98 per cent of FTSE 100 companies have a subsidiary in a tax haven (where the definition of "tax haven" is adjusted so that it includes G7 and EU countries) is very quickly misunderstood to claim that 98 per cent of FTSE 100 companies are based in tax havens, and when this is combined with a misunderstanding that companies pay no tax in tax havens (as opposed to less tax), we end up with a patently false and absurd belief that 98 per cent of the FTSE 100 do not pay tax.

Even to the extent companies can and do relocate their activities in order to minimise their tax burdens (Section 3.1.1.2), that is not the simple tax avoidance strategy it is sometimes portrayed as. Taxation is levied on the basis of where profits are made, not simply the location a firm claims or where it locates its headquarters. If a firm makes profits in Britain but is headquartered in Monaco then its British profits will still be liable for British Corporation Tax. The location of a firm's headquarters is significant but matters only because many countries also tax profits made in other countries when they are repatriated. That means firms cannot simply pick and choose under which jurisdiction they are taxed, but when the burden is sufficient for them to relocate genuine economic activity, including jobs and likely consumption and payroll that can be e taxed, their headquarters may relocate as well.

In reality, of course, FTSE 100 companies are responsible for paying a great deal of tax (on behalf of their shareholders, employees and customers) to the Treasury. The proportion of total tax paid and collected by these firms is now higher even than at the height of the economic boom. Revenue from Britain's largest companies rose 14 per cent in the year ending March 2011 to reach £67.7 billion. The receipts for Corporation Tax went up by 60 per cent in the same period. Additionally, for every £1 paid in Corporation Tax, firms paid a further £1.53 in other taxes, and helped generate an additional £4.15 through taxes they administer such as PAYE.[522]

Throughout this debate one gets the impression that Corporation Tax is the main (or possibly only) way that companies contribute to the public finances, but it is not the only tax levied on business. They also make payments of Income Tax, National Insurance and PAYE. Although in this regard they are acting as tax collectors to pass on employees' taxes, by increasing employment, purchasing goods and services, paying business rates, and generally participating in the wider market, well-run and successful firms increase tax receipts.

The final point is that some people imply that firms merely need to spend enough money on tax lawyers and they can pick and choose how much tax to pay. The Robin Hood Campaign's Max Lawson claims that bankers are "unhampered

521. Sky News *All But Two FTSE 100 Firms 'Avoid Paying Tax'*, 12 October 2011
522. PricewaterhouseCoopers *Total Tax Contribution: Surveying The Hundred Group*, February 2012

by the inconvenience of paying tax".[523] Aside from the fact that bankers pay tax, Corporation Tax is not voluntary. These so-called scandals are not examples of tax evasion or illegal behaviour, but companies operating under the law and utilising established procedures that were set up for these very situations.

Corporation Tax lacks public legitimacy

It is tempting to believe that this debate is all down to ideological differences. But the idea that banks and large corporations aren't paying the 'right' amount of tax is too widespread despite the fact it is incorrect. Indeed the fact that the Barclays story coincided with protest groups that squatted in a branch demonstrates the scale of the problem – high passions are resting on some fairly basic misunderstandings. It is possible that some MPs, journalists and activists are all part of a conspiracy to deceive the public, but there is a simpler explanation – that the rules of Corporation Tax are not well known and that people do not trust the system. In other words, Corporation Tax lacks public legitimacy.

It's not only the public who do not understand Corporation Tax – consider the example of Warren Buffet. In a *New York Times* article he complained that it was unfair that the proportion of taxable income that he paid to the US Inland Revenue (17.4 per cent) was lower than that paid by other members of his office (on average 36 per cent).[524] It is difficult to analyse this point without knowing the details of his and his office's sources of income. It is a fair bet that Buffet's income is not solely derived from his annual salary as Chairman and Chief Executive of Berkshire Hathaway – someone of his wealth will be earning a return on the investments that he makes. But any income that he enjoys as a result of dividends or capital gains has already been taxed.

Corporation Tax falls on workers and shareholders, companies themselves do not pay taxes. Some ignore the impact on workers shown earlier by suggesting that it is actually borne by investors, and therefore less socially harmful. However, the higher the share of Corporation Tax that is borne by investors, the higher Warren Buffet's real tax bill must be.

That is what Warren Buffett is missing: the fact that the 17.4 per cent figure he quotes does not include the tax that has already been levied on his investment income prior to him receiving it. In 2008 Berkshire Hathaway paid $3 billion in Corporation Taxes, and given that he's one of the largest shareholders he will have paid a substantial part of that tax bill. Barro pointed out that overall, once additional taxes like Corporation Tax are accounted for, the tax system is not tilted in favour of the kind of capital returns that Buffett is making:[525]

> *Buffett's 17.4 per cent claim is deceptive. While the figure includes his personal income tax, as well as payroll taxes for Medicare and Social Security, it doesn't include another levy that he pays, albeit indirectly: the corporate income tax. The money that Buffett makes as an investor is simply a share of the profits of the companies whose stock he owns. Those companies have already paid the corporate income tax – as much as 35 per cent of their incomes – which dramatically reduces their profits, and thus Buffett's take.*
>
> *Another way of looking at this is to remember that a shareholder is a part owner of a company. In the current tax system, he's essentially paying taxes twice: first as corporate income tax, and second as personal capital-gains or dividend tax. Because of this double taxation, the tax code winds up treating*

523. Treanor, J. Barclays bank forced to admit it paid just £113m in corporation tax in 2009, *Guardian*, 18 February 2011
524. Buffett, W. E. Stop Coddling the Super-Rich, *New York Times*, 14 August 2011
525. Barro, J. A Tax Code for Tomorrow, *City Journal*, Autumn 2011

investing less favourably than labor. In 2005, the Congressional Budget Office, adding together the corporate- and personal-level taxes, estimated that the total federal tax burden on capital investments in corporations was 26.3 per cent. Personal income and payroll taxes, by contrast, accounted for just 17 per cent of personal income that year.

5.1.5. Corporation Tax and other capital taxes can be replaced with a single tax on capital income from dividends, interest or rent

The fairest way to tax people on their income from capital is to abolish all corporate taxes entirely and tax the income as and when it flows to people. Companies do not pay tax any more than buildings, toasters or cows do. Those who bear the cost of corporate taxes are people: shareholders and employees in the form of reduced dividends and lower wages and salaries. But it is hard to quantify by how much individuals or groups suffer from taxes on profits. This uncertainty means that corporate taxes are almost certainly unfair – it's just impossible to know by how much because we cannot reliably and accurately assess who really pays them. Better to tax the actual beneficiaries of profits as and when they benefit: capitalists on their interest and dividend income and employees on their wages and salaries.

However, rather than entirely abolishing tax collection at the corporate level and leaving it up to individuals to declare their dividend, interest and earnings income individually, the 2020 Tax Commission proposes to levy the tax at the corporate level – similar in principle to Pay As You Earn (PAYE) for labour income, though effectively a new corporate tax base. Companies would pay tax on their total dividend and interest payments less any dividends and interest they had received (because they would already have been taxed by the company paying them).

The reasons for applying the tax at a corporate level are broadly similar to those for PAYE on income from labour. It reduces the overall burden of administration, both for HMRC and employees, and reduces the scope for simple evasion. For the recipient, the system is simple: any dividends or interest received from a UK company would already be taxed. No further payment or administration would be required. In addition, foreigners would be subject to full tax on their UK income from capital as they are on UK income from labour. British business people would no longer find it advantageous for their spouses to domicile overseas in order to avoid tax on income from dividends for shares held in the spouse's name.

This system is a modified version of the 'S-base' system described in the 1978 Meade report published by the Institute of Fiscal Studies, which categorised corporate transactions as relating to shareholders, finance or real economic activity; 'S', 'F' or 'R', respectively.[526]

The S-base is $S - \dot{S}$ in the Table 5.1 or, as the Meade report put it:

This S basis levies tax on the net amount of cash flowing out of the corporate sector of the economy on account of share capital, i.e. the total of dividends paid to outside shareholders less the amount of new share capital raised from them. In other words, the tax is based on the net amount of cash which the shareholders take out of the corporate business.

It is important to note that S_2 and $\dot{S}_2$ relate to share buybacks and issues by the third party company, not to trading in the secondary market by the company being assessed.

526. Meade, J. E. et al. *The Structure and Reform of Direct Taxation*, Institute for Fiscal Studies, 1978

Table 5.1: Corporate flows of funds

Inflows		Outflows	
Real items			
R_1	Sale of produce	$\dot{R}_1$	Purchase of materials
R_2	Sale of services	$\dot{R}_2$	Wages, salaries and purchases of other services
R_3	Sale of fixed assets	$\dot{R}_3$	Purchase of fixed assets
R		$\dot{R}$	
Financial items other than shares of corporate bodies resident in the UK			
F_1	Increase in creditors	$\dot{F}_1$	Decrease in creditors
F_2	Decrease in debtors	$\dot{F}_2$	Increase in debtors
F_3	Increase in overdraft	$\dot{F}_3$	Decrease in overdraft
F_4	Decrease in cash balance	$\dot{F}_4$	Increase in cash balance
F_5	Increase in other borrowing	$\dot{F}_5$	Decrease in other borrowing
F_6	Decrease in other lending	$\dot{F}_6$	Increase in other lending
F_7	Interest received	$\dot{F}_7$	Interest paid
F_8	Decrease in holding of shares in other corporate bodies not resident in the UK	$\dot{F}_8$	Increase in holding of shares in other corporate bodies not resident in the UK
F		$\dot{F}$	
Share items of corporate bodies resident in the UK			
S_1	Increase in own shares issues	$\dot{S}_1$	Reduction in own shares issued
S_2	Decrease in holding of shares in other corporate bodies resident in the UK	$\dot{S}_2$	Increase in holding of shares in other corporate bodies resident in the UK
S_3	Dividends received from other corporate bodies resident in the UK	$\dot{S}_3$	Dividends paid
S		$\dot{S}$	
Tax items			
T	Tax repaid	$\dot{T}$	Tax paid
Total inflows $(R + F + S + T)$ = Total outflows $(\dot{R} + \dot{F} + \dot{S} + \dot{T})$			

The 2020 Tax Commission proposes to use the S-base, modified to include loans, bonds and interest, in order to tax income from capital at source. A firm would receive a credit against tax for any cash it receives from issuing its own shares, repurchases of shares it holds in other UK companies, dividends it receives from UK companies, any debt (loans or bonds) it takes on plus any interest payments it receives on loans and bonds from third parties. This credit is to ensure that tax on income from capital is only set against the income *from* the capital, not the capital itself. Effectively, it ensures that investors do not pay tax when the principal of their loan is repaid to them, or when their paid-up share capital is returned.

The tax on income from capital would apply to money distributed back to capital, once the credit had been deducted from the total: dividend and interest payments it makes; loans it provides to third parties; bonds it buys and repayments of borrowings; repurchases of its own share capital and subscription to new shares in other UK companies.

5.1.5.1. Features of the design

5.1.5.1.1. Only distributed income is taxed

Under the proposed tax system profits would not be taxed, only distributed income. That does not mean that someone who creates a business, grows it without taking an income or dividend and then sells it for a substantial capital gain is not effectively taxed. The price the owner can sell his business for is determined by the after tax dividends the business is expected to pay out in future.

The tax on dividends will depress the price that any potential purchaser of a firm, expecting to receive the dividends, is willing to pay for it. As a result, taxes will effectively be paid on the expected dividends and there is no need for a second tax on capital gains. There is a more detailed discussion of how Capital Gains Tax is an unnecessary double tax in Section 5.2.2.1.

5.1.5.1.2. Equal treatment of debt and equity

A key objective for reform of tax on income from capital is to eliminate the distortion caused by differential treatment of returns to capital in the form of debt versus equity (Section 6.1.2). The 'S-base' system identified by Meade proposes taxation of returns to equity separately from income derived from interest. This does not address the problem in the existing system whereby debt is advantaged by interest being deducted from taxable corporate income while dividends are paid after tax. This distortion has contributed to the expansion of corporate debt and restricted the growth of equity finance leading to more fragile corporate balance sheets than would otherwise be the case. We propose to include items F5, F6 and F7 (other borrowing and lending and interest payments) on both sides of the transaction to capture loans and debt instruments such as bonds.

5.1.5.1.3. Holding companies and financial corporations

Because holding companies and financial corporations are likely to receive more interest and dividend payments than they distribute, they will create a recurring tax asset.

A holding company will receive dividends from the companies it owns. However, assuming they are all UK companies, those subsidiary companies will have already paid income tax on dividends paid. Because the holding company has its own costs, some of the dividends received from subsidiary companies will be used to pay these costs rather than be passed on to their shareholders. Therefore, assuming the holding company carries out no trading activity itself, it will pay out less to its shareholders than the dividends it receives.

If holding companies are not able to trade the excess credit for tax already paid on income they receive, a distortionary tax incentive would be created for them to trade themselves or merge some of their subsidiary companies directly into the holding company because they would be able to use the credit against the tax liability of that additional trading or newly merged subsidiary's distributed income.

In the case of a bank, this is because the interest they pay out to depositors will be less than that they charge to borrowers. The difference is used to pay their staff and for other costs. So a bank, like a holding company, will generate an excess of credit for tax already paid on dividend and interest received over that it is liable to pay out itself. The same principle applies to investment trusts, pension funds (whose costs are, principally, pension income for policy holders) and other financial corporations.

As with holding companies, if financial corporations are not able to trade the excess credit for tax already paid on income they receive, a distortionary tax incentive would be created for them to acquire non-financial companies in order to provide their shareholders with a greater income with the same tax liability.

Two options are available to avoid the distortion. The first is a set of rules requiring financial and holding company activities to be calculated separately from non-financial and subsidiary activities for tax purposes. The advantage of this method is that it would create a wider tax base and therefore produce either greater revenue for the Treasury with the same tax rate or allow for a lower tax rate in order to raise the same revenue. The disadvantage is the additional complexity it would add to the tax code, along with the opportunity for avoidance and consequent monitoring it would require to define which activities would be classified as financial (shared overheads, etc.). It would also significantly distort corporate structures and discourage holding company structures that may be good for corporate governance and efficiency reasons.

A more attractive option would be to make the credits transferable, entirely removing the tax incentive for conglomeration and poor corporate governance. Financial corporations would simply sell their excess tax credits to buyers with a tax liability. The disadvantages and advantages of this approach are the mirrors of those for a rules-based separation: a simpler code with lower administration and compliance costs and less room for avoidance but a narrower tax base.

Such a system would mean the incidence of tax on income from capital would continue to fall on the owners of financial corporations but those financial corporations would no longer be legally liable for the tax paid. It would be economically damaging to impose a higher tax *burden* on shareholders in one sector of the economy simply because it does not appear to be paying any tax as its burden is accounted for in the tax already *paid* by another sector.

5.1.5.1.4. Pensions

As the proposed changes treat savers fairly, unlike the current tax system, there should not be a need for exceptions in order to ensure pensioners are not double taxed. However under their current legal terms pensions may not properly take advantage of this new system. A mixture of changes in regulation and changes in fund practice are likely to be needed in order to ensure that those saving receive the same treatment as other investors and are not disadvantaged by these proposals. It is beyond the scope of this report to set out those changes in detail, but there is no reason that pensions cannot function properly under the proposed system.

Similar arrangements may be needed to replace ISAs, and transitional arrangements of some kind will also be needed to protect savers already using them.

5.1.5.1.5. Life assurance investment functions

Many people invest through unit trusts, open-ended investment companies, investment trusts and life policies. The tax system should neither advantage nor disadvantage investment through such vehicles, as against direct investment in shares and securities. Neutrality could be achieved in one of two ways. The first way would be to treat the vehicles exactly like ordinary companies, receiving and paying out dividends and interest, issuing new shares when investors subscribed money (or paid policy) and redeeming shares when investors extracted their money. The second way would be to treat the vehicles as if they were individuals, and to make transfers between them and individual investors non-events for tax purposes. The 2020 Tax Commission has no preference between these means, so long as the objective of neutrality is achieved. That choice, and the detailed design of a method, would be a matter for consultation with those who run such investment vehicles.

5.1.5.2. Credits against taxation on income from capital
UK companies transacting with other UK companies would not need to pay tax when distributing income from capital because their distributions would be within the UK corporate sector rather than to the ultimate owners. Both parties would need to follow relevant procedures to satisfy themselves that their transactions were indeed to other UK companies and therefore not liable to tax. However, in cases where it is not possible or convenient for the company distributing funds to determine that the recipients are other UK companies, or in cases where it knows that some or all of the recipients are (or might be) outside the UK corporate sector, tax would be payable and credits should be available for those recipients who do happen to be other UK companies.

Credits should be available for two main reasons:

- Credit against taxation already paid, which would exempt after-tax receipts from further tax
- Credit for new capital received

To ensure credits are transferable and therefore avoid the distortions that would otherwise arise, HMRC should create a well-designed system that would enable companies to transfer credits between themselves but also prevent fraud.

5.1.5.2.1. Transferable credits mechanism

Five key principles would ensure a robust system. Credits should:

- Never result in a cash payment out by HMRC
- Only be used to reduce a tax liability
- Not be issued until after a corresponding tax liability has been settled
- Be divisible at the request of the taxpayer with the corresponding liability
- Only be issued when the corresponding taxpayer confirms the details of the credit

The system should have three basic components:

Firstly, the ability to generate a credit against taxation on income from capital for a UK company which receives either a) taxable cash from another UK company on which tax has already been paid or b) cash representing new capital invested into the company from outside the UK corporate sector. A UK company which received new capital (i.e., not capital transferred from another UK company) would receive a credit to exempt from tax distributions equal to the value of the new capital. This reflects the fact that such distributions represent a return of the new capital, not income. Credit would also be given for distributions received on which tax has already been paid to account for the fact that the company is merely distributing on income which has already been taxed.

Secondly, the ability to transfer credits between UK companies including, where agreed, for a financial consideration.

Thirdly, the ability for UK companies to discharge their credits against a liability for tax on income from capital.

Suppose a UK company plans to distribute £100 in total in dividends to its ten equal shareholders and the tax rate is 30 per cent. The company would pay the tax bill of £30 to HMRC and request ten equal ‘credit notification references’ which HMRC would issue to the company on receipt of the cash. The company would then send these references out along with the dividend payments. Recipients of the dividends who were UK companies would then notify HMRC's system that they were the owners of the credit notification references, which would then notify the original company of the claims. The original company would then check that the claimant was genuinely the recipient of the distribution and approve the claims. The credits would then be issued to the claimant companies for the amount received for which tax was already paid (£7 for each dividend recipient).

A company that wished to transfer some or all of the credits it owned would simply log into the HMRC system and transfer the credits in much the same way as someone transfers money between bank accounts using a BACS transfer with internet banking. The company would enter the amount of credit to be transferred and the reference number of the company to whom it wished to transfer the credits.

Similarly, when a company wished to discharge the credits against a tax liability it faced, it would simply select an amount of its credits to be discharged, for which a unique reference number could be generated should it need to be used for any other administrative purposes.

A system would also probably have to incorporate an expiry date for new credit notification references due to the administrative cost of indefinitely maintaining unclaimed new credits. Many would be created in respect of distributions outside the UK corporate sector and would therefore never be claimable. However, an expiry date should also be reasonable and take into account the fact that a failure by the claimant to meet the expiry date would lead to double taxation. The credits themselves, however, once properly issued, should probably not hold expiry dates as they would be fungible and transferable. Attributing expiry dates to issued credits would make them less fungible and involve additional administrative expense.

5.1.5.3. Other returns to capital

In order to make this system work, all kinds of return to capital need to be taxed at as similar a rate as possible, not just dividends and interest.

5.1.5.3.1. Carried interest payments

'Carried interest' is where a manager who is also a partner or shareholder in a hedge fund or private equity company is entitled to a share of the organisation's return on the capital in the fund in excess of a predetermined 'hurdle'. The payment arising from that entitlement is usually treated as a capital gain rather than income and is therefore subject to Capital Gains Tax rather than Income Tax. The classification as a capital gain is justified on the grounds that it is largely paid from and derived from the capital gain of the fund and because it is linked to a holding in the fund which stops the payment from being wholly employment-related. The situation is the same elsewhere, too. In an article for the *New York Times*, Harvard economist Greg Mankiw highlights a neat example to explain why:[527]

> *Dan is a real estate investor and a carpenter, but he is short of capital. He approaches his friend, Ms. Moneybags, and they become partners. Together, they buy a dilapidated house for \$800,000 and sell it later for \$1 million. She puts up the money, and he spends his weekends fixing up the house. They divide the \$200,000 profit equally…. Carried interest from a private equity partnership is like the income that Dan earns from his real estate partnership. In this case, however, Dan is not a carpenter but a specialist in business turnarounds. The partnership does not buy dilapidated houses to fix*

527. Mankiw, G. Capital Gains, Ordinary Income and Shades of Gray, *New York Times*, 3 March 2012

up and sell; it buys troubled businesses to fix up and sell. And just as Dan the carpenter can treat his share of the partnership income as a capital gain, Dan the business specialist can do the same.

If carried interest did not represent a distribution to an employee, which would be taxable as labour income, it would have to represent a distribution of income from capital, which would be taxable under the capital taxes proposals. The extent to which a carried interest arose from an increase in the capital value of a fund's portfolio of assets would be the extent to which they would face double taxation under the corporate income from capital proposals. Money included in a carried interest payment by virtue of an income from a fund's portfolio of assets would also be taxed, but in this case it would not be double taxation as this income would neither have been taxed already nor reduced to account for future taxation.

Carried interest has long been a source of controversy and even cited as a reason to raise the rates of Capital Gains Tax, to bring it in line with labour income. But a study in America examined carried interest and found that the case for taxing it as labour income is not as appealing as first thought:[528]

Although the reallocation allows mangers to avoid restrictions that would apply if similar results were sought through borrowing, it is not entirely clear that the reallocation is inappropriate since the use of carried interest serves significant non-tax purposes by addressing the effects of asymmetric information. In some cases, moreover, the tax savings from carried interest partly offset an implicit payroll tax imposed on fund managers by the corporate income tax.

Abolishing the current corporate tax structure for a simpler model would offset the "implicit payroll tax" that Corporation Tax undeniably levies. The most elegant solution would be to treat carried interest as capital income. Under the Commission's proposals, this means that it can be taxed at the same rate as labour income, making it fairer and more equitable.

5.1.5.3.2. Payments contingent upon capital movements in corporate restructuring

Payments made between companies or to or from companies which are contingent upon movements of capital must be deemed as capital to avoid companies distributing income to shareholders untaxed by giving it the appearance of a business expense.

For example, suppose a company (let's call it "Original Company") restructures with a new holding company (called "New Holding Company"). For each Original Company share they own, shareholders are issued with one New Holding Company share and one New Holding Company warrant.

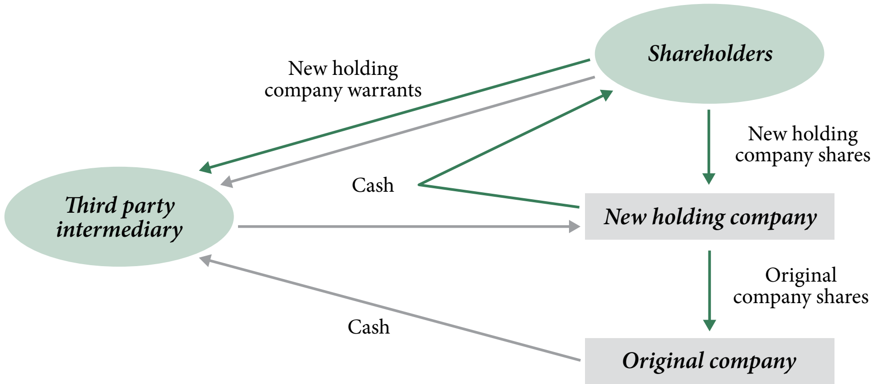
The warrants states that before a fixed date the holder can acquire one extra New Holding Company share from a (non-corporate, such as a partnership) intermediary third party by paying a price fixed (£1). As part of the restructuring the following is agreed:

- New Holding Company grants the third party intermediary an option to subscribe for new shares at the market spot price on the date of exercise

528. Vair, A. D. The taxation of carried interest: Understanding the issues, *National Tax Journal*, Vol LXI, No.3, 2008, pg. 459

- Original Company agrees to cover any shortfall of funds needed by the third party intermediary to exercise its option, plus an amount (x) representing its management fee
- New Holding Company agrees that for every £1 Original Company pays to the third party intermediary under this agreement, it will waive £1 of dividends that Original Company would otherwise have paid to New Holding Company

Figure 5.1: Payments contingent upon capital movements in corporate restructuring



Suppose when the share price has risen to £1.50, a shareholder exercises a warrant. The shareholder would pay £1 to the third party intermediary. Original Company would then pay 50p (plus x, the management fee) to the third party intermediary who then pays £1.50 to New Holding Company for a newly issued share which it would pass back to the shareholder who exercised his warrant.

This means that New Holding Company would have received £1.50 for a new share, which it could use to claim a credit against tax on income from capital (because returning that additional £1.50 would not be income, merely returning capital). If New Holding Company had simply issued the share to the shareholder under the warrant, it could only have claimed £1 against its shareholders' tax liability.

Effectively, as well as the £1 of new capital from the shareholder, 50p has been transferred from the Original Company into the New Holding Company, which leaves the corporate world as non-taxable expense and returns as capital. Without a rule stipulating that payments contingent upon movement of capital must be treated as movements of capital themselves (with appropriate exemptions for legitimate management fees), this would make it look like more new capital had entered the two businesses than it actually had and therefore artificially reduce the liability for tax.

5.1.5.3.3. Foreign investments

UK firms may try to avoid tax by making bogus investments in foreign firms which pass on the investment to the beneficial owner tax-free in another jurisdiction. One option to avoid this would be to implement rules similar to those regarding transfer pricing. Alternatively, investments made outside the UK could be a taxable event with a corresponding credit which could be realised when the investment returned cash to the (UK corporate) investor.

For example, suppose an individual invests £100 in a UK company which used it to buy a stake in a foreign company. The UK company would receive a credit against its tax liability of £100 when the money came in from the individual. The investment in the foreign company would be taxable, but the credit would be used and therefore no tax would be due. Suppose the foreign company returned £200 to the UK company. This would not be treated as new capital, as it would be if it had come from a UK individual or company. Instead, the company would be eligible for a credit equal to the original investment, to ensure that the original capital from the UK household would not be taxed when distributed back, but that the income (the additional £100) from it would.

The credit for foreign investments could be transferable within the company between different foreign investments. This would ensure that only net income would be taxed, not capital.

5.1.5.3.4. Foreign tax

To ensure foreign income is not taxed twice, foreign corporation tax and dividend withholding taxes should be deductible from a tax liability on income from capital. For example, if the UK tax rate is 30 per cent and the foreign corporation tax rate of country A is 35 per cent, then a dividend received by a UK company for £65 would have been £100 without the foreign tax. As the UK rate is lower than the foreign rate, no further tax should be due. However, if Country B has a tax rate of 10 per cent and a UK company receives a dividend of £90 from a company there, the dividend without tax would again be £100. However, the UK tax would be £30, so an additional £20 would be due.

Therefore, in countries where the combination of the corporation tax plus dividend withholding tax is equal to or greater than the UK tax rate, a full credit against the liability should be given for income from capital received. In countries where the combined rate is lower than the UK rate, a credit against income from capital received from those countries should be given that is equal to the foreign tax rate divided by the UK tax rate. In the example where the foreign tax rate is 10 per cent and the UK rate 30 per cent and the pre tax dividend would have been £100, the credit against tax would be for £33.33 ((10/30)x£100).

For simplicity and the avoidance of burdensome administrative costs, it would be preferable not to have to refer to foreign tax actually paid by the foreign company concerned. However, many countries have very complex tax regimes where effective tax rates are far below the headline rate due to various exemptions and reliefs. To avoid underpayment of taxes in this way, HMRC should compute notional tax rates for countries to use instead of the headline rates. This system could also be subject to an inspection of the actual taxes paid in the foreign company's accounts.

5.1.5.3.5. Repurchase agreements, leases and hire purchase

A repurchase agreement is where a seller agrees to buy back the item he is selling at a fixed future date at a fixed price. The agreement has the effect of a loan while appearing like a trade. The same effect can also be achieved with a futures or forward contract (a standardised or non-standardised contract where a purchase is arranged in advance for a price determined at the time of the contract for delivery in the future).

Treating them as loans would for tax purposes would include them in the tax base and consequently create some additional administrative burden on companies which would need to reconcile the trades as movement of capital in their accounts, together with the monitoring required by HMRC. Conversely, treating them as ordinary trades would exclude them from the tax base, thereby creating a distortion between conventional loans and repurchase agreements. On balance, the advantages of removing distortions and an obvious opportunity for tax avoidance appear to outweigh the disadvantages of some additional administration and complexity.

Leases of assets can also be equivalent to purchases with loans, and accounting principles should be followed for tax purposes. For accounting purposes, such agreements are treated as loans when they meet certain criteria:[529]

- The net present value of the instalments exceeds 90 per cent of the fair value of the asset at the time of sale, or
- The length of the lease exceeds 75 per cent of the useful life of the asset, or
- Title to the asset either automatically passes automatically at the end of the lease or if the right exists to buy the asset for a substantial discount to the fair market value.

Similarly, hire-purchase agreements are when a purchaser agrees to hire an asset and, once the final payment has been made, has the option to buy the asset for a (normally nominal) predetermined price. The difference between the market price for the asset and the sum of the payments is equivalent to the interest in a conventional loan. The seller effectively lends the buyer the price of the asset at the same time as selling it, with the loan to be repaid in instalments.

Islamic principles forbid charging interest, so the growing area of Islamic finance makes frequent use of both hire-purchase and repurchase agreements in order to obtain approval from Islamic scholars as upholding the principles of Islam while still obtaining the benefits of finance and banking.

5.1.5.3.6. Derivatives

Options contracts are where the buyer has the right either to buy or to sell an asset to the seller of the option either at a specific time in the future or at any time up to a specific time in the future at a predetermined price. Futures contracts are like options contracts but without the choice. Forward contracts are like futures but are bespoke rather than over-the-counter and often require actual delivery of a physical asset, whereas futures usually only require settlement of the money. Finally, swaps contracts are where two parties agree to exchange the rights to income streams from different assets. For example, the contract might stipulate that the buyer will pay the other party the income from a specific corporate bond while the other party will pay back a fixed amount.

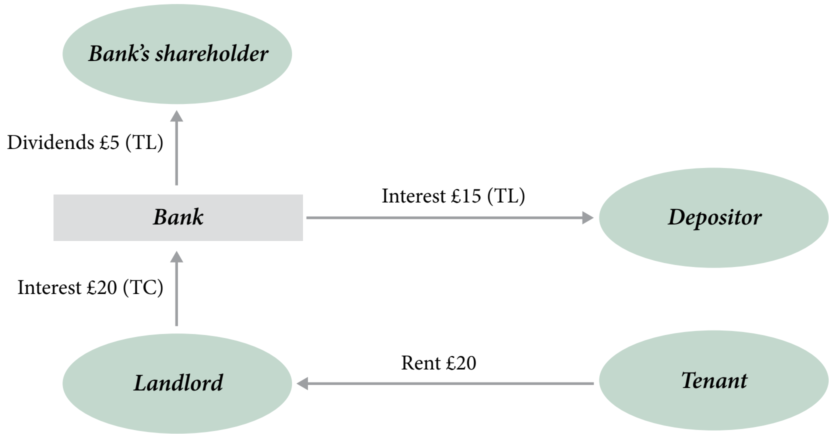
Derivatives do not necessarily involve movements of new capital and therefore should not be treated as being in the tax base but as real items. Anti-avoidance rules will be required to ensure derivatives are not used as a way to distribute income without tax.

5.1.5.3.7. Rents from property

Rental income from letting a property should be subject to income tax. However, the treatment of interest payments should differ according to how it is structured. The three different treatments are shown in examples of a £20 rent below, with companies indicated by rectangles and individuals with ovals. Liabilities for PAYE tax on income from capital are indicated with "(TL)" and credits against PAYE tax on income from capital are indicated with "(TC)".

529. The definition used comes from Accounting Standards Committee 840 by the (US) Federal Accounting Standards Board. See also similar definitions from International Accounting Standard 17, paragraph 4, by the International Accounting Standards Board and Statement of Standard Accounting Practice 21 by the UK Accounting Standards Board.

Figure 5.2: Landlord borrowing from a UK corporate lender



A private landlord who borrows money from a UK company should not be able to deduct interest payments from rental income. This is because the interest payment is already deducted from tax on income from capital of the lender so would represent a double deduction. Not allowing these interest payments to be deductible prevents someone from avoiding tax entirely. This could have been achieved by structuring payments so that the interest equalled the rental income, which would in turn equal the dividend and/or interest payments to the UK company's shareholders and/or lenders.

Prohibiting it would align the treatment of a private landlord with that of an investor who set up a company to manage the property and took the income in the form of dividends instead. In this case, the investor would not enjoy any advantage by setting up a UK corporate lender because the property company would be liable for tax on income from capital whether it was distributed in the form of dividends to the investor or interest to the lending company. Rental income received by a company should be treated as a real item to ensure that no credit could be set against the tax payable on its distribution onto either lenders or shareholders.

A private landlord who borrowed money from a private lender (i.e. not a UK company) should be able to deduct these interest payments from his rental income. This is because the interest payments in this case are also liable for Income Tax, meaning that the same amount of tax is paid on the whole rental income irrespective of what proportion goes directly to the landlord and what proportion goes instead to the lender.

Foreign companies and individuals should be taxed on their property in the same way that British companies and individuals are, in order to avoid recreating the current inequity with Stamp Duty. That would mean declaring their rental income and being taxed on it in the same way, with sanctions if rent from, to or between foreign landlords or tenants is not declared. Given that the property would be in Britain, there is no practical reason those sanctions cannot be applied.

Figure 5.3: Landlord with a property company borrowing from a UK corporate lender

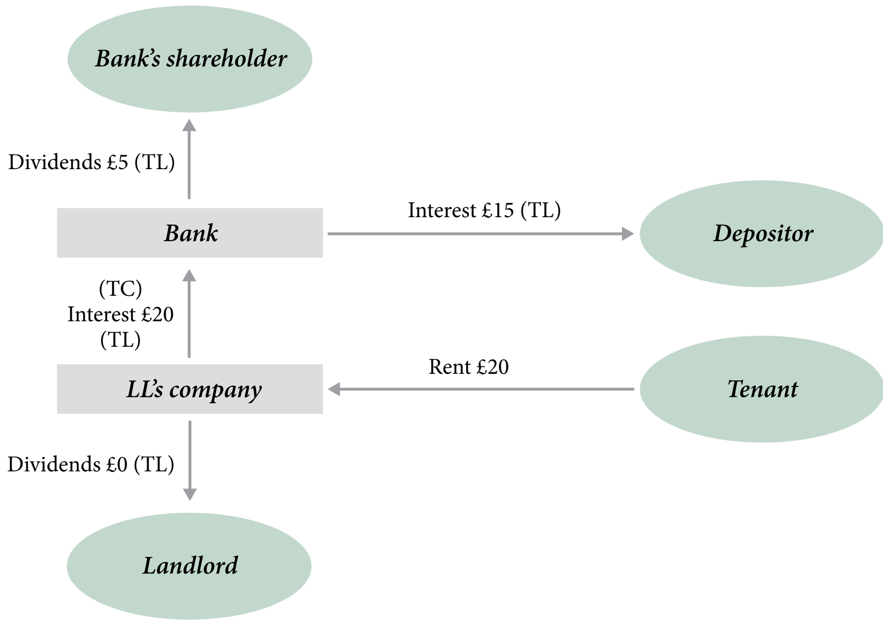
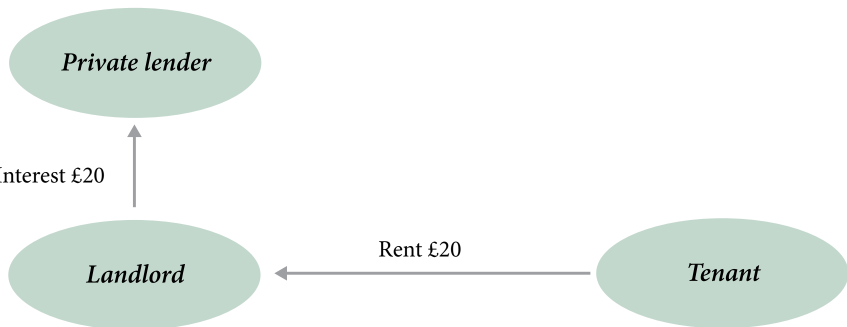


Figure 5.4: Landlord with a property company borrowing from a UK private lender



5.1.5.4. Taxes on assets that produce no income

Discussion of taxes on capital so far has concerned assets which entitle the owner to one or more cash flows at some point in the future. The principle has been to tax the amount of the future cash flow out of the asset that exceeds the cash flow into the asset. In other words, to tax the income from the asset but not the principal. The excess of the price achieved from the sale of an asset over the price paid for it has not been taxed at the point of the sale because the sale value achieved already accounts for the tax due on the expected future cash flows from the asset. Taxing a capital gain would therefore represent double taxation on the income from the asset.

An asset which does not entitle its owner to a cash flow, however, does not present an incidence of double taxation when an appreciation in the value of the asset is taxed, because its value is not already reduced by taxation on its income. The asset's value is based on whichever is higher: the present consumption value or its discounted net present value of an expected future consumption value.

The main asset classes here are precious metals, art and paintings, antiques, fine wines and property that isn't rented.

Gains made from selling wine are currently exempt from both Income Tax (if trading is sufficiently infrequent to avoid classification as a 'trader') and Capital Gains Tax, on account of having a useful expected life of under 50 years (being a 'wasting chattel'). Art, on the other hand, is currently subject to Capital Gains Tax unless the seller owned it in the capacity of a dealer, in which case gains are classified as income and are subject to Income Tax.

Investment gold is defined as gold which is above a certain level of purity; stored in certain physical shapes: bars, wafers and coins; and of weights which are accepted by the bullion markets. Sales of gold which qualify as 'investment gold' are exempt from VAT. Generally, gains made are subject to Capital Gains Tax or, for dealers, Income Tax. The same treatment is generally applied to art, paintings and antiques.

It follows that the approach taken should be to consider such assets as consumption goods, albeit ones typically held for long periods between trades and prior to eventual consumption. The gain made from selling an 'investment wine' to a connoisseur after a long holding period is little different from that made by selling a bottle of inexpensive table wine on a supermarket shelf. If the supermarket owners should pay VAT on the sale and Income Tax on the gain, why shouldn't the dealer who thinks of his deals as 'investments'?

There are two problems that would be created by such an approach:

The first is that using the full weight of the tax system to handle a small area of activity might seem disproportionate. The 'dealers' this would capture would include ordinary people making one-off sales of furniture and wine, often due to personal circumstances. Existing rules exempting an amount from Income Tax or Capital Gains Tax might answer some of the concerns with respect to disproportionality of the tax system to small, one-off gains. But even with such a rule, the cost of monitoring when individuals make such gains and enforcing tax payments when they do may still be too high compared to the avoidance and distortions to the investment markets that might otherwise arise. The extent of the distortions is also limited to the final demand for consumption of the assets involved and the extent to which any tax advantage for individuals would displace people acting within companies. This question does not arise with gains made by UK companies because they would be taxable when the cash is distributed on to shareholders and holders of debt.

The second concern relates to taxing inflation on gains that are typically made in part because their nominal value has increased as prices generally have risen during the years between the purchase and sale. If the price of everything doubles over, say, twenty years, I will not really have accrued any profit because I sold my asset for twice what I paid for it twenty years ago. It is still worth the same quantity of goods and services as it was originally. Only the value of money has changed. A rule could be introduced here to exempt the part of the gain which could be accounted for by the loss of purchasing power of money by 'indexing' the gain to a measure of inflation such as the Retail Prices Index or the Consumer Prices Index. This, however, obviously complicates the system as it requires tables and rules regarding when and how to apply the relief.

In addition, indexation only covers the general rise in prices. Prices change relatively, too, especially over longer time periods. Suppose the price of fine wines rises more rapidly than prices in general. An investor will have made a profit from selling wine bought before the price rise. If that excess gain is treated as an income and he is liable for Income Tax then he would not be able to use the proceeds to buy an equivalent but different bottle for consumption, if that was his intention.

It seems best not to tax these items. There is a limit to demand for these goods which means these assets cannot replace other investments on too large a scale.

And the fact that they do not generate an income means that they are often risky long-run investments.

5.1.5.4.1. Current accounts and credit cards

Money flowing into or out of current accounts of UK companies would not be taxed as it would not constitute money entering or leaving the UK corporate sector. However, this leaves current accounts in the names of individuals and other institutions which are not UK companies.

Regardless of how account balances were treated for capital adequacy purposes, they could be treated as a special class for tax purposes to avoid the administration of reconciling a very large number of ordinary payments through the tax system that do not, in effect, represent a movement of capital into or out of the bank.

Deposits and withdrawals (including those transacted by third parties) would be treated as non-events for tax purposes. The money would only be treated as new capital into the UK corporate sector if it were transferred to another account whose purpose was investment rather than managing transactions. A rate of interest could be chosen to distinguish between transaction management accounts and investment accounts, with those paying above the chosen rate designated as an investment account and those below it eligible as a transaction management account. Interest payments to and from transaction management accounts would be counted as distributions of capital (in the case of interest payments from the bank) and new capital (in the case of interest payments to the bank).

Similarly, credit cards could be treated in a the same way, with interest and fees treated as movements of capital but purchases made using the cards treated as real transactions rather than capital movements (both when the money is initially paid to the retailer and then also when it is repaid to the credit card company by the cardholder). Again, this treatment should only apply to accounts whose purpose is managing transactions rather than financing them. A rate of interest could be chosen to distinguish between transaction management accounts and financing accounts, with those charging below the chosen rate designated as a financing account and those above it eligible as a transaction management account.

5.1.5.4.2. Property

When a property is sold by an individual to a landlord, the price the landlord will pay will be determined by the discounted net present value of the expected future cash flows from rental income. It would therefore represent double taxation if the increase in the value of the property were to be taxed as an income.

However, the gain in the value of a property sold to an owner-occupier is not reduced by taxation, because the price an owner-occupier would be prepared to pay is determined by the discounted net present value of his expected future consumption value of the property. To the extent that the useful life of a property development is consumed by an owner-occupier, the value added by the developer would be completely untaxed if that developer is an individual. Investors who used a UK company to develop property would face tax on their income when it was distributed to them from the company.

One approach to resolving this added value being tax free would be to impute notional rents owner-occupier householders pay themselves for renting their own property. This approach would be unsatisfactory, however, for reasons discussed in Section 6.2.4.3. And it would require a significant bureaucracy to second-guess what the rents might be were the owner-occupied properties to be let.

Another approach would be to tax gains made from property sales only when they were sold to owner-occupiers. However, the difficulty of determining which properties should be liable and how much of their net present value should be attributable to untaxed future owner-occupancy would make the approach unworkable.

In addition, these approaches would open up the question of highly popular but distortionary tax advantages for main residences. If a tax treatment is sound with respect to a second or third property, that same treatment cannot be unsound for a first property.

Gains made by individuals from investments in property should not, therefore, be liable to Income Tax. Property taxes such as business rates and Council Tax together with land use planning restrictions all have some effect in artificially restricting the attractiveness of property development which, to some extent, will counteract the distortionary effect of this tax advantage.

Again, the extent to which second homes could replace other investments is limited. Holding properties as investments for substantial periods of time and not renting them out would be very expensive, almost certainly a poor decision even if those rents would be taxed (Section 6.2.4.3). To the extent second homes are rented, or a potential purchaser would want to let them, they will be taxed.

5.1.5.5. Remaining distortions

5.1.5.5.1. Capital gains made by corporations

A problem arising from taxing income using a modified S-base is that capital gains made by UK corporations would be liable to tax, creating a distortion in favour of individual and foreign corporate investors and double taxing income when transacted through a UK company.

Suppose an individual (or foreign corporation) buys a share in company A for £100. The share price increases and he sells the share for £200; he would pay no tax as there is no capital gains tax. The tax would be paid by whoever owned the shares at the time the expected dividend was paid out and this tax would be reflected in the price of their sale.

Suppose instead that the individual forms company B with that £100 and uses it to buy the shares in company A. When company B sells the shares in company A, again for £200, it distributes the entire sum back to the individual (either through a dividend or buyback) and closes. However, company B would be liable to corporate tax on the excess of the distributed funds over the subscribed equity, i.e. £200 less £100. So tax would be payable on the capital gain, thereby taxing the same income twice.

A solution to this could be to subtract capital gains from taxable income from capital.

The first drawback to this exemption approach is that it would mean some of the administration for capital gains tax would need to remain in the form of definitions. There may be an opportunity for evasion/avoidance by creating assets that create artificial capital gains and losses in order to benefit from the tax advantage of the 'gain' but not the corresponding loss. The question of how to handle capital losses would also arise. If gains were to be subtracted from taxable distributions, would losses be added to them?

The second, more substantive, drawback is the opportunity for almost perpetual avoidance of tax by deferment. A company with an income tax liability would be incentivised to crystalise as much capital gain as possible each year in order to minimise its shareholders' tax liability. For example, it would make sense to sell its property, including intellectual property, to itself in repurchase agreements in order to capture the rise in value. It would also create an obvious incentive to invent bogus capital gains by selling assets to other companies it controlled or to its owners at falsely high prices, thereby registering a capital gain and reducing the tax liability for its shareholders and bondholders. For that reason, the distortion probably creates fewer problems than it would take to fix it and it may have to be accepted as a necessary imperfection in the system.

5.1.5.5.2. Distortions in capital markets – Secondary trading versus new issues.

UK corporate subscribers to new issues of shares would face a tax liability on the money they invest, in order to cancel out the credit given to the company issuing the shares. However, because transactions on secondary markets are not in the scope of the tax, they would prefer to buy the shares second hand after the issue, assuming they believed the price would not rise by more than the value of the tax liability they would face if they subscribed to the new issue. This would create a distortion between corporate and non-corporate (and foreign) subscribers to new shares. Because households are not liable for such a charge and corporate buyers are not liable for it on purchases on the secondary market, an arbitrage opportunity would be created for households (and foreign individuals and corporations) to subscribe to new issues at a price depressed by the tax charge on corporate buyers and then sell on the secondary market at a higher price (no longer depressed by a tax charge on would-be corporate buyers).

A solution would be to disregard subscriptions by corporate investors on both sides of the transaction, perhaps by mutual agreement or possibly by rule. A disadvantage to this solution would be that issuers would not know the precise value to their company of the issue until after it had happened, because the shares subscribed by households would attract an allowance whereas those subscribed by corporate buyers would (or might) not.

While the distortion would be material and harmful, the problem would not be as great as it might first appear. Corporate investors would face an immediate and certain tax liability of their own in exchange for a credit against tax in the issuing company. The net present value of the issuer's credit against tax to the investor would be less than the tax liability by a combination of

a. the required rate of the investing company less any periodic adjustment to the value of tax assets carried over, and
b. a risk premium to cover the likelihood of the company not generating return against which to net the tax asset, or
c. the discount to the face value of the credit if it is sold to a third party.

This may not present a serious problem if the companies involved are a controlled subsidiary owned by a parent company. But in other circumstances, the benefit to the issuing company may only be captured by the investing company to the extent of the latter's proportion of ownership of the former. In other words, the investing company will lose a credit against tax for its own shareholders and gain back only its share of the equivalent in the issuing company. If it is subscribing to 10 per cent of the issuing company's shares, 90 per cent of the value of the corresponding credit against tax on income for the issuing company would be captured by the other shareholders.

The problem could be solved by exempting equity from UK company subscribers from the base such that subscriptions from them neither create a tax asset for the investee nor a tax liability for the investor.

The obvious drawback to this approach is that it would mean that equity subscribed by a UK company investor would be worth less to the issuing company at the same price than that subscribed by a different type of investor and so, in a sense, the approach simply inverts the original problem.

Nonetheless, it may be more transparent and orderly to arrange it this way and let issuing companies determine quotas and/or price differentials in their public offers to reflect the lack of tax assets from UK company investors. While a price differential would disappear in the secondary market, thereby still leaving some room for arbitrage, the fact that issuing companies could price the value of the asset into the offer would mean that the scope would likely be reduced and more of the value difference would be captured by the issuing company than arbitrageurs.

However, rather than attempt to second guess the relative merits of the two approaches, it might be best to leave the issue for the market to decide by allowing issuing companies to choose whether their share offers include a transfer of tax liability from investing UK companies or not.

The problem also arises for new issues on the bond markets and loan agreements. The approach should be the same as that taken with respect to equity, in order to ensure neutrality.

5.1.5.5.3. Decisions over saving or consuming

There is even a case that capital income should not be taxed at all. In 1990, Nobel Laureate Robert Lucas Jnr wrote that:

> *When I left graduate school in 1963, I believed that the single most desirable change in the U.S tax structure would be the taxation of capital gains as ordinary income. I now believe that neither capital gains nor any of the income from capital should be taxed at all.*

That is currently the view of a number of prominent economists. Sumner makes the case using a simple hypothetical:[530]

> *[Consider] twin brothers who each make $100,000 in wage income. Most people would regard these two people as equally well off, even if one freely chose to consume his income now, while the other chose to consume later. But not advocates of the income tax. They insist the more patient twin brother is "richer" and deserves to be taxed at a higher income tax rate. For instance, compare a 40 per cent wage tax with a 40 per cent income tax. Under the wage tax (sometimes called a "payroll tax") the spendthrift brother is able to consume $60,000, which is 40 per cent less than in a no-tax economy. Now assume the thrifty brother invests the after-tax wage income for 20 years, and sees the money double to $120,000. Then he can consume $120,000 20 years in the future, which is also 40 per cent less than the no-tax consumption level. This sort of tax is neutral with respect to saving and investment; it's essentially a flat rate tax on consumption, whenever it occurs.*
>
> *But that's not good enough for proponents of taxation of capital income. They want the thrifty brother to pay a 40 per cent income tax on the $60,000 in capital income, leaving him with only a net gain of $36,000. Now the thrifty brother can only consume $96,000 in 20 years, thus he essentially paid a 52 per cent tax on his consumption (as he would have consumed $200,000 in a no-tax scenario). The mistake people make is forgetting that the present*

530. Sumner, S. The proper tax rate on capital income is zero, Economics by invitation, *The Economist*, 24 February 2012

value of $120,000 worth of consumption 20 years in the future is the same as $60,000 today. And in a sense that should be obvious, as both brothers are free to spend their money when they choose in the no-tax situation, so obviously the thrifty brother would not be economically "better off" merely because he chose a different year to consume his income. Both are equally "wealthy", where wealth is the present value of lifetime consumption.

Based on a similar example, Saint-Paul[531] has argued that "capital income taxation is like having higher VAT rates in the future as compared to today. But this is generally not an optimum, as it will induce people to consume too much today and not enough in the future, just like taxing tomatoes more than apples will induce people to consume too many apples and not enough tomatoes. In macroeconomic terms, capital income taxation reduces the savings rate and makes us poorer in the future as we have underinvested relative to the optimal situation."

There are practical and political limitations to the economic logic that says capital income should not be taxed, though:

Capital income is additional money generated from using resources more efficiently, thanks to the investment that saving allows. Taxing that return affects incentives but so does taxing labour.

Those receiving capital income, particularly in cases where it is less immediately connected to prior labour than in the case of the two brothers set out by Sumner, have a distinct capacity to bear taxes. If they are not taxed but those receiving labour income are, that will strike many people as unfair.

At the same time it will be very difficult in practice to police all the ways in which people can mask labour income as capital income. While there is a credible case for setting the capital income tax rate at zero, the 2020 Tax Commission recommendation is for the rate to be the same as that on labour income, but to remove double taxation.

5.1.5.6. Proposals

Considering all of those issues, the final proposals for a new capital tax system – which will function effectively as part of the wider 2020 Tax Commission proposals – are as follows:

5.1.5.6.1. Domestic

Income from capital should be taxed once and collected by companies on behalf of shareholders and lenders

1. Income from capital should be taxed once and collected by companies on behalf of shareholders and lenders. Where short-term capital gains constitute a substitute for a trader's income, they will be treated as income, as is currently the case for many property and second-hand car dealers.
2. The personal allowance should not be applied through the capital income tax in order to maintain the simplicity of the system. The personal allowance would not be relevant to anyone with other sources of income which exceeded it, because it would be accounted for there. But individuals whose other income is below the personal allowance will have some or all of it unused. Those individuals should be able to reclaim tax already paid on income from capital through their annual tax returns at the end of the tax year.

531. Saint-Paul, G. Don't penalise future consumption relative to current consumption, Economics by invitation, *The Economist*, 28 February 2012

3. The tax base is returns to capital invested in the company, net of returns to capital invested by the company (so that there is one level of taxation when there is a chain of companies, imposed at the bottom of the chain).
4. Returns to capital invested in the company are dividends and interest paid, plus share buybacks by the company and repayments of loans, minus share issues by the company and new loans to the company.
5. Returns to capital invested by the company are dividends and interest received, plus buybacks of the shares it holds and repayments of loans made, minus share issues to it and lending by it.
6. If the tax base is positive in a given year, that amount is taxed at the standard rate on income.
7. If it is negative, the amount will be converted into a credit which the company may carry forward and use to offset future tax liabilities. Alternatively, the company may instead sell the credit to a third party, who would be able to use the credit to reduce its own tax liability.
8. HMRC should never (even on winding up) buy credits. In order to keep the system simple, credits should not be able to be set against the tax payment made in previous years.
9. Individuals would not be liable to pay tax on income from interest, dividends and the money from share buybacks from UK companies because the tax would already have been paid on a PAYE basis by the company. Individuals would not be permitted to set their interest costs against rental income from properties.
10. Hire purchase (leasing) and repurchase agreements should be treated as other loans and included in the tax base, according to accounting standards.

5.1.5.6.2. International

12. UK investors (both directly and through UK companies) should continue to pay tax on their income from foreign companies received in the form of dividends, interest and share buybacks. Foreign tax paid on dividends should be deductible from a UK tax liability on each asset. For investments by UK companies, a credit (in terms of income rather than tax) should be issued on receipt of the income equal to the full amount where the foreign tax rate is equal to or higher than the UK rate. Where the foreign country's rate is lower than the UK rate, the credit should be equal to the income multiplied by the foreign rate divided by the UK rate.
13. Instead of using actual headline tax rates, notional foreign tax rates should be determined by HMRC to account for the gap between effective tax rates and headline tax rates.
14. Investors whose income flows through UK companies should be treated equivalently to those who invest directly:
    a. Capital which companies use to make loans, or subscribe to shares or bonds in non-UK institutions should, be taxed at the standard rate. This would cancel out the credit against the tax on income that they would have received when the money originally passed to them from households.
    b. When capital is returned to the UK company, the UK company should receive a credit against tax up to but not exceeding the value of taxable capital paid out under point a. This will ensure that an individual's foreign investment through a UK company is not taxed twice by the

UK Government. Capital payments should include loan repayments, bond redemptions, share buybacks, dividends and interest.

c. Foreign tax paid on foreign income from capital received by UK companies should be deductible from the UK company's liability.

d. Interest on loans should not be grossed up as there is little evidence to suggest that any of the burden of corporation tax is borne by creditors.

5.1.5.7. Examples

5.1.5.7.1. Example 1: a single UK company

An individual sets up a company which issues shares for £300 and makes a profit of £100, £200 and then £300. In the fourth year the company is closed down and the remaining balance used to repurchase the shares as it is wound up. The tax rate is 30 per cent. Because all of the income is returned to capital in this example, as it captures the entire life of the company, the rate yields the same revenues (£180) as if there were a tax levied on profits instead.

Table 5.2: Example of a single UK company

	Year 1 (£)	Year 2 (£)	Year 3 (£)	Year 4 (£)
Current account at start	0	350	400	400
Profit	100	200	300	0
Shares issued	300	–	–	–
Credit before distributions	300	250	100	0
Gross dividends	50	150	300	–
Buybacks	–	–	–	400
Credit used	50	150	100	–
Credit remaining	250	100	£0	–
Taxable distributions	0	0	200	400
Tax paid for shareholders	0	0	60	120
Distributions paid to shareholders	50	150	240	280
Current account at end	350	400	400	0

5.1.5.7.2. Example 2: a purely UK group

In this example, Holding Company owns Sub-Holding Company which in turn owns two trading companies, Trading Company 1 and Trading Company 2. The tax rate is, again, 30 per cent.

In year 1, Trading Company 1 pays a dividend of £50 and Trading Company 2 pays a dividend of £100. Sub Holding Company pays a dividend of £100.

In year 2, Sub Holding Company pays a dividend of £100 (having made some profits of its own to cover this), and Holding Company pays a dividend of £150.

Trading Company 1 pays tax of £15 and Trading Company 2 pays tax of £30. Sub Holding Company has dividend income of £105 and receives a credit against tax on income from capital of £105, because the trading companies have already paid tax on the income. Sub Holding Company uses up credit and so does not pay any, and carries forward into year two dividend income of £5 and unused credit against tax also of £5. Holding Company received a dividend of £100 and therefore receives a credit against tax of £100. It carries forward both the income and the credit into year 2.

In year 2, Sub Holding Company has dividend income of £5 and a credit against tax also of £5 both brought forward from year 1. It pays tax on £95 of its £100 dividend payment, because it uses the credit against tax of £5 to reduce its liability. The tax bill is £28.50, which is deducted from the £100 dividend so that Holding Company receives only £71.50, and it has nothing to carry forward.

Holding Company has dividend income and a credit against tax both of £100 brought forward from year 1. In addition, it receives dividend income and therefore additional credit against tax of £71.50. It pays no tax on the dividend payments because it uses £150 of its credit against tax. It has £21.50 of both dividend income and credit against tax remaining which it carries forward to year 3.

5.1.5.7.3. Example 3: a UK company with a 40 per cent stake in a foreign company

UK Company owns 40 per cent of Foreign Company. Foreign Company makes profits of £100, pays foreign tax of £45 and pays out £55 as a dividend. UK Company receives £22 as its dividend. UK Company makes its own profit of £50 and pays out the greatest dividend it can. The UK tax rate is 30 per cent.

UK Company receives a tax credit in respect of the foreign tax of £22 because the UK rate is lower than the foreign rate. It has available cash of £72 (its own £50 profit plus the £22 dividend received).

UK Company pays all its cash out as a dividend of £72. The company has no credit against tax other than the £22 credit for foreign tax paid. So this is deducted from the dividend payment leaving £50 of taxable distributions. The tax rate is 30 per cent, so the tax due is £15, which UK Company pays directly to HMRC. The remaining £57 is paid to shareholders along with credit notification references in case any of the shareholders are UK companies.

5.2. Income should be taxed once

Britain's tax system currently taxes many streams of income repeatedly. When income is earned from labour it is taxed three times: through Income Tax and two forms of National Insurance. National Insurance is no longer an insurance policy (Section 5.2.2.3), but just another income tax with minor differences that increase the cost to employers (Section 5.2.3).

If it is then saved and invested in a company, the profits will be taxed three times again before they reach the investor: by Corporation Tax, again as dividend income to the individual (though there is some relief for that double taxation), and finally when any resulting rise in the value of the asset is crystallised as a capital gain (Section 5.2.2.1).

When someone dies, their family can be liable for tax yet again. Inheritance Tax is deeply unfair and rightly resented by the public (Section 5.2.2.2). Add the taxes on income earned, saved, invested in a company and then passed on to children together and the top combined marginal rate is 95 per cent. The Single Income Tax would cut it to a far more reasonable 73 per cent (Section 5.2.1).

Any money left can be spent but it will be taxed up to three times yet again: by Value Added Tax; through duties like Fuel Duty or excise duties on tobacco; and by Value Added Tax on that duty.

The final result is taxes that are unfair and inefficient. There is an ethical responsibility for the government to impose taxes that are as transparent (Section 5.2.4) and as neutral between different taxpayers as possible (Section 4.2.4). And maintaining a series of different taxes to achieve the same basic objectives is enormously wasteful (Section 5.2.3). As far as possible, the 2020 Tax Commission will move to a system where each stream of income is taxed once, partly by replacing Corporation Tax and other taxes on capital with a single capital income tax (Section 5.1.5), and partly by entirely merging Income Tax and National Insurance (Section 5.2.5).

5.2.1. The combined top marginal rate on income earned, saved, invested in a company and passed on to children would fall from 95 per cent to 73 per cent

The combined effect of the tax system on high earners, such as entrepreneurs, can be understood by looking at the marginal tax rate on income that is earned, saved and invested in a company and then passed on as an inheritance at the top rates and above the various thresholds (the Inheritance Tax threshold is the largest but will often be consumed by the family home). The same assumptions and calculations have been used by economist N. Gregory Mankiw to examine policies put forward by US presidential candidates at the 2008 US Presidential election:[532]

> *On a regular basis, I am offered opportunities to make some extra money. It could be giving a talk, writing an article, editing a journal, and so on. What incentive is there to put forward that extra work effort?*
>
> *To a large extent, the beneficiaries of that extra effort are my kids. My lifestyle is, as a first approximation, invariant to my income. But if I make an extra few dollars today, I will leave more to my kids when I move on. I won't leave them enough so they can lead lives of leisure, but perhaps I will leave them enough so they won't have to struggle too much to afford a downpayment on their houses or to send their own kids to college.*
>
> *[…]*
>
> *Let's suppose Greg Mankiw takes on an incremental job today and earns a dollar. How much, as a result, will he leave his kids in T years?*
>
> *The answer depends on four tax rates. First, I pay the combined income and payroll tax on the dollar earned. Second, I pay the corporate tax rate while the money is invested in a firm. Third, I pay the dividend and capital gains rate as I receive that return. And fourth, I pay the estate tax when I leave what has accumulated to my kids.*

If t1 is the combined tax on labour income, t2 is the corporate tax rate, t3 is the capital gains or dividend tax rate (in Britain the capital gains tax rate is lower so that will be used) and t4 is the inheritance tax rate and r is the pre-tax return on an investment in a company. One pound earned before tax will, assuming annual taxation of returns at the shareholder level, yield:

(1-t1){[1+r(1-t2)(1-t3)]^T}(1-t4)

Assume that the entrepreneur lives 35 years from receiving such a return on his or her enterprise and that r is 10 per cent. Without any taxes an investment of £1 would yield £28.10 thanks to compound interest over the 35 years. This is a substantial return but, equally, it is a long time to leave money invested.

532. Mankiw, G. *My Personal Work Incentives*, 26 October 2008

In 2011–12, t1 – the combined top income tax rate – was 57.8 per cent; t2 – the corporate tax rate – was 26 per cent; t3 – the upper capital gains tax rate – was 28 per cent; and t4 – the inheritance tax rate – was 40 per cent.

With those taxes, using the formula above, the return would be reduced from £28.10 to £1.55. That means the total top tax rate on income earned, saved, invested in a company and passed on to children is nearly 95 per cent. And that is before taxes on consumption such as Value Added Tax.

Of course, many entrepreneurs take their initial return as a capital gain, and they may qualify for Entrepreneurs' Relief, which would change t1 to 10 per cent. The size of their capital gain would be diminished by prospective corporate taxes but, even leaving that aside, their total top marginal tax rate would still be 88 per cent.

Incentives for entrepreneurs would improve substantially with the abolition of Corporation Tax, Capital Gains Tax and Inheritance Tax, and their replacement by a single tax on capital income. The top total marginal tax rate on income earned, saved, invested in a company and passed on to children would fall to 73 per cent.

That implies entrepreneurs and others in that situation will be left with a much larger share of the long-term returns on their investment, even without the advantages they currently enjoy under Entrepreneurs' Relief. Over time that is likely to lead to more jobs and higher wages, as greater innovation leads to rising productivity.

5.2.2. Income is currently taxed more than once in a number of ways

5.2.2.1. Capital Gains Tax constitutes a double tax on income from business assets and can be abolished without increasing the incentive to mask income as a capital gain

Capital Gains Tax acts as a double tax on earnings from business assets growing in value. The Gordon Growth Model, which provides a simple understanding of the fundamental value of an asset,[533] helps to explain why:

$$P = \frac{D}{(r-g)}$$

Where P is the price; D is the value of next year's dividends; r is the cost of capital; and g is the rate at which dividends are expected to grow.

Any increase in a company's profits currently gets taxed twice: once by Corporation Tax as profits (and often by Income Tax when it is paid out in dividends); and again because the rise in profits increases expected dividends, immediately or in the future, and thereby increases the price of the shares (producing a capital gain).

Capital Gains Tax acts as a double tax on earnings from business assets growing in value

Taxing income from business profits twice biases decisions against saving and investing and against entrepreneurs taking a chance by investing money in a new or growing business. Removing Capital Gains Tax would not mean that someone who starts a business, takes no income or dividends while building it up, and then sells it for millions of pounds would not pay tax. While they would not pay directly, the price they could sell it for would be depressed by the tax on the returns that any purchaser would make. There is no need for Capital Gains Tax in order to tax business assets fairly and taxing growing businesses twice is a very bad idea, as they are critical to the creation of jobs and long-term prosperity.

533. A slightly more complicated expression that explains how equity prices are the present value of expected future dividends is that $\frac{P}{E}=\frac{div\,(1+g)}{(r+rho-g)}$ where P/E is the price-earnings ratio; div is the dividend payout ratio; g is the medium-term real earnings growth rate; r is the real return on a 'safe' asset and rho is the equity risk premium.

Some firms do not pay dividends for substantial periods of time, and hold substantial amounts of cash, but expected dividends are still fundamental to the value they offer their shareholders. Microsoft did not pay a dividend for some time but then announced a special dividend of $3.00 per share, $32 billion in total.[534] After growing pressure for Apple to pay a dividend from the nearly $100 billion in cash on its balance sheet, it announced a $10 billion share buyback and a $2.65 per share dividend in March 2012.[535]

While investment in equities can be risky, they tend to outperform cash and Gilts over time. The Barclays Capital Equity Gilt Study sets out how – since 1899 – equities have outperformed cash over ten year investment periods in 93 out of 103 years; and outperformed Gilts in 81 out of 103 years. That performance is heavily dependent on reinvesting income. Without reinvesting income, £100 invested at the end of 1899 would have been worth £11,808 in nominal terms and £160 in real terms in 2010. The gross return with income reinvested is £1,639,368 in nominal terms and £22,239 in real terms.[536]

If companies do not pay dividends over a sustained period of time, they will therefore seriously depress the final returns to their shareholders in two ways: lower earnings will tend to mean a lower share price; and less will be available to reinvest which will mean lower overall returns.

Some companies – in very promising sectors like technology – may be able to increase their price to earnings ratio enough to make up for that. But such a strategy will not be tenable indefinitely or for most firms. Firms have to pay returns to capital and an effective tax system can tax those returns rather than the profits that make them possible or the capital gains that arise in prospect of them.

If companies do not pay dividends over a sustained period of time, they will seriously depress the final returns to their shareholders

The 2020 Tax Commission's recommendation is to abolish Capital Gains Tax. The Commission's broader proposals to replace corporate taxes with a capital income tax (Section 5.1.5) ensure that capital gains are taxed, just not in the same way, as capital gains will be depressed by that tax on the returns to capital. Other countries also operate without a Capital Gains Tax and tax some earnings on short-term trading as income in order to limit avoidance.

There remains a concern that a certain rate of Capital Gains Tax is essential to prevent an incentive to avoid the tax. As Nigel Lawson wrote:

> *I have long felt it is highly undesirable that Capital Gains Tax should have given rise to a substantial tax avoidance industry dedicated solely to converting income into capital gain, which is taxed very much more lightly.*

However, while our proposals abolish taxation on capital gains they also reduce other taxes and therefore that problem does not necessarily get worse. The difference between the current upper Capital Gains Tax rate (28 per cent) and the current combined top marginal tax rate on labour income (58 per cent) is 30 per cent. Under the 2020 Tax Commission proposals it would be 30 per cent.

The only exception proposed is that some people whose income results from short-term trading should have their overall gains treated as income, as many traders, in property for example, do today. That way they are treated the same way as those engaging in similar activities through a company and trading volatility is not tax-free. This rule should be defined quite narrowly though, as many trading profits are effectively taxed by a capital income tax that diminishes gains in value over time.

534. U.S. Department of Commerce – Bureau of Economic Analysis *How does the Microsoft special dividend impact the national accounts in the fourth quarter?* 13 January 2006
535. BBC News *Apple to pay dividend and buy back shares*, 19 March 2012
536. Barclays Capital *Equity Gilt Study 2012*

Key mechanisms that companies use to reduce tax liabilities by masking them as capital gains would actually be cut off by the new proposed capital income tax. For example, Jacob and Jacob have found "robust evidence that the tax penalty on dividends versus capital gains has close correspondence with firms' propensity to pay dividends and repurchase shares, and the amount of dividends and shares repurchased".[537] However under the 2020 Tax Commission's recommendations exactly the same tax would be levied on dividends and share buybacks. The 2020 Tax Commission also proposes to tax carried interest (Section 5.1.5.3.1).

5.2.2.2. The public rightly dislikes Inheritance Tax as an arbitrary additional tax on family income created by a death in that family

Inheritance Tax is an interesting case study in how the British public understands morality in tax policy. In *How to Defend Inheritance Tax*,[538] the Fabian Society – working with the Trades Union Congress – set out the range of reasons why the tax is beloved of the progressive left. They argue that:

- It tends to be paid by the relatively well off and not the poorest.
- It increases equality of opportunity between the generations.
- The tax is paid on unearned income.
- While it may be economically harmful, the case is not nearly as clear or emphatic as it is with other taxes like those on corporate income.

Despite all that, the tax is broadly loathed. In order to understand the public's attitude to taxation, it is helpful to consider why the public finds progressive appeals for "fair taxation" so unconvincing in this case. Does the public simply think that those claims are untrue, or are there deeper differences in how fairness is understood?

Most supporters of Inheritance Tax acknowledge that it is not popular. Here is how they report one study of public opinion on the issue:

> *Alan Hedges and Catherine Bromley (2001) conducted a quantitative survey of public attitudes to taxation for the Fabian Society Commission on Taxation and Citizenship. This covered 1,717 adults in the summer of 2000. They found that 51 per cent of respondents thought that inheritance tax should be abolished, while around 20 per cent thought that the threshold at which inheritance tax starts should be raised from its then level of £250,000 to at least £500,000. The remainder believed that the current level should be kept or reduced, with a mere two per cent thinking that all inheritances should be taxed. This research suggested that younger people are more opposed to inheritance tax than older people, and that lower income individuals are more hostile than those on higher incomes.*

Focus group work for the Rowntree Foundation found that the public did not blame someone for inheriting wealth, and as a result there was little appetite to take that money away. There was also little desire to try to limit inheritances in future:[539]

537. Jacob, M. & Jacob, M. *Taxation, Dividends, and Share Repurchases: Taking Evidence Global*, WHU – Otto Beisheim Graduate School of Management Working Paper, 28 February 2011
538. Prabhakar, R., Rowlingson, K. & White, S. *How to Defend Inheritance Tax*, Fabian ideas 623, The Fabian Society in association with the TUC, April 2008
539. Bamfield, L. & Horton, T. *Understanding attitudes to tackling economic inequality*, Joseph Rowntree Foundation, June 2009, http://lowtax.es/HP47rk

[M]any participants were resistant to the increased regulation or taxation of inheritances. This was confirmed in the poll results, with 55 per cent disagreeing (including 29 per cent strongly disagreeing) that 'Government should take action to reduce inequalities in inherited wealth', compared to just 25 per cent agreeing.

The improvement in the Conservative Party's opinion poll standing, following its pledge to significantly increase the Inheritance Tax threshold, shows the political potential of cuts in the tax. It suggests that the issue has sufficient salience to affect people's voting behaviour.

Why is the tax so unpopular despite having such supposedly impeccable progressive credentials? The authors of the Fabian Society report argue that the public is "generally not well-informed about the nature and incidence of the tax". They acknowledge though, that in the United States an attempt to defend that country's equivalent of Inheritance Tax, the estate tax, by focusing on the number and range of families paying it, failed:

So the repealers had moral arguments, narrative accounts and strong support from a large, diverse and powerful lobby. What about the opposition? Rather than construct a positive moral case for inheritance tax the anti-repealers tended to call on self-interest. For example, they argued that only two per cent of Americans had to pay it so it would not affect many people. They produced reams of statistics to back up their case. But the appeals to self-interest, backed up by statistics, failed to resonate when up against the fairness arguments of the tax's opponents, supported by compelling individual narratives.

The reason the tax is so unpopular is, ironically, that the progressive, socialist reasons for supporting the tax are too individualistic, whereas most people understand tax through the prism of its effect on families. To consider how this works, look at the key arguments the authors of the Fabian Society report give for supporting Inheritance Tax, and how they fare once the unit of study is shifted from individuals, bequeathing and inheriting, to families, earning and then being taxed at various points.

Their first argument for Inheritance Tax is that it promotes tax justice. They argue:

If someone receives a significant sum, say £300,000, from earnings, and this is subject to taxation, then why should someone who receives the same sum as a wealth transfer, such as an inheritance, not also pay tax?

That works if you think about how the tax affects individuals, except to the extent that someone planning to bequeath money is worse off because their satisfaction at their financial legacy is diminished. The tax clearly infringes people's right to dispose of their property as they wish. But it collapses if you think about taxing a family unit. That family has been taxed when the money was earned. It is taxed again, at forty pence on every pound above the threshold, and their wealth is diminished because a member of the family has died.

That explains why the public is convinced – and work by focus groups suggests this is a critical reason why they think the tax is unfair – by the description of Inheritance Tax as a "double tax". The authors of the Fabian Society report argue that is inappropriate as the person leaving the inheritance and the person receiving it are both only taxed once, when they first receive the money. They draw an analogy with someone providing a service:

> *Say I earn £x a year on which I pay some tax. I now employ Jones as a plumber to come and fix a pipe in my kitchen. I pay her £y for this, and she pays a tax on £y. Does the fact that the plumber pays tax on a transfer she got from me, a transfer out of income which had already been taxed, make this a case of double taxation?*

The difference again is that people would not see this as new income that they have accrued. While economics and tax law tends to operate on the basis of individuals, people are used to making household budgets and making decisions based on how they can provide for their family. By contrast, traders providing a service are more clearly a separate economic unit and payments they receive are understood as an income. The idea that a family is taxed again just because they have suffered the misfortune of one of their members dying strikes most people as unjust.

Of course, streams of income are often taxed more than once. The authors of the Fabian Society report point out that people will face sales taxes, like Value Added Tax, when they spend money on which they have already paid Income Tax. They argue that this undermines the idea that double taxation is objectionable in itself. But whether someone spends money themselves or leaves it to their children to spend, the eventual sales tax is just the same. Inheritance Tax constitutes an *additional* tax as a result of death.

Double taxation may not be the right term semantically. Instead they see it as unfair that the government imposes a fresh levy on a grieving family, using the source of their grief as a pretext. Double taxation is convenient shorthand even if the issue is technically treble, quadruple or quintuple taxation.

Their second argument for Inheritance Tax, about equality of opportunity, seems simply out of date with respect to most inheritances. The example that is given in the Fabian Society report is:

> *For example, imagine three people – Alf, Betty and Carl – who all want a career in journalism. The three have similar abilities, but Betty and Carl use inheritances to finance periods of unpaid internship work which enable them to get valuable work experience and so gain a clear edge over Alf when the three compete for a given job. Imagine now that Betty and Carl do not have these inheritances. The three will now compete on a more level playing-field for the available jobs.*

The National Centre for Social Research produced a study in May 2008 which looked at the pattern of inheritances.[540] It found that the number of people receiving an inheritance in the age range 16–29 fell from 4.94 per cent in the 1997–98 period to 2.44 per cent in 2003–2004. Those in the 30–49 range and aged 50+ have an around five per cent chance of getting an inheritance each year. People in the 16–29 age range who do inherit also receive smaller bequests, at £8,402 on average against £31,147 for the 30–49 age range and £60,284 for those aged 50+.

While an inheritance at any age may create opportunities, it is unlikely to provide the same kind of competitive advantage later on, when people will largely compete

540. Ross, A., Lloyd, J. & Weinhardt, M. *The Age of Inheritance*, A report of research carried out by the National Centre for Social Research on behalf of the ILC-UK, May 2008, http://lowtax.es/HV0UC7 for jobs on the basis of experience, proven ability or established connections. People may have an advantage competing for jobs on the basis of their parents' resources, but it will be the parents' ability to spend supporting their children while they are alive, not the inheritance they leave when they are dead. Even then, money will often be less significant than the non-pecuniary advantages that come with having hard-working, successful, well-educated parents as tutors, supporters and role models.

Irwin Stelzer, in supporting Inheritance Tax, contradicts the Fabians by arguing that the tax leads to parents spending more money on giving their children the kind of advantages the Fabian Society attacks.[541] If parents spend supporting their children while they are alive and the children are younger, that is not subject to Inheritance Tax. He thinks that is a good thing as it means "inheritance taxes encourage parents to invest in skills during their children's formative years" but does not explain why parents cannot work out for themselves how best to support their children, and why we should distort their decision over how much they spend while they are alive and how much they leave as an estate.

To the extent that inheritances later in life affect equality of opportunity, it is normally because they create an opportunity to put that influx of capital to use. Irwin Stelzer points to research showing that receiving an inheritance makes it more likely someone will drop out of the workforce, by retiring early for example, but that is only one part of the equation.[542] While some people do take an inheritance as an opportunity to work less, others use the money to take risks, work extremely hard, and create a new business. Many entrepreneurs get their initial finance from inheritances.

Opportunities earlier in life, of the kind highlighted in the Fabian report's example, can often be zero-sum games – I get the job or you do – but entrepreneurship normally is not. One person's advantage is not another's disadvantage and new businesses mean new jobs for employees and new services for customers. Reducing the value of inheritances will therefore often only improve equality of opportunity by levelling down and making us all worse off.

Finally, there is the argument over whether Inheritance Tax encourages virtue – principally thrift and industry – or not. The authors of the Fabian report argue that providing for your family is a good up to a certain point and beyond that it becomes equivalent to nepotism, caring for your own at the expense of sacrificing equality of opportunity in wider society. They also argue that it may encourage indolence in the children of those who leave a large bequest.

Again it is helpful to look at this issue with a family as the basic unit of analysis. Inheritance Tax essentially punishes those families who save and accumulate assets. If the next generation choose to live off those assets instead of working and saving themselves, they will reduce the next Inheritance Tax bill. At every stage, the family increase their long term expected Inheritance Tax liability by saving.

Society's economic and financial interests are best served by the family saving more. Even if the case for Keynesian stimulus at some points is accepted, structural policies like Inheritance Tax shouldn't be formed on the basis of short-term demand management. Increasing the savings ratio would be a social good, and families will normally face a greater incentive to save with lower Inheritance Tax.

And those are just the objections to a theoretical, even-handed and administratively efficient inheritance tax. Even Lord Lipsey, in an article defending the tax,

541. Stelzer, I. Listen to Adam Smith: inheritance tax is good, *The Spectator*, 17 October 2007
542. *Ibid*

conceded that it had become "all but voluntary except for the unwise and unlucky" in practice.[543] Edward C. Prescott has written that:[544]

> *You can't take it with you. Too bad, because it would sure be convenient to set up an eternal rollover account for financial assets. Just think of all the time and resources that would be saved if people didn't have to hire expensive lawyers and clever accountants to get around the government's attempt to grab a share of their earthly bounty. Not to mention the better use of those accountants' and lawyers' time.*
>
> *And while we're at it, our public employees have better things to do than construct estate tax codes, design Web sites with FAQs and answer phones to explain how those taxes work, and then penalise those who unwittingly or otherwise skirt the law. Those costs are real and must be part of the equation when considering the efficacy of estate taxes.*

These practical concerns are particularly telling given that the tax raises relatively little money. It will raise a little under half of one per cent of current receipts in 2011–12. A tax that is complicated to administer, hard to enforce and raises little money would be worth reconsidering anyway. But, as described earlier, that is not the main reason why the public is rejecting Inheritance Tax.

If people reject Inheritance Tax because it treats families unfairly, then it will continue to be unpopular. There are also lessons for understanding how other taxes can be seen as fair or unfair. In many cases, the simple arithmetic of progressive taxation does not capture people's circumstances and the extent to which they deserve and/or can bear more taxes (Section 4.3.2). Arbitrary additional taxation on the same income strikes people as deeply unfair.

5.2.2.3. National Insurance contributions are a tax, not an insurance premium

The overwhelming majority of National Insurance revenue does not pay for benefits which are dependent upon an individual's National Insurance contributions. Those who contract out of the Additional State Pension must join an approved pension scheme and their rebate is paid into the scheme. National Insurance contributions are based not on a risk profile but rather are a function of earnings, again like a tax and unlike insurance. The (compulsory) insurance function that does exist is minimal, relating only to a few marginal benefits and a tangential relationship with the State Pension system which the government seems likely to abolish. It is in effect, overwhelmingly, simply an additional tax on earned income.

National Insurance is, in effect, simply an additional tax on earned income

The National Insurance Fund was established in 1911 but took on its current form in 1975 when it merged with the National Insurance (Industrial Injuries) Fund and the National Insurance (Reserve) Fund. It is the account which receives most National Insurance contributions but also sometimes receives grants from HM Treasury. It is responsible for paying contributory benefits (89 per cent of expenditure is pensions) but operates on a pay-as-you-go basis in that a given year's contributions pay for that year's expenditure. The government has no powers to use the Fund's receipts to finance any other activities. The Fund has no borrowing powers but it deposits all of its working balance with the government for which it accrues interest at the Bank of England bank rate and this is administered by the Debt Management Office.

543. Lipsey, D. The 'death trap' menacing middle Britain is a myth, *The Guardian*, 12 February 2007
544. Prescott, E. C. Death and Taxes, *Wall Street Journal*, 1 June 2006

Despite these technicalities the Fund's finances are not, in effect, treated very differently from general taxation. The government decides how much contributions will be, what proportion of them will be paid into the Fund and the level of the benefits paid from it. It also provides it with grants, when necessary, to maintain its working balance. The Fund is effectively an accounting device to manage and label part of the government's current finances. It is not a fund in any meaningful sense of the term.

5.2.3. There is a range of differences between Income Tax and National Insurance which make the system more complex, expensive to administer and opaque

5.2.3.1. The differences between Income Tax and National Insurance

There are eight key differences between the two systems: the assessment period; the assessment unit; earnings definition; age applicability; employment status; pensions; expenses; and miscellaneous reliefs and international issues.

Table 5.3: Key differences between National Insurance and Income Tax

Key Area	Difference between National Insurance and Income Tax
Assessment period	National Insurance is assessed per employment period (as in per pay-slip, typically weekly or monthly, though company directors are assessed annually) while Income Tax is assessed annually (though typically an estimate is paid per employment period through the PAYE system with discrepancies resolved after the end of the tax year).
Assessment unit	National Insurance contributions are normally paid on a per-job basis, whereas Income Tax is assessed per person. This means that someone with two jobs benefits from bands of earnings under the 'Primary Threshold' (and not liable to National Insurance) for each job.
Earnings definition	Income Tax applies to most income, although with slightly different rate schedules for each of savings and dividends income. National Insurance, however, is payable only on income 'derived from an employment'. On technicalities such as expenses, gratuities (for waiters, etc.) and benefits-in-kind, the National Insurance rules are usually more favourable than those used to assess liability for Income Tax.
Person applicability	While Income Tax applies to everyone (with the exception of more generous age-related tax-free thresholds), National Insurance applies only to those aged between 16 and the State Pension Age. Pensioners and children do not pay National Insurance. There is a special reduced rate of National Insurance contributions for women who have been married since 1977 and in continuous employment. Other than that, National Insurance largely ignores marital status whereas Income Tax contains various assumptions (such as equal shares of income arising from jointly-owned property) which are dependent on marital status.
Employment status	Those classified as self-employed for National Insurance purposes enjoy considerably more favourable rules than the employed in terms of admissibility of expenses and exemption from Employers' National Insurance. Self-employed status affords much less favourable treatment under Income Tax rules. Also, for occupations including entertainers, construction workers, ministers of religion, part-time or visiting lecturers/instructors and office cleaners, the categorisation as employed or self-employed may not be the same under National Insurance rules as under rules for Income Tax, as the latter are categorised only by common law tests while, for the purposes only of National Insurance, HMRC is authorised to determine employment status under Regulations irrespective of the status for Income Tax purposes.
Pensions	Neither system taxes investment returns within a fund but pension income is subject to Income Tax and yet exempt from National Insurance contributions. Contributions to pension funds are exempt from Income Tax. However, while an employer's contribution to a pension fund is exempt from both Employers' and Employees' National Insurance contributions, they are payable on the employee's contribution to the pension fund.

Key area	Difference between National Insurance and Income Tax
Expenses	For an expense to be deductible for Income Tax purposes it must be "wholly, exclusively and necessarily" incurred for the employment whereas for National Insurance the test is "any specific and distinct payment of, or contribution towards, expenses which an employed earner actually incurs in carrying out his employment". However, deductibility for National Insurance only applies when the employee is reimbursed by the employer. So for items such as professional fees, which are deductible for Income Tax purposes, National Insurance must be paid if the fee is not reimbursed by the employer.
Miscellaneous and international	Reliefs such as blind person's allowance (a larger personal allowance for blind people) are applicable to Income Tax but not National Insurance. Liability for National Insurance and Income Tax varies for seconded employees to/from the UK. Some pay one but not the other charge, depending on UK and EU law and bilateral treaties.

5.2.3.1.1. Rates and schedules of Income Tax

Income Tax is levied on all 'taxable income' but there are separate sets of rates for some amounts of interest on savings and for dividends from companies. Taxable income is someone's entire income (including interest and dividend income) after deducting allowable expenses and the relevant personal allowances. Income Tax is applied to taxable income as a whole, but it is applied to the schedules sequentially. Income from interest and dividends is disregarded initially when assessing the liability under the main schedule. Interest income from savings is then added to assess what rate is applied to savings income. Finally, dividend income is added to the total to assess the applicable rate for dividend income. With the sole exception of the "starting rate for savings income", rates on bands of income are applied only to the portion of someone's total taxable income that falls into a band.

5.2.3.1.2. Personal allowances

Different personal allowances apply for the two taxes. (2011–12 amounts are given here.)

Table 5.4: Personal allowances for Income Tax (2011–12)

Personal allowance	Description
Under 65	£7,475 for those whose income is under £100,000. Thereafter it is reduced by £1 for every £2 earned. The allowance falls to zero at £114,950 so those earning this amount or greater have no personal allowance.
65–74	£9,940 for those whose income is under £24,000. Thereafter it is reduced by £1 for every £2 earned. The allowance falls to £7,475 (the under 65 amount) when income reaches £28,930 and stays at this level until income reaches £100,000 where it reduces again by £1 for every £2 earned until income reaches £114,950 where its value falls to zero.
Over 75	£10,090 for those whose income is under £24,000. Thereafter it is reduced by £1 for every £2 earned. The allowance falls to £7,475 (the under 65 amount) when income reaches £29,230 and stays at this level until income reaches £100,000 where it reduces again by £1 for every £2 earned until income reaches £114,950 where its value falls to zero.

5.2.3.1.3. Other allowances

- Blind Person's Allowance: This allowance of £1,980 reduces taxable income and is granted to blind people in addition to other allowances to which they are entitled.

- Married Couples Allowance: Civil partners and couples who married after 5 December 2005 where one was born before 6 April 1935 are entitled to apply the Married Couples Allowance of £7,295 to the highest income in the couple. The allowance does not reduce the taxable income, but instead provides a relief of 10 per cent of the allowance against the tax bill of the highest earner in the couple. When that income rises above £24,000 the allowance is reduced by £1 for each £2 earned over £24,000 until the allowance falls down to its minimum amount of £2,800. For couples who married before 5 December 2005 (civil partnerships did not exist then) the allowance always applies to the husband's income.

5.2.3.1.4. Main schedule (excluding savings and UK dividends income)

Taxable income from sources other than savings income and UK dividends is taxed at the rates in the table below:

Table 5.5: Income Tax rates for sources other than savings and UK dividends (2011–12)

Rate name	Total taxable income (£)	Tax due at (%)
Basic	Up to 35,000	20
Higher	35,001–150,000	40
Additional	Over 150,000	50

5.2.3.1.5. Savings income

Income from interest on savings is added to the non-savings income to ascertain the applicable rate and taxed at the rates in the table below:

Table 5.6: Income Tax rates for savings (2011–12)

Rate name	Total taxable income (£)	Tax due on savings income (%)
Starting rate for savings*	Up to 2,560	10
Basic	Up to 35,000	20
Higher	35,001–150,000	40
Additional	Over 150,000	50

* Unlike all the other rates, the "starting rate for savings" income band only applies if the total taxable income falls within the band. The 20 per cent basic rate applies to the income within the starting rate if taxable income exceeds the starting rate's threshold. For example, if Person A's entire taxable income of £2,560 comes from interest on savings, it will be falls just inside the threshold for the starting rate and it will be taxed at 10 per cent, leaving his tax bill at £256. Suppose Person B's circumstances are identical but he earns just one pound more than Person A. His taxable income is £2,561, just above the threshold and therefore it will all be taxed at the basic rate of 20 per cent. Despite earning just one pound more, his tax bill would be £512.20.

5.2.3.1.6. UK dividend income

UK companies are deemed to pay Income Tax at a flat rate of 10 per cent when distributing dividends to shareholders. Vouchers are issued with dividends to credit shareholders with a proportionate share of the tax paid by the company. These credits reduce individual shareholders' tax liability but they are not refundable to taxpayers whose income is not high enough to be taxable. Income from UK dividends is added to other income to ascertain the applicable rate and taxed at the rates in the table below:

Table 5.7: Income Tax rates for UK dividends (2011–12)

Rate name	Total taxable income (£)	Liability (%)	Tax liability on total dividend income (including tax already paid at source) after deducting 10 per cent tax credit (%)	Amount due on dividend cash received after deducting 10 per cent tax credit (%)
Basic	Up to 35,000	10.0	0.0	0.0
Higher	35,001–150,000	32.5	22.5	25.0
Additional	Over 150,000	42.5	32.5	36.1

5.2.3.1.7. Rates and classes of National Insurance

National Insurance 'contributions' are compulsory and payable on earnings "derived from an employment". They are not payable on rental, savings, dividends or pension income or on employment earnings of people aged under 16 or (except for employers' contributions) over the state pension age. Most contributions are payable by employment period (monthly for most people) but converted into weekly rates for assessment. Those who register as self-employed must pay the flat rate weekly Class 2 in addition to the annually assessed Class 4 rate. People can volunteer to pay a weekly flat rate amount (Class 3) to maintain their contribution record and thus entitlement to benefits in cases where they are not otherwise liable or treated as having made contributions.

People who earn between £102 and £139 per week do not pay National Insurance contributions but are treated as though they did when assessing eligibility for benefits through National Insurance 'credits'. In addition, people who claim Carer's Allowance, Jobseeker's Allowance, Incapacity Benefit or Employment and Support Allowance, parents of a child aged under 12, approved foster carers and those who care for a severely disabled person for at least 20 hours per week are all treated as if they had made National Insurance contributions.

Table 5.8: National Insurance classes and rates (2011–12)

Class	Description	Rate	Revenue (£bn)
Employees' National Insurance			
Class 1	Standard rate between weekly earnings of £139 and £817 payable by the employee (usually through the PAYE system) from the employee's official wage or salary. two per cent above £817. Married women in continuous employment since 1977 or before and widows pay a reduced rate of 5.85 per cent. A rebate of 1.6 per cent is due for those who 'contract out' of the Additional State Pension.	12.0%	40.3
Class 2	Self-employed flat rate	£2.50/week	0.3
Class 3	Voluntary contribution flat rate	£12.60/week	0.1
Class 4	Self-employed rate for profits between £7,225 and £42,475. two per cent for profits above £42,475.	9.0%	2.0
Employers' National Insurance			
Class 1	Employers' rate payable by employers on weekly earnings in excess of £136 in addition to the stated wage or salary. Rebates apply for those who are members of contracted-out pension schemes which are paid into the schemes by HMRC.	13.8%	53.4
Class 1a	Employer-provided benefits	13.8%	1.0
Class 1b	Contribution relating to certain expenses under 'PAYE Settlement Agreements' between HMRC and an employer.	13.8%	0.2

5.2.3.1.8. Interaction with benefits

The National Insurance system interacts with nine benefits which currently rely on National Insurance contributions: the State Pension; the Additional State Pension; contribution-based variants of Jobseeker's Allowance; Employment and Support Allowance and Incapacity Benefit; Maternity Allowance; Bereavement Allowance; Bereavement Payment; and Widowed Parent's Allowance.

Table 5.9: How National Insurance interacts with different benefits (2011–12)

Benefit	Operation and interaction with National Insurance
State Pensions	The Government is consulting on replacing the State Pension and the "Additional State Pension" with a new flat rate state pension not related to National Insurance contributions, thereby abolishing the already weak link. The value of current state pensions are based in part on National Insurance contributions, although the system is very complicated and can even have the effect of making a pension worth less if National Insurance contributions are paid in certain circumstances.[545] People qualify for the State Pension if they have accrued enough "qualifying years" (years where they earned enough to pay National Insurance contributions) while the Additional State Pension's value depends on the level of National Insurance contributions paid.
Jobseeker's Allowance	A non-means-tested payment of £67.50 per week (for those over 25) is paid for up to six months for people with complete National Insurance contributions records in the previous two tax years. This is in place of a means-tested equivalent payment for those who do not qualify for the (National Insurance) contributions-based JSA.
Employment and Support Allowance	ESA is paid to those with a disability which restricts the claimant's ability to work. The 'contribution-based' element is available to those who meet the National Insurance contributions criteria (firstly having paid National Insurance contributions on earnings of 25 times the weekly "Lower Earnings Limit" (currently £102) in each of the previous three years and secondly having paid or being treated as paid at least 50 times the LEL in each of the two previous years). This replaces Incapacity Benefit but those who do not meet the criteria may be eligible for the means-tested 'income based' ESA instead. Neither are available to people who are eligible for Statutory Sick Pay or Jobseeker's Allowance. It is paid at £67.50 per week in a 14-week assessment period and subsequently £94.25 or £99.85 depending on the assessment.
Incapacity Benefit	Incapacity Benefit closed to new applicants on 31 January 2011. Existing applicants are being moved to Employment and Support Allowance (see above). Consequently, Incapacity Benefit will soon cease to affect potential National Insurance and Income Tax reforms.
Maternity Allowance	Maternity Allowance is a benefit of £128.73 (or 90 per cent of average weekly earnings, whichever is lower) payable for up to 39 weeks to pregnant women who are or have recently been self-employed or who are employed but not eligible for Statutory Maternity Pay. National Insurance records are used to determine this, although contributions have almost no effect (people earning under £139 per week pay no National Insurance contributions but receive MA of £125.10, this rises to £128.73 for those earning £143.03 or above. Self-employed people are treated as earning £143.03 if they have paid Class 2 National Insurance contributions in 13 of the 66 weeks before the pregnancy due date).
Bereavement benefits	The surviving spouse (when the deceased partner had a good record of National Insurance contributions or whose death was caused by their job) in a marriage or civil partnership but who is neither over the state pension age, nor divorced, nor living with another person as a spouse nor in prison, is eligible for: ▪ Bereavement Payment, a £2,000 tax free payment made if applied for within 12 months of the death. ▪ Widowed Parent's Allowance, a weekly benefit of up to £100.70 when the surviving spouse receives Child Benefit or is expecting the deceased's baby. ▪ Bereavement Allowance, a weekly benefit of a maximum of £100.70 for those aged 55 to the state pension age decreasing to £30.21 for those aged 45. Payments are reduced when the deceased's National Insurance contributions record is incomplete. The benefit is not payable to those aged under 45.

545. 2010, *Abolish NICs* by David Martin for the Centre for Policy Studies, pp18–19

There is no reason why other existing taxes cannot be used to determine benefit eligibility, to the extent that is necessary, if National Insurance is abolished.

5.2.3.2. Problems with National Insurance

Running two taxation systems concurrently creates a number of serious problems.

5.2.3.2.1. Economic growth and employment

It seems best to assume, in most circumstances, that Income Tax and National Insurance will have similar economic effects, as they are very similar taxes. In research for the OECD, Johansson et al. reported that "the empirical analysis for this paper found only weak evidence that employees' social security contributions have less of an impact than personal income taxes in terms of reducing GDP per capita."[546] As a result, the harms created by higher marginal income tax rates are also likely to be created by higher National Insurance contribution rates (Section 4.1.2.1).

However there may be particular problems created by Employers' National Insurance, as it is a non-wage labour cost which may create unemployment if it rises and employers are not able to pass that cost on to labour. Afonso and Furceri found that "indirect taxes and social contributions" were the "most detrimental to growth".[547]

Lilico and Sameen, in a study for Policy Exchange, reported that the Oxford Economics model, which they used due to its similarity to the model used by the Treasury, suggested the harms created by an increase in employer's NI were "so powerful they should be treated very cautiously [as they may not be reliable] – a 2p rise in Employers' National Insurance in the model reduces GDP after three years by two per cent. However it seems fairly clear that Employers' National Insurance is one of the worst possible taxes to raise."[548]

5.2.3.2.2. Administration

In 2006 KPMG produced a report for HMRC measuring the administrative impact on business of tax regulations.[549] The report ignored the costs relating to non-compliance, the cost and uncertainty of change, the cost of economic activity discouraged by the perception of complexity and operational grit in the system and only measured direct, marginal compliance costs. Despite its narrow focus, KPMG found that just three of the 'information obligations' the separate National Insurance system imposed on businesses incurred a compliance cost to business of £146 million. It did not detail the cost of other, less onerous obligations.

HMRC spends substantially more in order to maintain separate National Insurance and Income Tax systems than it would if one of the charges did not exist and the remaining charge was commensurately higher. It charges £300 million to the National Insurance Fund for collecting contributions.

The two systems require companies and their tax accountants to know more detail and this places demands on employers' and employees' time. That duplication means lower incomes, as the money is used to pay for tax advisers and HR administration, and higher taxes on those lower incomes to pay for the additional HMRC inspectors and their other costs.

---

546. Johansson, A., Heady, C., Arnold, J., Brys, B. & Vartia, L. *Tax and economic growth*, OECD, Economics Department Working Paper 28, 11 July 2008
547. Afonso, A. & Furceri, D. *Government size, composition, volatility and economic growth*, ECB Working Paper No. 849, January 2008
548. Lilico, A. & Sameem, H. *Taxation, Growth and Employment*, Policy Exchange, 2010
549. KPMG, 2006, *Administrative Burdens – HMRC Measurement Project* http://lowtax.es/HdlMWN

By splitting up employees' tax bills and labelling part of them as National Insurance contributions, the tax system is made more opaque

5.2.3.2.3. Opacity

By splitting up employees' tax bills and labelling part of them as National Insurance contributions, the tax system is made more opaque. To determine exactly how much tax is payable on income, taxpayers must add together National Insurance contributions and Income Tax payments. While this is not a complicated mathematical exercise, it is nonetheless a disadvantage to all those who favour an open, honest and transparent taxation system.

But what makes the National Insurance system particularly opaque is the employers' part of National Insurance. It is an additional amount which needs to be added to Income Tax and Employees' National Insurance for taxpayers to compute their true total income tax bill. But it is classified as being paid by the employer and, as a consequence, is not stated on payslips as a burden on employees. This hides from employees the full extent of their tax bill by effectively disguising part of their income under an economic fiction that it is paid by the employer instead.

5.2.3.2.4. Complexity

By definition having two sets of rules is more complicated than one. People who want to understand the system have to learn the different rates and thresholds; but as Section 5.2.3.1 illustrates, the additional complexity spreads significantly further than that. The two charges apply over different times. Indeed, the National Insurance timeframe is variable (whatever the 'employment period' is) whereas Income Tax is fixed at annual assessments. They apply to different units; National Insurance is applied per job and Income Tax per person. And then there are myriad differences in the minutiae of classification of such things as whether or not someone, particularly in the case of an entertainer, is 'self-employed'. As the Institute for Fiscal Studies explains:[550]

> *"This position changed in July 1998, when the DSS admitted that its general position towards entertainers was unsustainable in law. The Categorisation Regulations subsequently introduced between July 1988 and April 2003 ensured that most entertainers would be treated as if they were employees for National Insurance purposes (again irrespective of their status for Income Tax purposes as determined under the usual case law). Under the present National Insurance regime, the Categorisation Regulations apply, and Class 1 NICs are payable, unless the entertainer's remuneration does not involve any amount of 'salary'. At first, the Categorisation Regulations applied only where the remuneration was 'wholly or mainly' salary, but the test was extended to any amount of salary in 2003 once HMRC discovered that most entertainers entered into contracts providing for residuals and royalty payments which often exceeded the basic salary element. 'Salary' is defined in the regulations as payments made for services rendered under a contract for services where there is more than one payment, payable at a specific period or interval, and computed by reference to the amount of time for which work has been performed. If the Categorisation Regulations apply, all payments under an engagement (including residuals and royalties) are subject to NIC, not merely the salary element."*

All these differences amount to more complexity than would otherwise be the case. That complexity means more tax officials are required to administer and collect

550. Adam, S. & Loutzenhiser, G. *Integrating Income Tax & National Insurance: An Interim Report*, Institute for Fiscal Studies, 2007

the tax, but it also means employers and employees alike (together with their tax advisers) must familiarise themselves with a greater number of rules and peculiarities. The likelihood of errors and unintentional non-compliance also increases with greater complexity, which is unfair.

5.2.3.2.5. Public-personal finances

The complexity and opacity described above also has the effect of making it more difficult for taxpayers to link and compare the cost of the government services they receive with the tax they pay. Consumer law requires companies to advertise all compulsory charges to ensure customers know exactly how much they are paying when they make a purchase.

Without that law, customers would discover the final price anyway when they actually paid the bill. But the law makes it clear that enforcing honest and transparent labelling of pricing structures is in the public interest. This principle should apply to taxation and government services, too. The overwhelming majority of National Insurance revenue does not pay for benefits which are dependent upon an individual's National Insurance contributions. The 'insurance' function that does exist is minimal, relating only to a few marginal benefits and a tangential relationship with the State Pension system. It is, overwhelmingly, simply an additional tax on earned income.

5.2.3.2.6. Labour relations

Because Employers' National Insurance is a tax largely paid for by workers through lower incomes, and results in higher unemployment (see above), but is not clearly marked as such – on payslips, by politicians or in media coverage of the Budget – it acts as a stealth tax with damaging effects in the labour market which go beyond that of an equivalent amount raised by Income Tax.

Many employees simply do not realise the true level of their compensation as a direct result of Employers' National Insurance. Many believe the financial reward employers provide in exchange for labour is limited to the official salary plus other visible benefits and simply do not realise that their employer pays Employers' National Insurance in addition to this. That has the effect of diminishing both employees' perception of the financial remuneration provided by employers and the perception of the burden of taxation they personally bear. While this approach to raising revenue for public spending holds an obvious appeal for politicians keen to be seen to be offering 'something for nothing', such dishonesty cannot be a healthy part of any prospectus for government. But this has ramifications beyond honesty in politics, government and public spending.

The gap between the value to employers of the labour an employee provides and the value of the compensation received in return for that labour is a direct consequence of Employers' National Insurance. This gap creates the perception that employers reap much higher profits than is the case and leads many to conclude that the basis of profitability lies not in efficient and successful organisation but simply underpaying workers. In turn, this must be responsible for a significant proportion of friction between employees and employers with all the strikes, workplace disharmony and loss of productivity and prosperity that entails.

5.2.4. There is an ethical responsibility for governments to impose taxes that are simple and transparent

A government can make the tax burden more or less transparent. In the UK, for example, there is considerable obfuscation of personal taxation because there are three forms of income tax on employment income: Income Tax itself, Employees' National Insurance and Employers' National Insurance. Greater transparency could be achieved in several ways in the context of the current tax system, including a simpler structure of taxes, making the burden on a given transaction or a given taxpayer easier to calculate, and the tax statements recommended in Section 3.6.5.4.

The utilitarian case for transparency is that it should improve decision-making, on two levels. First, citizens are asked to vote for various prospective governments. If they can see clearly what the effects of government policies are, that should make their choices better-informed. Second, citizens have to take decisions on their own work, spending and investments. Such decisions may well be influenced by the amounts of tax involved. A decision made purely on the grounds of economic advantage might not be so influenced: the net benefit from work, spending or investment is what matters, and the gross return is irrelevant. But people might, entirely rationally, decide that they do not want to work, spend or invest in ways that largely benefit the state, or conversely, might prefer activities with higher gross benefit but the same net benefit to themselves, on the grounds that they wanted to contribute to the common good.

Virtue ethicists would also recommend transparency. It is better to be completely open with people than to give only as much information as one must give. Deontologists are primarily concerned with the wrong of outright dishonesty, rather than with the virtue of openness. However, they might well favour transparency because, to the extent that one does have an obligation to make a just contribution to the public purse, it is very helpful to be able to see whether one has in fact made it.

A simple tax system is not only likely to be more transparent than a complex one. It also reduces administrative burdens on taxpayers, and makes it more likely that all taxpayers will pay what Parliament intended, rather than some missing out on reliefs because their entitlement is not obvious, or because the reliefs are too much trouble to claim.

The ethical case for simplicity is a straightforward utilitarian one. Complexity wastes resources, both of taxpayers and of officials. And if a tax system has been designed intelligently, to distribute the burden in the way that will do least damage to utility, it is better if that design is put into effect, through people paying the right rates of tax and obtaining the reliefs that they should obtain.

5.2.5. National Insurance can be abolished and merged with Income Tax into a single tax on labour income

National Insurance should be abolished, with all the rates and schedules of Income Tax replaced by a single proportionate tax on labour income. Such a change would require careful implementation and a serious attempt to inform the public to avoid the obvious danger of it being perceived as a tax rise, but would be worthwhile.

Abolition would be a major change in the operation of the part of the tax system that applies to half the population at any time and most of the population at some point in their lives. There is a risk of public confusion from those who might worry that they will suffer financially as a result of the change either because the amount of tax the government will admit people are paying will indeed increase or simply because they may have heard that the system is changing and naturally worry about what their worst case scenario might be.

It is because of this risk that we propose that abolition ought to be carried out in two phases. The first phase consists of the alignment reforms that would harmonise the operations of the two systems without the fundamental change involved with abolition. This operational alignment, together with renaming elements of the two charges would both more accurately reflect their true functions and enhance public understanding which would in turn make the reforms in the second phase clearer.

After that first phase, the second phase of abolishing National Insurance and with it the contributory principle should be better understood as making the accounting operation of the system match the economic reality and in the process creating a simpler, cheaper and more transparent tax system. Government bodies are notoriously bad at delivering new IT projects, so that might cause concern that this merger could cost millions in transferring over to new systems. But this would not need to be the case as National Insurance rates could simply be set to 0, and the Income Tax adjusted accordingly.

5.2.5.1. The transition to merged Income Tax and National Insurance

5.2.5.1.1. First phase (2013)

There should be an immediate move to align the two taxes. This would mean:

- Abolishing the Social Security (Categorisation of Earners) Regulations 1978 and apply the same categorisation of employment status to National Insurance as to Income Tax. This will reduce complexity and mean that employees, employers and their advisers need only familiarise themselves with one set of rules.
- Altering National Insurance from periodic, per-job to annual, per-person applicability (company directors are already assessed annually) with the same thresholds as Income Tax with a combined periodic deduction under the Income Tax PAYE system. This will standardise the system and mean people need only consider one set of thresholds and applicability with only the rates differing between the two charges.
- Exempting employees' contributions to pension funds from National Insurance contributions to match the treatment for employers' pension fund contributions and the Income Tax treatment of both. The current system of taxing pension incomes rather than pension contributions is logical and should be consistent. There is no reason beyond a minor attempt at raising revenue to apply one charge but not the other.
- Merging the two sets of rules for deductible expenses into a single set of rules equally applicable to both National Insurance and Income Tax.
- Renaming both National Insurance charges and Income Tax so they accurately reflect their actual functions.

Table 5.10: Renaming National Insurance

Current name	New name
Employers' National Insurance	Income Tax (Payroll Levy)
Employees' National Insurance	Income Tax (National Insurance Contribution)
Income Tax	Income Tax (Standard Earnings Charge)

- Amending remuneration advice notices to add new lines in both the 'Payments' and the 'Deductions' schedules. This will add clarity to the three economic facts currently absent: the fact that employees pay Employers' National Insurance, the total amount of direct tax employees pay and the total compensation employers provide to employees. Two new lines should be added in the Payments schedule under 'Gross salary'. The first to list Employers' National Insurance contributions (as "Income Tax (Payroll Levy)") with the second new line being the sum of Income Tax (Payroll Levy) and 'Gross salary', reported as 'True Total Earnings', so employees see the full extent of the financial compensation they receive from employers. In the Deductions schedule a line should be added for Income Tax (Payroll Levy) followed by another line for "Income Tax Total", representing the sum of all three charges. Year to date figures should be amended similarly.
- Abolishing the National Insurance Fund. It has no useful purpose and its assets and liabilities should be assumed by HM Treasury.
- Assisting employers with adjusting pension contribution rates, redundancy payments and other additional remuneration to reflect the new larger earnings base.

5.2.5.1.2. Second Phase (2016)

- Abolish both forms of National Insurance (renamed Income Tax (Payroll Levy) and Income Tax (National Insurance Contribution) in the First Phase).
- Require gross salaries and wages in the last year before the abolition of National Insurance to be treated as if they included the Income Tax (Payroll Levy) when determining wages and salaries effective after abolition. For example, an employer who paid an employee a salary of £25,000 would have attracted an Income Tax (Payroll Levy) (currently Employers' National Insurance) of approximately £2,500. Therefore, the salary from immediately after the abolition of National Insurance would be approximately £27,500 before applying any agreed annual increases or decreases to convert the pre-abolition salary into a post-abolition salary as per normal negotiations and contractual obligations.
- Replace all Income Tax and National Insurance charges with a new single rate and a single single personal allowance on all income, except dividends which would be taxed through the new capital income tax system.

5.2.5.1.3. Remaining items

- **Pension income**. While pension incomes are subject to Income Tax they are exempt from National Insurance contributions. This differential treatment of those over 65 (who benefit from both a larger personal allowance and a lower combined Income Tax and National Insurance rates) complicates the tax system and there are legitimate arguments in favour of equalising rates, the personal allowance or both. However, unlike Budget 2012, the 2020 Tax Commission proposals level up the personal allowance (the proposed personal allowance is higher than even the allowance for those aged 75 and over in 2010–11), and level down marginal tax rates.

- **Pension contributions.** Employer contributions to pension funds are exempt from all three charges. Employee contributions, however, are subject to National Insurance but exempt from Income Tax. This anomaly is a result of the difficulty of feasibly applying Employers' National Insurance to defined contribution scheme employee contributions as the employee may have several employers, leaving the question of how to assign the rebate. Likewise it would not be feasible to apply Employers' National Insurance to withdrawals from defined benefit schemes as the employer may not exist at the time of the withdrawal. This is an area where new arrangements will be needed to reflect the new tax environment for savers (Section 5.1.5.1.4).

5.2.5.2. Adjusting pays slips with the Income Tax and National Insurance merger

Table 5.11: Existing typical pay slip

Employer	Typical company		Joe Bloggs	
Payments	**£**	**Deductions**		**£**
Salary	2,004.65	Income Tax National Insurance		276.35 168.32
Employee no:	**000000001**	**Year to date totals**		
Pay period:	3/12	Pay YTD:		6,013.95
Date:	28 June 2011	Tax YTD:		829.05
NI no:	AA 12 12 12 B	NI YTD:		504.96
NET PAY:	***£1,559.98***			

Table 5.12: Typical First Phase pay slip

Employer	Typical company		Joe Bloggs	
Payments	**£**	**Deductions**		**£**
Official Salary Payroll Levy	2,004.65 195.35	Income Tax (Standard Earnings Charge) Income Tax (NIC) Income Tax (Payroll Levy) Total Income Tax		276.35 168.32 195.35 640.02
Total Salary	2,200.00			
Employee no:	**000000001**	**Year to date totals**		
Pay period:	3/12	Pay YTD:	6,600.00	6,600.00
Date:	28 June 2011	Tax (SEC) YTD:		829.05
NI no:	AA 12 12 12 B	Tax (NIC) YTD: Tax (PL) YTD: Tax Total YTD:		504.96 586.05 1,920.06
NET PAY:	***£1,559.98***			

Table 5.13: Typical Second Phase pay slip

Employer	Typical company		Joe Bloggs
Payments	**£**	**Deductions**	**£**
Salary	2,200.00	Income Tax	640.02
Employee no:	**000000001**	**Year to date totals**	
Pay period:	3/12	Pay YTD:	6,600.00
Date:	28 June 2011	Tax YTD:	1,920.06
NET PAY:	***£1,559.98***		

5.2.5.3. Non-domicile status

The reforms being made to labour and capital income taxes will not resolve the issues around non-domicile status. Non-domicile (non-dom) status means foreign nationals can live in Britain and only pay tax on British income or foreign income remitted to Britain. Despite the popular misconception, it does not mean they pay no British tax. There are four options for the 2020 Tax Commission:

- End the taxation of foreign income for all taxpayers. From first principles, there is a case that the state has a proper claim only on domestic income, which depends on support from the nation state such as its maintenance of the rule of law and property rights. Moving to only tax domestic income would reduce the size of the tax base though, necessitating higher rates, and would be difficult to implement while not creating substantial opportunities for tax avoidance.
- Extend the advantages given to non-doms to all taxpayers, and stop taxing income that is not remitted to Britain. Again this would be fairer and keep the tax system competitive but it would reduce the size of the tax base and, when applied to so many people, those rules might create opportunities to avoid taxes that would be hard to police.
- Keep non-dom status without any fundamental changes. Some inequity would remain but there would be no erosion of the tax base from its present level and the rules would continue to encourage wealthy people to move here, normally bringing substantial amounts of money either to invest or spend to the benefit of British nationals and the economy.
- Abolish non-dom status. That way everyone would pay tax on their foreign income. This would be more equitable. However, by making a claim on the foreign income of anyone who moved here we would undermine the attractiveness of Britain as a place to move to and invest in, and that could leave the rest of us worse off.

There is limited empirical information on the qualities of the non-dom population and their likely response to any change but, following the introduction of a £30,000 flat fee to use the status in 2008, the number of non-doms fell significantly.[551]

551. Wallace, T. Non doms flee UK tax attack, *City AM*, 20 March 2012

5.13: Number of non-doms, 2007–08 to 2009–10

Financial year	Number of non-doms
2007–08	140,000
2008–09 (tax introduced)	123,000
2009–10	118,000

Some may have shifted status and remained within the UK. Others are likely to have left for reasons other than the levy, particularly the economic recession. However, many will have simply chosen to relocate outside of the UK. Non-doms are often wealthy and extremely mobile. The wider economic benefits that they bring to the UK mean that a dramatic fall in their numbers will have much wider implications, and affect revenue from other taxes. The levy on non-doms was increased to £50,000 in April 2012, potentially exacerbating the situation.

To avoid any unintended consequences which might result in British families on modest incomes having to pay more, and in lieu of any more fundamental changes to how foreign income is taxed, the 2020 Tax Commission does not recommend any changes in this area. However if a government did want to change the way non-doms are taxed, the more competitive and simpler tax system recommended should make that easier.

5.2.5.4. Earlier proposals

There have been a number of studies that have looked at the potential to combine Income Tax and National Insurance:

- 1978, A *British Tax Review* article "National Insurance Contributions – A Second Income Tax" concluded "the contribution system is merely an adapted form of the income tax system, and its separate status is to some extent a mere illusion."
- 1984, Dilnot, Kay and Morris proposed the integration of the charges in *The Reform of Social Security* as part of a broad tax and benefits reform proposal.
- 1986, HM Treasury, "*The reform of personal taxation*". Under Nigel Lawson, the Treasury produced this green paper with a chapter on integration of National Insurance contributions and Income Tax which rejected a merger because the distributional effects, which (now Lord) Lawson referred to in his memoirs, *The View from No 11*, as an 'elephant trap', outweighed the administrative savings and benefits to business, which it predicted would diminish with the spread of information technology. The benefits of transparency did not feature in the green paper's concluding analysis.
- 1995, Dilnot argued for integration noting "the main continuing barrier … is politics and public perception", in Sandford (ed.), *More key issues in tax reform*.
- 1998, Chartered Institute of Taxation, *Report on Tax/NICs Harmonisation*, full integration likely long-term goal but focused on steps towards alignment.
- 1998, Work Incentives, a report by Martin Taylor in *The Modernisation of Britain's Tax and Benefit System No 2*, HM Treasury, noted the radicalism of integration but opted not to investigate the ideas which raised "such major policy questions".

- 2004, British Chambers of Commerce argued in *A New Tax Horizon* that the most efficient long term solution would be a "full merger of Pay-As-You-Earn with National Insurance. However, because this radical step presents a number of challenges, it would require strong political will".
- 2006, *Administrative Burdens – HMRC Measurement Project* report by KPMG was concerned only with measuring the administrative impact of taxes on business, but noted "a significant number of businesses considered that National Insurance Contributions and Income Tax should be rolled into one, so that there were not two different taxes covering the same payments".
- 2007, HM Treasury, *Income Tax and National Insurance alignment: an evidence-based assessment* decided the benefits of annualising National Insurance contributions did not warrant the disruption. It did not assess full integration.
- 2007, *Integrating Income Tax & National Insurance: An Interim Report*, by Adam & Loutzenhiser for the Institute for Fiscal Studies extensively covered issues on transparency and policy option details such as the treatment of pensions. It did not arrive at a conclusion but noted that "integration could facilitate bold policy options that would be welcome in their own right as well as allowing for a simpler merged tax" and postponed recommendations to a final report.
- 2010, *The Mirrlees Review* for the Institute for Fiscal Studies, by Sir James Mirrlees et al., was unambiguous. "National Insurance is not a true social insurance scheme; it is just another tax on earnings, and the current system invites politicians to play games with National Insurance Contributions (NICs) without acknowledging that these are essentially part of the taxation of labour income. The two systems need to be merged. Given our proposal to apply the same rate schedule to income from all sources, integration would be a good opportunity to, in effect, broaden the NICs base to cover self-employment and capital income in full".
- 2010, *Abolish NICs* by David Martin for the Centre for Policy Studies argued for abolishing National Insurance and making up for lost revenue by raising Income Tax and implementing a new payroll tax. This proposal is administratively simple but introducing a payroll tax would negate much of the transparency benefit from the abolition of National Insurance.
- 2011, *National Insurance contributions: an introduction* by Antony Seely for the House of Commons Library reviewed (without assessing the merits of the proposals) the operation of the system and opinion on reform with particular reference to parliamentary questions and answers on the subject.
- 2011, Institute of Directors, Richard Baron's article in the Institute's *Big Picture* magazine, "Income Tax and National Insurance: a marriage made in heaven or hell?", argued that abolition of National Insurance by way of merging Income Tax with only Employees' National Insurance and replacing Employers' National Insurance with a flat-rate payroll tax should be seriously considered.
- 2011, *The Mirrlees Review* confirmed the assessment provided when the findings were published in 2010. "The UK has two taxes on income – income tax and National Insurance contributions … integration would underline the illogicality of most of the current differences … it is patently

absurd, for example, to have one tax assessed on earnings in each individual pay period and another assessed on income over the whole year … transparency and administrative simplicity would be well served by merging them … there is a strong case for phasing out the employer contribution altogether, merging it with income tax and employee NICs to form a single tax", the review observed before concluding: "Income tax and employee NICs – perhaps employer NICs as well – should be integrated into a single tax."

- 2011, *Abolish National Insurance – A simpler and more transparent tax system* by Rory Meakin for the TaxPayers' Alliance argued for the complete abolition of both forms of National Insurance and their integration into the Income Tax system. The proposal maintained revenue-neutrality and 'no losers' by proposing the introduction of the new rates only on earned income, an intermediate set of rates on self-employed income and retaining existing rates for those who do not pay National Insurance and for other types of income.

Chapter six

Transaction, wealth and inheritance taxes should be abolished

6. Transaction, wealth and inheritance taxes should be abolished

6.1. Transaction taxes impede the effective allocation of capital

The vital function of financial markets is to effectively allocate capital where it can deliver the most value. There is a huge public interest in those markets functioning properly and providing capital where it can make the greatest contribution to our prosperity; where it will earn the greatest return so that savers can afford a comfortable retirement; and without creating systemic risks that can result in expensive bailouts and dismal recessions of the kind we have recently experienced.

Tax rises can make that harder by creating a macroeconomic supply shock, to which markets struggle to adjust (Section 3.4.4). However, a number of specific taxes also hinder the effective allocation of capital. Capital Gains Tax (CGT) leads people to delay crystallising gains, particularly when the rate frequently changes, and thereby locks in assets that may be better transferred to different ownership (Section 6.1.1). Corporate taxes distort decisions in a number of ways but particularly by encouraging firms to borrow rather than raise equity capital, increasing their vulnerability in the event of a crisis (Section 6.1.2). Finally, financial transaction taxes often lead to exactly the opposite result to that intended: they increase the volatility of financial markets (Section 6.1.3).

6.1.1. Capital Gains Tax leads to the misallocation of assets

CGT creates the problem of 'lock-in' when an asset holder defers selling that asset to defer paying the tax. Capital that may otherwise be better invested elsewhere is not reallocated. Instead, it is held so that tax payments can be deferred.

Suppose there are two individuals. One of them has little cash but a business which was built from scratch. The second has £1,000,000 in spare cash but does not own a business. The business looks healthy and generates £50,000 profits, which are expected to grow at a modest rate. The cash is deposited in a savings account that yields £50,000 annually in interest. This payment is not expected to change, but the deposit is thought to be much safer than the value of business.

Over the next ten years, the amount of tax due from the profits of the business, if they remain unchanged at £50,000 per year and assuming a flat tax rate of 30 per cent, would be £15,000 per year or £150,000 in total.

However, assume the two individuals decide to swap their assets, the £1,000,000 cash in exchange for the business. They do this because the business owner now wants the safety of cash whereas the investor with cash wants to take a chance on the business growing in the future. The business would still generate £50,000 of profits for the new owner and therefore £15,000 of tax. But because the sale represented a 'capital gain' for the seller, a capital gains tax would mean 30 per cent would be payable on that, another £300,000. It's not clear why a total of £150,000 of tax should be payable from the business when the two individuals keep their original assets but a total of £450,000 of tax from the business should be payable if they swapped. This example does show, however, why Capital Gains Tax stops the ownership of businesses and other assets from being transferred to people who are more suited to own them instead of remaining in the hands of those who simply owned them in the past.

This creates a number of practical problems. Chari et al. argue that locked in capital leads to entrepreneurs holding on to start-up companies longer than they necessarily should. They developed a quantitative model looking at entrepreneurial private businesses. Efficiency dictates that, as a company grows, professional managers buy into start-ups. But when entrepreneurs hold on to them for too long – to defer the payment of CGT – they are less efficiently run. Not only is capital locked in, inefficient management of growing businesses is, too.[552]

The same problem exists in tax systems with quite different structures. In Sweden – which operates a dual income tax system – a study was undertaken using the LINDA database produced by their statistics agency. This meant that the longitudinal study was particularly comprehensive. Daunfeldt's results suggest that higher taxes on capital gains are associated with both fewer and smaller realisations of capital gains. This means less money to reinvest and also less money for the exchequer.[553]

CGT can hinder the efficient allocation of resources when levied at the corporate level, too. Desai and Gentry found that this is increasingly important in the US, as corporate capital gains realisations averaged 30 per cent of individual realisations over the previous 50 years.[554] A time-series analysis of aggregate realisation behaviour was performed and showed that corporate capital gains taxes had a significant impact on decisions on when to realise capital gains. The study also analysed the investment and disposal of plant, property and equipment and found that taxes again played an important role in determining when these investment and disposal decisions were taken. This means that firms which want to upgrade machinery to become more efficient may hold off doing so because of distortive CGT rates.

There is also compelling empirical evidence showing that tinkering with CGT rates has particular detrimental effects. Gaurio and Maio developed a dynamic general equilibrium model and discovered that when capital gains tax cuts are unexpected and permanent, dividend payments, equity issuance and aggregate investment rise immediately. The model also finds that when tax cuts are unexpected and temporary, aggregate investment falls in the short run. This is because firms distribute large dividends initially in response to the temporary dividend tax cut, in the knowledge that it will not be there for long.[555]

6.1.2. Corporate taxes currently encourage firms to borrow more rather than raising capital from equity

Viard provides three reasons why the US corporate income tax is non-neutral.[556] Firstly, by taxing capital income it places a heavier burden on those who save and consume in the future. Secondly, it provides an incentive for businesses to avoid incorporating themselves as corporations. Thirdly, since companies can deduct

552. Chari, V. V., Golosov, M. & Tsyvinski, A. *Business start-ups, the lock-in effect and capital gains taxation*, February 2005

553. Daunfeldt, S-O., Praski-Ståhlgren, U. & Rudholm, N. Do high taxes lock-in capital gains? Evidence from a dual income tax system, *Public Choice* 145, 1–2, 2009, pgs. 25–38

554. Desai, M. A. & Gentry, W. M. The Character and Determinants of Corporate Capital Gains in Poterba, J. M. *Tax Policy and the Economy*, Volume 18, August 2004

555. Gourio, F. and Maio, J. *Transitional dynamics of dividend and Capital Gains Tax cuts*, NBER Working Paper No. 16157, July 2010

556. Viard, A. D. Three cheers for the design of the corporate income tax, *American Enterprise Institute Tax Policy Outlook*, 2, April 2008

interest paid on debt (but not the dividends paid on equity) it only applies to the income that is paid to equity holders, not debt holders. This provides an obvious distortion in favour of debt. Similar problems exist in Britain.

The main evidence to suggest that Corporation Tax creates distortions is that "the existence of discrete jumps in the marginal rate structure […] has led to companies choosing to locate their taxable profit at kink points in the marginal tax rate schedule".[557] It is possible that this merely reflects accounting activity and not real economic decisions; however, the existence of 'kink points' suggests that the tax code is influencing the decision making of managers.

Many different corporate decisions are affected by the structure and rates of corporate tax. Foley et al. argue that "the magnitude of US multinational cash holdings are, in part, a consequence of the tax costs associated with repatriating foreign income."[558]

This matters because malinvestments can occur. According to Chen and Mintz, neutrality "allows businesses to make efficient decisions that reduce the misallocation of resources and minimises tax planning and administration".[559]

The Mirrlees Review was rightly particularly concerned that "the standard corporate tax base favours debt rather than equity finance". Interest payments are deductible for corporate income tax but equity returns are not. Income tax on interest reduces the extent of that bias but capital gains taxes and taxes on dividends magnify it.

Research at the IMF has summed up the problems that a bias in the tax system toward debt can create:

"One cannot compellingly argue for giving tax preferences to debt based on legal, administrative, or economic considerations"

> *One cannot compellingly argue for giving tax preferences to debt based on legal, administrative, or economic considerations. The evidence shows, rather, that debt bias creates significant inequities, complexities, and economic distortions. For instance, it has led to inefficiently high debt-to-equity ratios in corporations. It discriminates against innovative growth firms, impeding stronger economic growth. Debt bias also threatens public revenues, because it enables companies to reduce tax liabilities by using hybrid financial instruments as well as by restructuring their finances internally, moving debt between affiliates.*

That paper examined the extent of the bias in the United States, Japan and an unweighted average for the EU27. The results are shown in Table 6.1 and suggest that the difference is substantial.[560]It assumed that without taxation the cost of capital would be five per cent, and actually found that debt is subsidised at the margin.

557. Devereux, M. P. & Loretz, S. *Corporation tax in the United Kingdom*, Oxford University Centre for Business Taxation, February 2011, pg. 7
558. Foley, C. F., Hartzell, J. C., Titman, S. & Twite, G. Why do firms hold so much cash? A tax-based explanation, *Journal of Financial Economics*, 86, 2007, pgs. 579–607
559. Chen, D. & Mintz, J. New estimates of effective corporate tax rates on business investment, *Cato Institute Tax & Budget Bulletin*, 64, February 2011
560. De Mooij, R. A. *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, IMF Staff Discussion Note, 3 May 2011

Table 6.1: Cost of capital for alternative sources of finance

	Income tax exempt investor			Investor paying income tax at top rate		
	Retained earnings	New equity	Debt	Retained earnings	New equity	Debt
US	9.2	9.2	4.8	5.8	6.5	4.9
Japan	10.4	10.4	5.6	9.5	15.4	5.6
EU27 average	6.8	6.9	4.6	5.6	6.4	4.7

That research cited an IMF Working Paper which reviewed the literature studying the effect on corporate debt ratios. It found that a "consensus estimate" of the impact of the corporate income tax (CIT) rate on the debt-asset ratio "lies somewhere between 0.17 for narrow and 0.28 for broad measures of financial leverage. A coefficient of 0.28 would mean that a 10 percent-point lower CIT rate, e.g., from 40 to 30 per cent, reduces the debt-asset ratio by 2.8 per cent, e.g., from 50 to 47.2 per cent. A country with a CIT rate of 36 per cent that would fully eliminate the corporate tax advantage of debt would see the average corporate debt-asset ratio fall by 10 per cent, e.g., from 50 to 40 per cent. These effects are significant, though not huge." There is evidence that the effect is becoming stronger over time and that it is stronger with intra-company debt at multinationals than with third party debt.

Limiting the deductibility of interest payments is both complicated in practice and only a limited response to the problem. As a result, both the IMF and the Mirrlees Review propose an Allowance for Corporate Equity (ACE) to correct the bias.[561] Such an allowance "supplements interest deductibility with a deduction for the notional return on equity and has attractive neutrality properties besides the debt-equity choice." It is another sticking plaster for the tax system though. The more fundamental reform proposed by the 2020 Tax Commission would also eliminate the bias in favour of debt over equity.

6.1.3. Financial Transaction Taxes impede the operation of financial markets and increase volatility

The original Tobin tax was designed to cushion exchange rate fluctuations. Economist James Tobin initially proposed a one per cent tax on short term currency trades in 1972. Since then, the proposed rate has fallen – most proposals now suggest about 0.1 to 0.2 per cent – but the scope has been expanded to include other transactions as otherwise the tax can easily be avoided by trading via other cash-equivalent derivatives.

One reason why few have supported a Tobin tax is that worries about foreign exchange speculation have slowly subsided as more countries have moved towards floating exchange rates, which do more to limit the potential for exchange rate speculation than a Tobin tax possibly could. Attempts to fix rates such as – in the 1980s and 1990s – the European Exchange Rate Mechanism (ERM) meant large and sudden movements in exchange rates when speculators sensed that a peg could not be maintained, rather than the more fluid shifts of today. Currencies do still fall in value. But in 2008 when the value of the pound collapsed at the start of the recession it wasn't the fault of speculators but uncertainty about Britain's fiscal position and economic prospects.

561. Mirrlees et al. *Tax by Design*, Institute for Fiscal Studies, September 2011, pg. 421

The whole idea of a Tobin tax is based on the flawed view that trading – or speculation – is a bad thing

The whole idea of a Tobin tax is based on the flawed view that trading – or speculation – is a bad thing. The truth is that it helps the process of price discovery, makes markets work better, enhances liquidity, ensures that resources are priced correctly and generally helps oil the cogs of the global economy. Things only really go wrong when there is a bubble – and bubbles always require excessively loose monetary policy to form.

Goodhart has set out why there will be big problems if we impose a transaction tax on the foreign exchange markets, in particular:[562]

> *[The] Tobin tax is a bad idea, since it would greatly increase both the costs and volatility of foreign exchange dealing and throw a huge spanner into the workings of the global financial economic system. The proponents of the Tobin tax mistake the fact that commercial end-use of foreign exchange (fx) dealing is not more than about 10 per cent, at most, of the total of fx transactions into a belief that the other 90 per cent is a form of 'socially useless' speculative froth, which could, and should, decline without real loss. This latter viewpoint is just wrong. Taking an unhedged, open fx position is risky, and, hence, bank market makers are not allowed to do so, beyond limits. So any new commercial order unbalances a market maker's initial position, almost forcing him to rebalance by trading out of his new position with another market maker. The 'hot potato' will pass from hand to hand until prices and quantities eventually adjust to a new equilibrium.*
>
> *Essentially a Tobin tax imposes much greater costs, even if it seems proportionately low, because the margins on which the market makers are operating are low. The costs of transacting out of an unbalanced position would rise sharply, and with it the bid-ask spread on fx deals, liquidity would disappear and fx volatility would be enhanced. Meanwhile speculators, betting on a significant change in the asset/currency price, would not be much deterred by a small increase in transaction costs.*

The European Central Bank sets out how and why financial transaction taxes tend to increase volatility in financial markets:[563]

> *Economic literature provides little evidence that a transaction tax such as the Tobin tax would reduce exchange rate volatility. In fact, the effect of such a tax on volatility is ambiguous, i.e. it could also increase volatility, as it may result in reduced depth and liquidity of the foreign exchange markets.*

Most empirical studies find that a transaction tax increases volatility, at least in the short term.[564] The case for these taxes is no better looking at specific types of trading that the tax's supporters say it would prevent.

562. Goodhart, C. *An Alternative to a Tobin Tax*, EuroIntelligence, 26 November 2009
563. European Central Bank *Opinion of the European Central Bank at the request of the Belgian Ministry of Finance on a draft law introducing a tax on exchange operations involving foreign exchange, banknotes and currency*, CON/2004/34, 4 November 2004
564. Schulmeister, S., Schratzenstaller, M. & Picek, O. *A General Financial Transaction Tax: Motives, Revenues, Feasibility and Effects*, March 2008, pg. 18

An argument made by proponents of the financial transactions tax is that it would discourage high volume, short term trading. High frequency trading (HFT) is when traders buy and sell stocks in very short spaces of time, in order to capture small but numerous profits. Critics say that this kind of trading fuels market volatility and has no social value. Further, executing these transactions at very high speeds could exacerbate market failures. But there are also many benefits of HFT including liquidity provision, lower transaction costs and price discovery. Adjustments in prices have been getting quicker anyway as technology has improved.

Cowen argues that much of the criticism of HFT is unfounded and a reflection of misdirected anger after the financial crisis:[565]

> *[There] is lots of talk of "unfairness" and "manipulation," combined with snide references to the financial crisis. I'd like to see a serious efficiency argument against high-frequency outlined and defended, without the polemics. That would include a case that regulation will prove workable and catch only the "bad liquidity," while at the same time avoiding capture by envious and inferior competitors.*

Academic studies have shown that rather than distorting prices, HFT can actually help to make prices more efficient. This is because HFT tends to trade in the direction of permanent price changes and in the opposite direction of transitory pricing errors. A 2011 paper found this to be true on average trading days and the highest volatility trading days.[566] There is also no evidence that HFT makes markets more volatile. In fact, a paper by Brogaard found that high frequency traders and computer based algorithms act in the same way a longer term trader would. Increased stock specific volatility causes HFT firms to reduce aggressive activity. The author also finds that HFT actually decreases intraday volatility.[567]

Cowen argues that HFT can bring social benefits by reducing the gains from rent seeking to nearly nothing:[568]

> *Long-term investors do not have to buy and sell into the possible froth. HFTers thus "tax" the traders who were previously the quickest to respond, discourage their trading, and push the rent-seeking costs of those traders out of the picture. More fast computers, fewer carrier pigeons.*

There are a number of ways in which government action made the financial crisis worse

A Financial Transaction Tax is particularly irrelevant to the recent financial and economic crisis. Its root cause was simply that too many big banks were too exposed to unreliable mortgage loans. When a housing bubble in the United States burst, those banks got into huge trouble and taxpayers' money was used to keep many of them afloat. Reducing the number of financial transactions at any point would not have changed anything (and many mortgage collateralised debt obligations were held for long periods, not constantly traded).

There are a number of ways in which government action made matters worse. In the build-up to the crisis policy often encouraged banks to take more risks. Low interest rates, in particular, encouraged both more borrowing and riskier lending.

---

565. Cowen, T. High-frequency trading, *Marginal Revolution*, July 2009
566. Hendershott, T. & Riordan, R. *High Frequency Trading and Price Discovery*, Social Science Research Network, 2012
567. Brogaard, J. *High frequency trading and volatility*, Social Science Research Network, 2012
568. Cowen, T. *Do our intuitions about deadweight loss break down at very small scales?*, Marginal Revolution, May 2011

Even the housing bubble itself cannot be separated from policy decisions, as strict planning regulations make the supply of housing more inelastic and mean changes in demand are almost entirely reflected in prices. Once the crisis got underway, regulators performed poorly and made matters worse once again. There were clearly problems at the Financial Services Authority and the Bank of England has been described as "flying blind" with the tripartite system leaving it bereft of the detailed information on individual banks needed to maintain financial stability. Finally, regulations exacerbated the crisis.

As far back as 2004, a study for the Board of Governors of the US Federal Reserve System had warned that Basel II's capital requirements would be procyclical.[569] Friedman and Kraus argue that "by encouraging banks to invest in highly rated mortgage-backed bonds, the Basel Accords created an overconcentration of risk in the banking industry" and "accounting regulations required banks to reduce lending if the temporary market value of these bonds declined, as they did in 2007 and 2008 during the panic over subprime mortgage defaults."[570]

The last serious deposit bank failures in Britain, before the recent crisis, were in 1878, when the City of Glasgow Bank and the West of England & South Wales District Bank failed.[571] The Tobin tax is not the way to return the British banking system to that kind of stability.

Existing Stamp Duty on shares already leads to substantial distortions in how people trade, as it does not apply equally to all financial products. Spread betting is not subject to Capital Gains Tax or Stamp Duty and that partly explains why it has grown relative to the direct trading of shares. Contracts for difference (CFDs) are subject to Capital Gains Tax but not stamp taxes and are sometimes preferred by investors who want to be able to claim relief through Capital Gains Tax for losses.[572] While a more comprehensive financial transaction tax might erode those differences, that would likely close off ways that the impact on activity in Britain – and therefore employment and taxable income – has been limited, and make the overall distortion from the tax even worse. Instead of just executing some trades in other countries, or buying out of the tax through a clearing service – though that arrangement has been challenged in the courts[573] – or trading in different ways, more trading may move wholesale to other jurisdictions.

The measure is likely to create significant economic harm overall. Even the European Commission's own impact assessment found that "at 0.1 per cent, a transaction tax on securities could, without the application of mitigating effects, reduce future GDP growth in the long run by 1.76 per cent of GDP and of 0.17 per cent at a rate of 0.01 per cent".[574] The Danish economy minister Margrethe Vestager has said that the measure could cost hundreds of thousands of jobs.[575]

569. Sinclair, M., Petrova, D. & Smith, D. B. *How inept regulation and poor policy decisions drove the financial crisis*, TaxPayers' Alliance, 23 November 2008

570. Friedman, J. & Kraus, W. *Engineering the Financial Crisis: Systemic Risk and the Failure of Regulation*, 2011

571. Capie, F. & Collins, M. *Have the Banks Failed British Industry?* Institute of Economics, Hobart Paper No. 119, July 1992

572. Bennett, T. The advantage of spread betting – no taxes, *MoneyWeek*, 21 October 2011

573. Morgan Lewis *United Kingdom Stamp Duty Reserve Tax: Clearance Services*, 8 October 2009

574. European Commission *Executive Summary of the Impact Assessment accompanying the document Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC*, Commission Staff Working Paper, 28 September 2011

575. Wallace, T. Danes join Cameron in fight against financial transactions tax, *City A.M.*, 11 January 2012

6.2. Wealth taxes lead to capital flight or constitute retrospective taxation

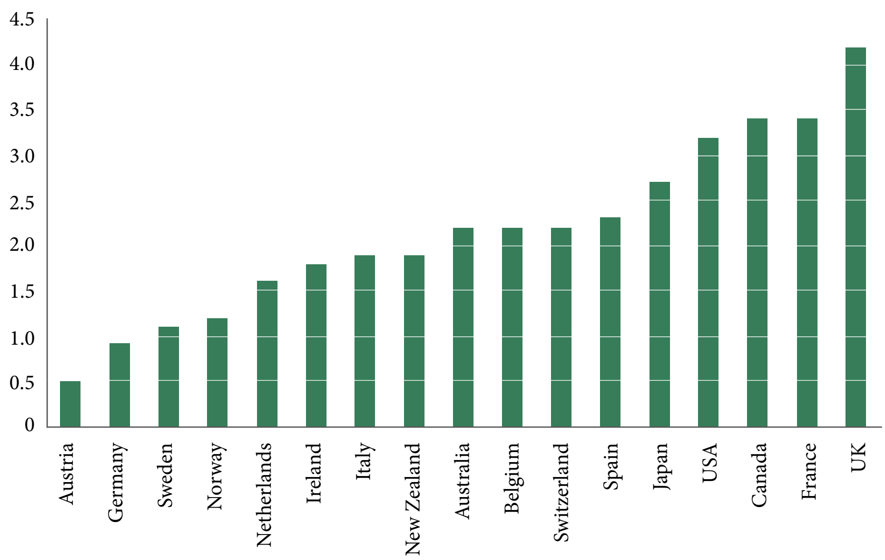
There have recently been a number of proposals to increase the taxation of wealth. These are partly based on a misconception that property, the principal store of wealth for most British families, is relatively lightly taxed. However that is not the case compared to other developed economies. Britain in fact has the highest property taxes as a share of national income in the OECD.[576]

Partly for that reason, those new taxes are unlikely to generate substantial new income. Revenue from taxes on wealth has been in decline as a share of total revenue across the developed world for a number of decades,[577] and annual wealth taxes raise considerably less than existing taxes on residential and business property.

Cabral and Hoxby report that in the US there are "fairly regular 'tax revolts' against the property tax, many of which are based on local or statewide referendums. Property tax limits, whether imposed by referendums or by state legislatures, often remain binding for a number of years – even decades. In contrast, successful revolts against other taxes, such as the income, sales, or corporate tax, are rare and often temporary. Although limits on other taxes are often considered and occasionally enacted, it appears that the public rarely has the will to insist upon their literal enforcement. In part because of tax revolts, tax limits, and general antipathy towards the property tax, property tax revenue has declined greatly as a share of all taxes collected in the U.S. It has also declined as a share of U.S. GDP."[578]

Broad popular hostility to taxes on property may partly be due to loss aversion, the well-established psychological finding that people prefer avoiding losses to acquiring gains. That explains why a tax on income (which reduces your gain) is less painful than an equivalent property tax (which creates a loss).

Figure 6.1: Property taxes as a share of national income, OECD



576. OECD *Revenue Statistics*
577. Kessler, D. & Pestieau, P. *The Taxation of Wealth in the EEC: Facts and Trends*, Canadian Public Policy, 1991
578. Cabral, M. & Hoxby, C. *The hated property tax: salience, tax rates, and tax revolts*, Stanford University Working Paper, 2010

The fundamental challenge is that taxes on assets that are easy to move or sell are avoided, either by shifting to different assets or moving the assets abroad. But taxes on assets which are hard to move or sell are retrospective and unfair. People are taxed on decisions they have already made and it can be very hard for them to pay.

That means that wealth taxes create more hardship and economic disruption than equivalent income taxes. Attempts to address those problems often end up creating highly complicated taxes where different assets are treated very differently. That distorts people's decisions and makes the whole system far less efficient.

The last serious attempt to introduce a wealth tax in Britain came in the 1970s, but then Chancellor of the Exchequer Denis Healey gave up after finding it "impossible to draft one which would yield enough revenue to be worth the administrative cost and political hassle" (Section 6.2.1). In other European countries they have introduced such taxes and have found they lead to substantial capital flight (Section 6.2.2.1) and unfair treatment for many classes of asset (Section 6.2.2.2). As a result of those problems, revenues are normally limited (Section 6.2.2.3).

Another way of achieving a similar objective is to introduce a mansion tax. That would likely lead to very unfair results or create huge administrative problems though (Section 6.2.3). Such taxes, and other tax hikes on property, are often justified by a supposed need to tax imputed rents but to the extent that logic is credible it would imply taxing all manner of non-market transactions in a way that is practically unthinkable (Section 6.2.4.3).

6.2.1. The last proposals for a wealth tax in Britain were abandoned on the grounds they would create capital flight and treat the owners of some assets unfairly

British politicians have been considering wealth taxes for a number of decades. Glennerster, at the Centre for the Analysis of Social Exclusion, has studied the most serious attempt to introduce it here.[579] Before the 1964 general election the Labour Party Tax Working Party produced an internal report, with an attached paper by Nicholas Kaldor setting out the case for a wealth tax, which argued:

> *We are in favour of an annual Wealth Tax [on the grounds explained by Prof Kaldor in RD 677] namely that it is not only income but wealth which represents spending power and that an equitable tax system should take account of both.*

For the February 1974 general election, that was translated into a manifesto commitment to "introduce an annual Wealth Tax on the rich; bring in a new tax on major transfers of personal wealth; heavily tax speculation in property – including a new tax on property companies."

After it was elected the new Labour Government pressed ahead but, with concerns in the Treasury that the tax would undermine economic confidence and lead to a "possible exodus of UK capital", and opposition from external interests and in Parliament, those plans were abandoned. A Treasury paper, looking at the likely impact, concluded that a wealth tax:

- Will lead people to seek non-resident status, resulting in a considerable outflow of funds in the form of dividends and interest.
- Since it will apply to all wealth held world-wide, foreign employees in foreign companies resident here would be subject to tax. This would result

579. Glennerster, H. *A Wealth Tax Abandoned: The role of the UK Treasury 1974–6*, CASE/147, June 2011

in a big movement of banks, insurance and shipping business moving out of the UK.
- Assets held here would be affected. This would reduce the level of business in UK.

The civil servants involved met the Treasury Permanent Secretary in secret and concluded that "the tax would produce little revenue, be extremely difficult to administer and risk serious damage to the economy and run into serious opposition."

They approached the Chancellor Denis Healey with those concerns, who then briefed the Prime Minister and the plans were shelved. Those plans were not revived despite concerns that might endanger relations with the unions.

Healey concluded that the measure was a mistake:

> *Another lesson was that you should never commit yourself in Opposition to new taxes unless you have a very good idea how they will operate in practice. We had committed ourselves to a Wealth Tax: but in five years I found it impossible to draft one which would yield enough revenue to be worth the administrative cost and political hassle.*

"I found it impossible to draft one [a wealth tax] which would yield enough revenue to be worth the administrative cost and political hassle"

Denis Healey

6.2.2. Wealth taxes in other European economies have been ineffective and economically harmful

6.2.2.1. Wealth taxes in other European countries lead to significant capital flight

The *Financial Times* reported that the Swedish wealth tax was abolished in 2011 in response to capital flight:[580]

> *The move will have virtually no effect on government finances. The tax raises around SKr4.5bn a year from just 2.5 per cent of all tax payers, but it has been blamed for years of massive capital flight from the country estimated at up to SKr1,500bn.*

Research for the Swedish tax authority in 2002 found that capital flight from Sweden had amounted to 275 billion Swedish kroner since the beginning of the 1980s, around 400 billion in 2002 prices or 500 billion assuming that capital would otherwise have grown at five per cent a year.[581]

That finding has been updated by the Swedish Enterprise Institute, which found that – based on the same five per cent annual growth rate of capital – capital flight from 1980 to 2005 was 973 billion Swedish kroner.[582]

In December 2011, Italian Prime Minister Mario Monti said that his government had dropped plans for a wealth tax after finding that it risked capital flight and would not produce a significant increase in revenue.[583] Both the Irish and Dutch governments cited capital flight as the primary justification for scrapping their wealth taxes as well.[584]

Hansson argues that the wealth tax deters entrepreneurs. She reports that using "simple differences-in-differences estimation using abolition of the wealth tax in

580. Ibison, D. Sweden axes wealth tax, *Financial Times*, 28 March 2007
581. Persson, A. *Oroliga skattebaser – Riskområden för skattefel med internationell anknytning*, January 2002, http://lowtax.es/Hi31mQ
582. Their estimate of how capital flight has grown is shown here: http://lowtax.es/HdE1fh
583. Davis, Monti Says Wealth Tax Risked Producing Capital Flight From Italy, *Bloomberg*, 13 December 2011
584. Heckly, C. Wealth Tax in Europe: Why the Downturn? in Taly, M. & Mestrallet, G. *Estate Taxation: Ideas for Reform*, Institute Reports, Institute de l'enterprise, June 2004

four countries as natural experiments, it is found that abolishing wealth tax increases self-employment by 0.2 to 0.5 percentage points."[585]

The dangers of capital flight have been enough to cause a number of countries to abandon wealth taxes, and others to cancel plans to introduce them.

6.2.2.2. Wealth taxes in other European countries often treat different assets unequally

It is extremely difficult to treat all assets equally under a wealth tax due to pressure for exceptions. Those exceptions are not simple mistakes that proponents of a new wealth tax can wish away. They result from practical considerations, which have been summarised by the Institute for Fiscal Studies:[586]

> *Governments do not generally try to tax wealth held in the form of pension rights. Wealth tax can be more easily imposed on all real estate owned directly by the relevant person or indirectly through a company. However, should any reliefs be given for agricultural property or business property? If these assets are not subject to wealth tax then the desired social effects would not be achieved. On the other hand, a wealth tax on capital could prove an unacceptable burden for the owner of illiquid assets since the assets may well not generate sufficient income to enable the owner to pay an annual wealth tax on the capital. Presumably there would be some sort of exemption given for household chattels up to a certain value; if works of art are charged this could well lead to a dispersal of the national heritage. (France exempts works of art and the 1974 Green Paper proposed that assets of pre-eminent national importance should be exempted from wealth tax while made available for public display.) While one could give a conditional exemption for works of art (not merely a deferment) provided the owners continued to meet appropriate conditions about public access there are particular issues of disclosure and valuation for works of art. It is easy to hide a picture. There would be very adverse economic results if wealth tax was imposed on holdings of UK quoted shares by non-residents but if wealth tax is imposed on any commercial enterprises here it is likely to deter foreign investment.*

They also ask whether a tax should be levied on net or gross assets. Taxing gross wealth could produce quite unfair results but taxing net wealth would create opportunities for tax avoidance.

There is not only the question of which classes of asset are included, but how they are valued. For example, in Germany real estate was considerably undervalued, as the official taxation bases were not updated, whereas financial assets were valued at market rates. The inequity of the tax ultimately led to it being declared unconstitutional by the Constitutional Court and abolished in 1997.[587] In Britain, rising property taxes are in danger of creating the same problem in reverse, with much higher taxes on property than other assets.

Treating different classes of assets differently is not just unfair. It also distorts resources allocation. People base their investment decisions on the quirks of the wealth tax and how it interacts with existing taxes on business assets in particular,

---

585. Hansson, A. The Wealth Tax and Entrepreneurial Activity, *Journal of Entrepreneurship*, 17, 2, 2008
586. Boadway, R., Chamberlain, E. & Emmerson, C. Taxation of Wealth and Wealth Transfers in *Dimensions of Tax Design*, Institute for Fiscal Studies, 2010
587. Silfverberg, C. *The Swedish Net Wealth Tax – Main Features and Problems*, Stockholm Institute for Scandinavian Law, 2009

rather than on returns. Over time any misallocation of resources will diminish economic growth.

6.2.2.3. Wealth taxes in other European countries produce underwhelming revenues, thanks to small bases and capital flight

Kessler and Pestieau found that there were substantial exceptions in existing wealth taxes. They argued those exceptions explain why revenue tends to be underwhelming, and a wealth tax does not allow for the promised reductions in other taxes thanks to its underwhelming base:[588]

> *First, several categories of assets are excluded from the tax base. In no country does the value of pension rights enter into the tax base. Moreover, with the exception of Spain, furniture, jewels and domestic properties are also tax-exempt. Objects of art, patents, copyrights, three-quarters of the value of agricultural land and forest and business properties are also exempted in France.*
>
> *Second, there are thresholds which vary substantially from $9,000 in Luxembourg to $520,000 in France for a married couple with two children. These thresholds are explicitly price-indexed in the Netherlands only.*
>
> *Third, several countries have provisions which limit the proportion of income that can be taken as wealth and income taxes combined. The level of this ceiling varies across countries: 70 per cent in Denmark, France and Spain, and 80 per cent in the Netherlands.*
>
> *Fourth, there are valuation provisions and avoidance schemes that (further) contribute to shrink the tax base. In addition, the assessed or estimated value of real estate is often undervalued. For stocks and bonds, the market value is used, but their holdings are sometimes not reported by residents, and more unlikely by non-residents.*

In France, they estimated that only 100,000 households out of a total of 20 million paid the tax. Assuming they were the wealthiest, those households' wealth would have been about 19 per cent of total private wealth but only a fraction of that was subject to the tax. The final yield rate, tax revenue as a percentage of total wealth, was a tiny 0.04 per cent. That leaves the tax ineffective both as a source of revenue and as a means of redistribution.

The low revenue is particularly onerous given that the management costs of the tax are high. In 1976, Germany's Union of Fiscal Civil Servants argued the wealth tax should be abolished due to its complexity. In the Netherlands a study showed cost of collection was 26.4 per cent of revenue as opposed to 4.8 per cent for income tax.[589]

6.2.3. Introducing a mansion tax would produce administrative disruption and unfair results for some homeowners

Another measure proposed to tax wealthy people is a mansion tax. There have been a number of different proposals described by this term:

- An annual tax on the value of expensive properties. In their manifesto for the 2010 general election, the Liberal Democrats pledged to introduce

588. Kessler, D. & Pestieau, P. The Taxation of Wealth in the EEC: Facts and Trends, *Canadian Public Policy*, 1991
589. Heckly, C. Wealth Tax in Europe: Why the Downturn? in Taly, M. & Mestrallet, G. *Estate Taxation: Ideas for Reform*, Institute Reports, Institute de l'enterprise, June 2004

a “Mansion Tax at a rate of one per cent on properties worth over £2 million, paid on the value of the property above that level.”

- Removing the exception for first homes from Capital Gains Tax for properties above a certain value. In June 2011, it was reported that the Liberal Democrats were pushing for the introduction of Capital Gains Tax on profits from first homes worth over £1 million.[590]
- Introducing new rates of Council Tax. Anthony Browne for example has raised the possibility of new higher Council Tax bands to differentiate between high and very high value properties.[591]

Of these proposals, the new rate of Council Tax seems the simplest and most practical, but the structure of Council Tax should ideally reflect local circumstances and new bands might necessitate an expensive and unpopular revaluation.[592] A revaluation should not be used to impose an increase in overall taxation or it will create the problems seen in prior attempts to revalue discussed in Section 8.2.3.1. The most disruptive of the three options would probably be the first, as it would make things very difficult for those with high value properties relative to their incomes.

The Treasury is consulting on introducing such a charge for a small number of homeowners who hold homes through corporations, as part of the crackdown on the use of such a structure to avoid the tax. The combination of that annual charge with a new rate of Stamp Duty making it more expensive to sell the property is likely to create significant disruption. Those using the structure now will be unable to keep or transfer the property without a heavy tax bill, and is only expected to raise £65 million in 2014–15.[593] While most of those affected may be foreign owners previously avoiding Stamp Duty, others may use corporate envelopes for privacy reasons instead.

There are a number of situations in which any mansion tax would not properly reflect people’s circumstances:

There are a number of situations in which any mansion tax would not properly reflect people’s circumstances

- House prices can vary sharply between different parts of the country and over time. Someone could pay a mansion tax on a relatively modest family home in London but not in a much larger house in the countryside. And more families are likely to have to pay the tax over time if the threshold does not increase in line with house price inflation.
- Someone could have a flat in London and a house in the countryside and escape the tax while someone with a single London family home pays it.
- Someone struggling to pay an 80 per cent mortgage on a £2.1 million property has much less net wealth than someone with who owns a £1.9 million property with no mortgage.
- Someone with £10 million in liquid cash and a villa in Monaco, but who has only a small property in London, would not pay the mansion tax whereas someone with a £2.5 million family home in London and no other assets would.

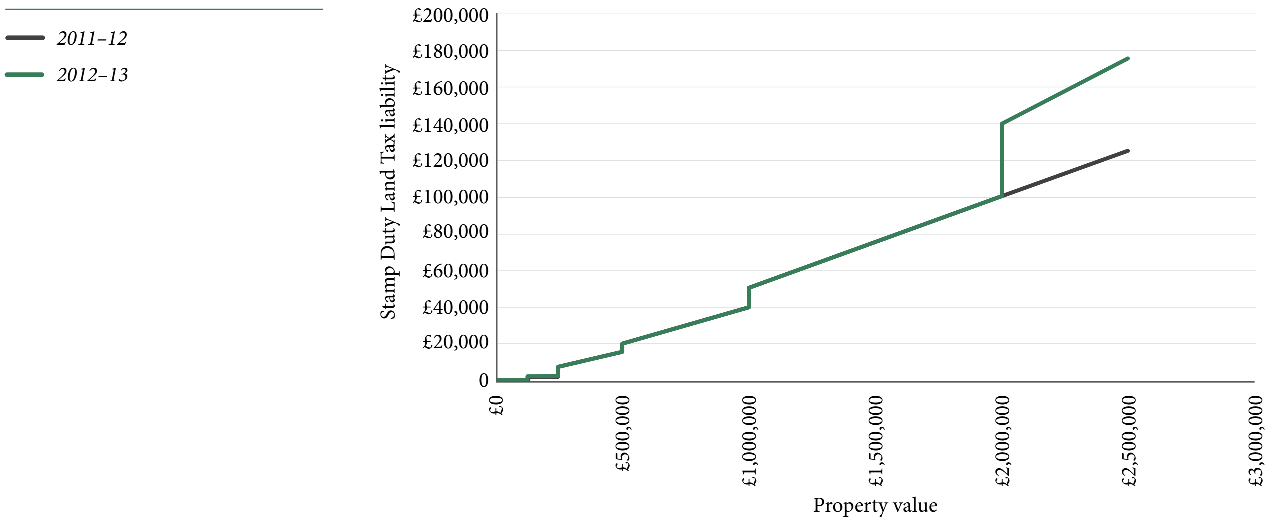
590. Eaton, G. The Lib Dems’ new property tax plan, *New Statesman*, 24 June 2011
591. Browne, A. Wealth taxes are in decline, except in ‘Liberal Democrat World’, *ConservativeHome*, 22 September 2011
592. Moss, J. Some difficult facts about implementing a Mansion Tax, *ConservativeHome*, 25 February 2012
593. HM Treasury Budget 2012 policy costings, March 2012

If a mansion tax is designed poorly it could easily affect different people in very arbitrary ways. Given that property is already heavily taxed the most promising of these proposals is probably new bands for Council Tax. But any tax on property people have already bought – which is expensive for people to sell – in part thanks to the tax system, will be disruptive.

If such a tax were introduced, its inequities could easily lead quite quickly to demands for a more comprehensive wealth tax, particularly given that revenue is likely to be underwhelming. Research for the Centre for Policy Studies has reported that it is unlikely to raise more than £1 billion.[594] There is certainly little reason to think that sufficient revenue can be obtained that it would enable significant cuts in taxes on income or consumption. The introduction of a wealth tax would in turn result in capital flight and the other problems created by a broader wealth tax.

The same inequities are created by Stamp Duty thanks to its slab rate structure. With the introduction of a new rate of seven per cent on properties sold for over £2 million at Budget 2012, for example, someone selling a property for just over £2,000,000 will pay £140,000. By contrast, someone selling a property for just under £2,000,000 will pay £100,000. An additional pound of property value increases the tax by £40,000. That is likely to highly distort the market and property prices. The slab rate structure, and the sharp increases in liability it produces as property values rise, is shown in Figure 6.2.

Figure 6.2: Stamp Duty liability by property value



And, in just the same way, someone selling two £1.5 million properties for £3 million will pay £150,000 in Stamp Duty, whereas someone selling a single £2.5 million property will pay £175,000. In other words, they would pay £25,000 more in tax despite a £500,000 lower total value.

Stamp Duty also makes it harder for people to respond to changes in circumstances. It has all of the problems associated with a transaction tax in that it impedes the effective allocation of capital (Section 6.1). As it is more expensive for people to move, some will not go where they can find work and will not sell to those who might value the property more. The slab rate structure has been described in the Mirrlees Review as "especially perverse".

594. Cook, L. *Taxing Mansions: The taxation of high value residential property*, Centre for Policy Studies, 5 March 2012

The report argued that there "is no sound case for maintaining stamp duty and we believe that it should be abolished", though it did argue for the introduction of other property taxes. Stamp Duty is still vulnerable to avoidance, even after the changes made at Budget 2012. Reports suggest that people are leasing properties rather than selling them, or even selling options to buy houses at a future date to avoid a Stamp Duty liability.[595] The 2020 Tax Commission also recommends the abolition of Stamp Duty.

Property will be taxed through taxation on income from rent, as part of the capital income tax (Section 5.1.5), and Council Tax (Chapter 8).

6.2.4. Higher property taxes open up property rights without good reason and are unjust and disruptive

6.2.4.1. Opening up property rights is unjust and disruptive

Taxing investments that may have been made many years ago means opening up property rights. Someone has bought something and owns it, then that ownership is called into question by a tax which extracts a part of the value each year. Breaching the principle of secure property rights is extremely unfortunate as that principle is at the heart of the stable capital accumulation and rule of law that is fundamental to economic prosperity.

As Lilico argues, if we accept Locke's case that property exists conceptually prior to states, then we should not believe in wealth taxes:[596]

> *The ethical justifications for wealth taxes are either that the state creates a property right – and so charges for enforcing it – or that all property is fundamentally collective and only held on license by private individuals (so a charge is made for use). The state exists fundamentally to regulate activity and interaction, and to protect property. Proper laws say we must or must not do such-and-such; they do not say we must or must not be such-and-such. By regulating activities the state adds value. It is thus justifiable, in principle and in moderation, for the state to claim a portion of the value added in activities – e.g. in transactions. So the state can charge me for buying or selling something or for hiring someone.*
>
> *But if the state charges me for simply owning things, it is not taking a portion of what it itself has created. Instead, it is plundering that which it exists to defend – private property.*

In recommending policies for the developing world, many commentators have pointed to the importance of establishing strong property rights. Weak property rights are widely seen as an impediment to capital accumulation and economic development;[597] World Bank research even suggests they cause civil wars.[598]

While property taxes are not a breach of the principle of secure property rights to the same extent that they are responsible for extreme poverty, they are still an infringement of rights which produce unjust results and economic harm.

595. Hammond, E. & Pickard, J. Rich root out stamp duty loopholes, *Financial Times*, 6 April 2012
596. Lilico, A. Conservatives believe in property and we should understand that a Conservative should not believe in wealth taxes, *ConservativeHome*, 29 March 2012
597. O'Driscoll, G. P. & Hoskins, L. *Property Rights: The Key to Economic Development*, Cato Institute, Policy Analysis No. 482, 7 August 2003
598. Djankov, S. & Reynal-Querol, M. *The Causes of Civil War*, World Bank, Doing Business, May 2007

Many high value properties were bought by their current owners years or decades ago. If someone wants to move in order to avoid paying the mansion tax that creates a number of costs:

- Finding a new property and moving into it, which costs time and money
- Disruption for their family
- Leaving behind a property to which they may have grown attached
- Paying Stamp Duty at five or seven per cent of value on properties likely to be eligible for mansion tax

As a result of decisions made some time before the tax was introduced, owners would be forced to either stay and pay the tax or move and pay those other costs. That means property taxes constitute retrospective taxation.

Retrospective taxation is illiberal and unjust in itself. It also deters capital accumulation. Anyone considering investing in property or other assets that might be subject to similar retrospective taxation in future will be deterred from doing so, or encouraged to invest in other countries where property rights are better respected.

6.2.4.2. Dry tax charges are disruptive and unfair

Most tax charges are associated with market transactions which mean that those paying them have money on hand. Income taxes and consumption taxes for example, take a share of the money that a certain person or business is being paid. Taxes on property that people already own – such as Council Tax and proposals for a Mansion Tax or Land Value Tax – are dry tax charges, not necessarily levied when people have the cash to pay them.

That can create serious hardship. Council Tax is currently a heavy burden on elderly people with fixed incomes. Help the Aged criticised how thousands of pensioners have fallen into "council tax poverty", where it takes over 10 per cent of their income, and been forced to cut their budgets for things like food and heating to afford tax rises.[599]

Business rates are also high which makes calls for a Land Value Tax odd. Given that residential and commercial property is already taxed at a local level, proposals for a Land Value Tax either double tax property or have a very narrow base. Nicholas Boles MP called for a Land Value Tax where "farmland and people's main homes are wholly exempt".[600] But given that non-domestic rates are already levied on commercial property, and assuming that we do not want to double tax those properties, all the new tax would really do is extend taxation to some properties like second homes and empty properties.

It would be unfortunate to take Council Tax away from being a charge connected to the services people consume. However, the bigger problem is that taxes on empty or otherwise less productive property can create unfortunate incentives for the owners.

Research for the TaxPayers' Alliance looked at the effect of new taxes on empty business properties which were introduced in 2010. It noted widespread evidence that buildings were being demolished to avoid the new tax. Nick Martin, lead member for finance at Swindon Borough Council at the time, said that: "We are spending public money demolishing buildings to avoid this ill-thought out stealth tax … Swindon, like many other towns across the country, could suffer if

599. BBC News *OAPs 'facing council tax poverty'*, 21 March 2005
600. Boles, N. It sounds bonkers but we should embrace a land tax, *Financial Times*, 29 September 2011

regeneration projects are shelved as a result of this." It is always likely that properties will fall empty in a recession as firms go out of business and then be reoccupied in an economic recovery. If they are demolished before that, then less slack in the property market will mean it is harder for firms to grow, slowing the overall economic recovery.[601]

In just the same way, other dry tax charges on property will tend to discourage capital formation. There are rightly concerns that a mansion tax would deter maintenance and improvement of high value properties, as that would increase their value and thereby increase the amount of tax due.

The objection to this is that people can liquidate those assets and pay the tax that way. That often causes substantial disruption though, as people are very attached to their homes and, as discussed in Section 6.2.4.1, there are significant transaction costs even without Stamp Duty. Forcing people to sell their homes is deeply unpleasant and is something tax reform should aim to avoid.

Their only alternative would be to raise the money by borrowing against their estate through equity release schemes. Also known as home reversion plans or lifetime mortgages, those schemes allow elderly home owners to cash in on the value of their homes and repay the debt when they die. But that would constitute a substantial additional tax on their estate: not just to pay the annual tax which, while a small share of the property value each year, could add up to a very large share of the property value over decades; but also to pay substantial borrowing costs. The *Daily Telegraph* personal finance editor Ian Cowie explains the problem:[602]

> *Facile suggestions that victims could seek equity release schemes ignore the fact that these lifetime loans typically cost twice as much as conventional mortgages. With interest rolling up at 7pc per annum, a debt will double in little more than a decade.*
>
> *What kind of Conservative Chancellor of the Exchequer would force older homeowners to choose between losing a lifetime's memories in the family home or allowing eye-watering interest charges to destroy a lifetime's savings?*

Wealth or mansion tax proposals could actually mean an extremely high effective rate of inheritance tax.

If someone owned a house worth £500,000 from the age of 55 till they died at 80, a wealth tax of one per cent on its entire value would mean they would have to pay £130,000 – 26 per cent of its value in tax. If they borrowed the £5,000 each year, at a typical interest rate on an equity release policy of around seven per cent, that would mean a total bill to their estate of £343,382, or 69 per cent of its value.

For a property of £2 million, under the same assumptions, the total charge on their estate would be £1,373,529. Assuming the existing Inheritance Tax remained in place, that would further reduce the total value of their estate, equivalent to a very high combined rate of 75 per cent (with no threshold). That would be deeply unfair for reasons discussed in Section 5.2.2.2.

6.2.4.3. Imputed rent does not justify high property taxes

There is a case that property should be taxed more as those who own their own homes are not currently taxed on the imputed rent, the benefit they take from

601. O'Connell, J. *Empty Property Rates*, TaxPayers' Alliance, 20 March 2011
602. Cowie, I. Budget 2012: how 'mansion tax' would hit countryside and cities, *Daily Telegraph*, 16 March 2012

owning that home by living in it and not having to rent somewhere to live. Britain used to tax imputed rents though – "Schedule A" was abolished in 1963 – and the reasons for its abolition show why taxing imputed rent would be unfair and inefficient now. More recently, Norway abolished the tax in 2005.

There are many ways in which people receive goods or services that, because they are non-market transactions, are not taxed

There are many ways in which people receive goods or services that, because they are non-market transactions, are not taxed. If one parent stays at home instead of both going to work and buying childcare, the labour at home will not be taxed. We do not charge annual imputed rents on machines or other capital that people own. As a letter to the editor of *The Times* on 5 February 1959 put it:[603]

> *The whole case for abolition of Schedule A tax on owner-occupied premises rests on the inequity of singling out one form of property and attributing an annual income to it. The inequity is only increased by treating such income as unearned. It would be interesting to hear what the Treasury would say about the position of the man who put his money into a piece of precision machinery rather than purchase his own business premises. Would the officials like to put an annual value on the piece of machinery and tax that part of his business profit as unearned income? The fact is that distinction between one class of "property" and another for taxation purposes is out of date.*

Any tax increases the cost of employing labour relative to doing something yourself. That is one reason why lower tax rates are important. There is no reason to single out owner-occupied property. Though it is dressed up in economic theory, imputed rent could as easily be called imagined rent. Taxing someone for renting their property when they haven't rented it is sufficiently artificial that the practice was seen as illegitimate and was consequently abolished.

These taxes discourage spending on maintenance and improvement of property, as a more valuable property means a higher imputed rent. As a result, Schedule A had an allowance for that spending which undermined the size of the base and was highly complicated, which led to unfair results as many people did not claim reliefs to which they were entitled. Gerald Nabarro MP argued that:[604]

> *In his opinion it was illicit because if all owners knew their fiscal rights and privileges, the Chancellor would collect practically nothing. There were six million houses assessed for Schedule A. Every one of those taxpayers could make a maintenance relief provided they spent money on repairs and so on. Out of that six million last year only 600,000 had made maintenance relief claims.*

The cost of collecting the tax concerned the Board of the Inland Revenue, who "were disturbed to find that the cost of collecting Schedule A tax in relation to its yield, about four per cent, was probably about three times as high as the relative cost of collecting other taxes."[605]

The Association of Certified and Corporate Accountants[606] and the Institute of Taxation both recommended abolishing the tax before it went.[607] Given that there

603. Letter to the editor *The Times*, 5 February 1959
604. *The Times* General dislike of Schedule A tax, 22 June 1960
605. *The Times* Schedule A Tax Collection, 6 December 1961
606. *The Times* Chancellor urged to abolish Schedule A tax, 11 January 1960
607. *The Times* "Abolish Schedule A tax" call, 9 March 1960

was a substantial debate over this measure before it was abolished with good reason, it would be incredible to bring it back now or attempt to duplicate it with other taxes.

There is no sensible way of avoiding taxes on investments by holding a number of owner-occupied homes, even if regulations do not limit someone to only owning one. While that would mean that someone was not taxed on the rents, so long as the tax rate was not absurdly high it would still be better to let the property out and obtain a rental income than leave it empty. On 11 February 1959, another letter to the editor of *The Times* argued that:[608]

> *To suggest that one will buy and occupy more than one house to avoid paying income tax on an income which one does not receive is to place a very low opinion on the standard of intelligence of the average investor.*

The real inequity between rented and owner-occupied properties is that main homes are not liable for Capital Gains Tax. As the 2020 Tax Commission proposes to abolish Capital Gains Tax that will no longer be an issue.

6.2.4.4. There is no evidence that people overinvest in property due to low taxes

There have been arguments that people in Britain simply invest too much in property, and that taxes should discourage them from doing so. There are a number of problems with that argument. It is hard to reconcile with the fact that Britain raises more from taxes on property than other developed economies, though that is partly a symptom of high house prices.

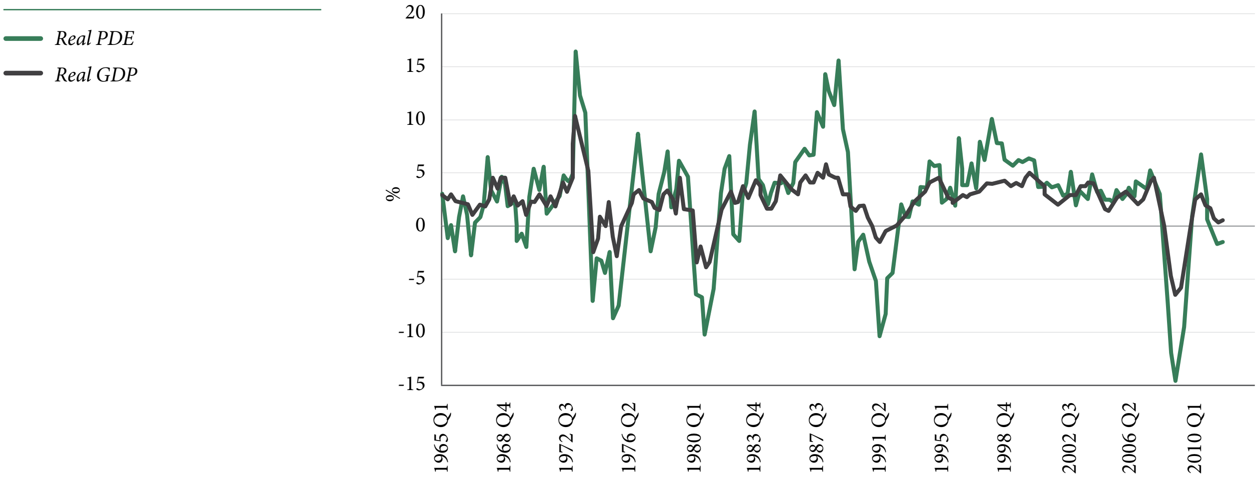
But more than that, low taxes cannot explain a property market where prices regularly boom and bust. Lower taxes would increase the fundamental value of property, by making it more affordable for buyers to pay a certain price. That would lead to a sustainable rise in prices rather than the rapid increases and decreases that have characterised the market for some time.

The best explanation for that pattern is that regulations in Britain make house prices far more volatile. As the supply of housing is extremely inelastic, shifts in demand are almost entirely reflected in prices. Those changes in prices have clearly played a central part in creating the present financial crisis. That also explains why property prices in those parts of the United States with strong planning regulations – what Paul Krugman has called "the Zoned Zone" – also saw a boom while those where constructing new property is easier did not.[609]

Underlying shifts in demand for assets are driven by monetary policy and prices overreact due to the fact that supply cannot respond to rising demand. That can be seen by comparing annual increases in UK broad money and house and share prices.[610]

608. Letter to the editor *The Times*, 11 February 1959
609. Krugman, P. That Hissing Sound, *New York Times*, 8 August 2005
610. House Prices: Department of Communities and Local Government; Share Price Index: FT Actuaries All Share Index; M4 Broad Money: Bank of England

Figure 6.3: Annual increases in UK broad money and house and share prices



There is nothing fundamentally irrational about investing considerable amounts in property. People attach considerable importance to their homes and policy should not aim to dissuade them from investing in buying a better one or improving the one they have. And it is not necessarily an obstacle to other investments. Many entrepreneurs invest using the equity they have built up in their home as collateral. Taxing property and diminishing home ownership is likely to make it more difficult for households to finance other investments when they need to.

Property taxes have been justified on the grounds that they are taxes on unearned wealth thanks to sustained and significant increases in house prices over time. But important research shows that property purchases are not the safe and lucrative investments that they are often portrayed as. Monnery produced new research in 2011 that showed how real house prices grew by just 1.3 per cent a year between 1900 and 2010 (and by just 0.8 per cent a year until 1995, before the bubble).[611] Indeed, looking at the figures we see that house prices were about the same in real terms in 1960 as they were in 1900. There has not been a steady increase in real prices in the way that is generally believed. In the US, real house prices grew by 0.2 per cent a year between 1900 and 2010; in Norway, they grew by 0.9 per cent a year during that same 110-year period; in Australia by 1.4 per cent a year. In Amsterdam, Monnery finds that they grew by 0.6 per cent a year on average over the past 110 years; and only by 0.4 per cent per year since 1628.

Another myth is that property taxes are particularly necessary because the UK has higher than normal levels of home ownership, compared with Europe where there is more of a rental culture. But in 2009 the home ownership rate was 69 per cent. In Spain it was 85 per cent, 78 per cent in Belgium, 77 per cent in Norway, 75 per cent in Ireland, 70 per cent in Australia, 67 per cent in the US and Canada, a still high 57 per cent in France and a lower but still significant 43 per cent in Germany.

611. Monnery, N. *Safe as houses? A Historical Analysis of property prices*, 2011

Table 6.2: Home ownership rates, by country

Country	Home ownership rate in 2009
Spain	85
Belgium	78
Norway	77
Ireland	75
Australia	70
UK	69
USA	67
Canada	67
France	57
Germany	43

In reality the rise in house prices does not reflect an unjustified rent to be taxed, but instead the consequence of people paying a lot for a scarce resource thanks to stringent limits on supply. Taxing property more would just make housing even less affordable. The proper objective should be to help ease the burden high housing costs impose on families, not exacerbate it.

Chapter seven

Other consumption taxes need to stay for now, but transport taxes should be cut

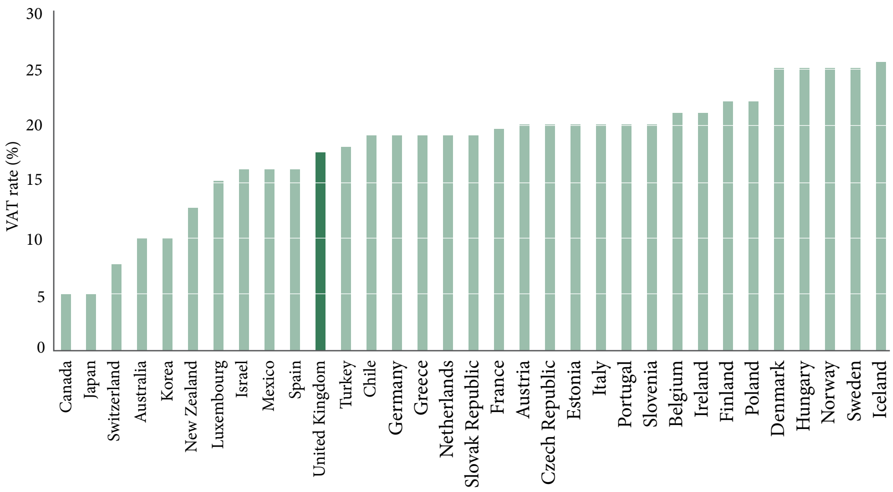
7. Other consumption taxes need to stay for now, but transport taxes should be cut

7.1. The burden of tax should not be concealed in prices

Britain's Value Added Tax (VAT) was introduced in 1973 as the country joined the European Union. Before accession, the UK operated a Purchase Tax with different rates based on the extent to which each good was felt to be a luxury. VAT raised £98.0 billion in 2011–12.[612] It is currently charged at a standard rate of 20 per cent on most goods and services, a reduced rate of five per cent on some goods such as electricity and gas and a zero rate on others such as food, books and children's clothes.

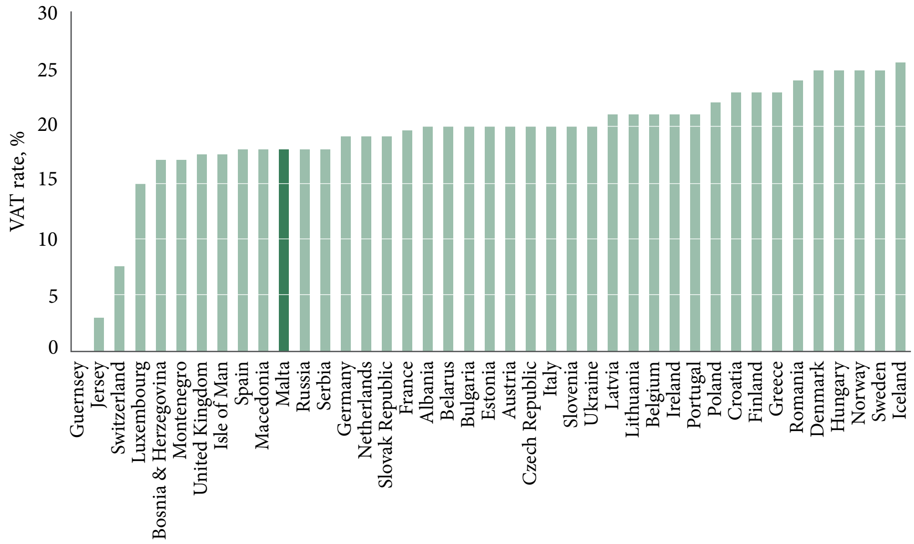
The KPMG Corporate and Indirect Tax Survey sets out consumption tax rates around the world since 2004.[613] The global average rate was 15.6 per cent in 2010, against 17.5 per cent in Britain (which rose to 20 per cent as part of the Government's plans to cut the deficit). The average for developing countries was 18.3 per cent and for European countries 19.7 per cent. Figure 7.1 shows Britain's rate before the rise to 20 per cent compared to other OECD countries. Figure 7.2 shows the same rate compared to other European countries.

Figure 7.1: OECD country VAT rates, 2010 (before the rise to 20 per cent in the UK)



612. HM Treasury *Budget 2011*, March 2011
613. KPMG *Corporate and Indirect Tax Survey 2011*

Figure 7.2: European country VAT rates, 2010



The structure and bases of sales taxes in the United States also vary substantially. In recent decades Britain has moved towards a European norm of high consumption taxes, and that process has been completed with the latest increase to 20 per cent. That rate is high compared to other countries outside Europe.

Along with other consumption taxes, VAT is not normally itemised on receipts or bills. It is a substantial stealth tax which is hidden within prices.

7.1.1. Higher taxes lead to a larger black market and broadly increase tax evasion

VAT is a substantial stealth tax which appears as higher prices

High taxes on goods such as cigarettes, alcohol, petrol and diesel can cause consumers to switch to the black market. The cost of fraud to the UK economy was £38.4 billion in 2010, according to the National Fraud Authority,[614] and a significant portion this will be made up of purchases on the black market. HMRC's estimates for the size of the illicit market share and the associated revenue losses for selected products are £24.5 billion between 2004–05 and 2009–10.

Table 7.1: Selected products and their official illicit market shares and associated revenue losses in 2009–10

Product	Illicit market share (upper estimate) (%)	Associated revenue loss (£m)
Beer	14	800
Spirits	11	440
Cigarettes	16	2,200
Hand Rolling Tobacco	50	880
GB Diesel	7	1,150
NI Diesel*	18	100
NI Petrol (2008–09 figures)*	20	80
Total		5,650

* Figures for Northern Ireland include losses associated with cross border shopping

614. National Fraud Authority *Annual fraud indicator*, January 2011

Table 7.1 shows those HMRC figures,[615] but estimates vary. For instance, the Tobacco Manufacturers' Association estimated in 2009 that non-UK duty paid consumption (NUKDP) accounted for 21 per cent of the cigarettes and 58 per cent of the hand rolling tobacco smoked in the UK.

The document that HMRC produces on these figures, *Measuring Tax Gaps*, is an annual report looking at a range of ways in which HMRC loses out on revenue, on direct and indirect taxes. When analysing losses to the illicit trade on the items outlined above, figures are provided for the amount lost in the previous five financial years. However, there is a strong tendency for the figures for a specific financial year to be revised up in later reports. This means that the figures HMRC supplies for the most recent year are likely to be an underestimate of how much revenue is actually lost to illicit trade.

A TaxPayers' Alliance research note found that £28.5 billion of tax revenue has been lost to the illicit market in spirits, beer, cigarettes, hand rolling tobacco and diesel between 2005–06 and 2009–10.[616] This would have been enough to fund a 1p cut in the basic rate of Income Tax during that period. Of this, £12.2 billion was lost to the illicit trade in cigarettes between 2005–06 and 2009–10; £6.4 billion was lost to the illicit trade in diesel; £4.5 billion was lost to the illicit trade in hand rolling tobacco; £3.2 billion was lost to the illicit trade in beer; and £2.3 billion was to the illicit market in spirits. While the data for diesel – estimated to have the largest black market – was not sufficient to allow a complete comparison, in all other goods there were sharp upward revisions of initially optimistic estimates.

Table 7.2: Tax gap estimates, spirits

Financial year	2008 report (£m)	2009 report (£m)	2010 report (£m)	2011 report (£m)	Difference between first and latest estimate (£m)
2002–03	500	–	–	–	–
2003–04	600	600	–	–	0
2004–05	250	250	350	–	+100
2005–06	400	400	450	430	+30
2006–07	450	450	550	550	+100
2007–08	–	350	550	550	+200
2008–09	–	–	300	310	+10
2009–10	–	–	–	440	–
Total	2,200	2,050	2,200	2,200	+440

615. HMRC *Measuring tax gaps 2011*
616. O'Connell, J. *Tax Gap: How cracking down on illicit trade could fund a 1.5p cut in the basic rate of Income Tax*, The TaxPayers' Alliance, April 2012

Table 7.3: Tax gap estimates, cigarettes

Financial year	2008 report (£m)	2009 report (£m)	2010 report (£m)	2011 report (£m)	Difference between first and latest estimate (£m)
2002–03	2,500	–	–	–	–
2003–04	3,000	3,000	–	–	0
2004–05	2,600	2,600	2,800	–	+200
2005–06	2,600	2,500	2,700	2,700	+100
2006–07	2,200	2,300	2,400	2,400	+200
2007–08	–	2,200	2,400	2,400	+200
2008–09	–	–	2,200	2,500	+300
2009–10	–	–	–	2,200	–

Table 7.4: Tax gap estimates, hand rolling tobacco

Financial year	2008 report (£m)	2009 report (£m)	2010 report (£m)	2011 report (£m)	Difference between first and latest estimate (£m)
2002–03	890	–	–	–	–
2003–04	840	840	–	–	0
2004–05	980	980	1,000	–	+20
2005–06	940	940	960	960	+20
2006–07	900	900	920	920	+20
2007–08	–	790	810	820	+30
2008–09	–	–	890	940	+50
2009–10	–	–	–	880	–

Schneider has produced influential literature on the informal economy. A 2002 survey looking at the size of the informal economy in 110 countries, including developing, transition and OECD economies, found that the average size of the informal economy, as a percentage of official GNI in 2000, was 41 per cent in developing countries; 38 per cent in transition countries; and 18 per cent in OECD countries. A large burden of taxation and social security contributions combined with government regulations were the main determinants of the size of the informal economy. He went on to estimate that the size of the UK's shadow economy in 1999–00 was 12.6 per cent of GDP, below the OECD average that includes economies such as Greece (where the black market makes up a far larger share of national income). However, the UK's shadow economy makes up a larger share of national income than the US, where fuel taxes in particular are far lower. Considering the scale of the work, it is telling that Schneider concludes that "in almost all studies it has been found out, that the increase of the tax and social security contribution burdens is one of the main causes for the increase of the informal economy."

Schneider updated this study a number of times, using 2002–03 and 2004–05 figures. Again, the key factors that increased the size of the shadow economy were high taxes and burdensome regulations.[617] In a paper from 2011, he examined the shadow economy and the shadow economy labour force, more specifically. Again he concluded that "the most influential factors on the shadow economy and/or shadow labor force are tax policies and state regulation, which, if they rise, increase both."[618] In another paper, Schneider found that there was a correlation of around -0.56 between the size of the tax and social security burden in a country and the size of the shadow economy.[619]

The Irish Office of Revenue Commissioners released a report in February 2011 that modelled the cigarette market in Ireland.[620] Of the statistically significant factors that affect consumption, price was found to be the most important (the others being, income, the introduction of the smoking ban, EU enlargement and the point of sale advertising ban). The model suggested a price elasticity of -3.6, implying that a 10 per cent increase in price would lead to a 36 per cent reduction in cigarette consumption. The report acknowledges that, while the modelling is robust, this is unrealistic, and that rather than consumption falling by such drastic levels, smokers are simply switching to the illicit market. In the 2010 Irish Budget, the Minister for Finance Brian Lenihan froze the duty on cigarettes:[621]

> *I have decided not to make any changes to excise on tobacco in this Budget because I believe the high price is now giving rise to massive cigarette smuggling. My responsibility as Minister for Finance is to protect the tax base. I have full confidence in the effectiveness of the current multi-agency approach but early in the New Year I want to explore what further measures we may need to stem the illegal flow of cigarettes into this country.*

The speech was a frank acknowledgement that the high duty on cigarettes had not necessarily curbed consumption but had led consumers to purchase substitute illicit goods instead.

The study by the Irish Office of Revenue Commissioners also provides a useful literature review on the effect of price on the consumption of cigarettes and its relation to illicit trade. Cullum and Pissarides found that:[622]

> *The increased complexity of the market for tobacco products means that earlier studies of the UK duty-paid segment of the market… struggle to predict the impact of price changes on demand. Normally, price increases would lead to reduced consumption. However, more recently the effects of higher prices have become more uncertain as consumers may switch their consumption to other sources or lower quality cigarettes.*

---

617. Schneider, F. & Buehn, A. *Shadow Economies and Corruption All Over the World: Revised Estimates for 120 Countries*, Economic E-Journals, 2007; Schneider, F. *Shadow economies and corruption all over the world: what do really know?*, Institute for the Study of Labour, 2006

618. Schneider, F. *The shadow economy and shadow economy labor force: What do we (not) know?* Institute for the Study of Labour, 2011

619. Schneider, F. *The shadow economy in Europe: Using payment systems to combat the shadow economy*, a paper for AT Kearney consultancy, 2009

620. Office of Revenue Commissioners *Economics of tobacco: Modelling the market for cigarettes in Ireland*, February 2011

621. Brian Lenihan T.D. *Financial Statement of the Minister for Finance*, 9 December 2009

622. Cullum, P. & Pissarides, C. A. *The Demand for Tobacco Products in the UK*, Government Economic Service, Working Paper No. 150, 2004

In a 2010 Australian study, PricewaterhouseCoopers found that the most common reason for using illegal tobacco was cheaper prices.[623] Geis, in another Australian study, acknowledges World Bank research that suggested tax increases bring more revenues and reduce smoking even with high rates. But he goes on to say that such research leaves:[624]

> *[unanswered] questions about the consequences for smuggling… what results might ensue if the tax reached what the public believes is an unacceptable level.*

Gabler and Katz carried out a study in Canada and their findings were stark:[625]

> *Contraband cigarettes are perceived to be a near-perfect substitute for lawfully purchased cigarettes. As such, contraband tobacco use neutralises the deterrent effect of higher taxes.*

They also highlighted that previous governments in Canada had been aware of these effects, with varying results:[626]

> *This dynamic was recognised by government officials in the mid-1990s, and tobacco excise taxes were reduced in order to weaken incentives to purchase, manufacture, distribute, and smuggle contraband tobacco. But the federal government began to raise tobacco taxes again in the early 2000s. Predictably, the higher taxes stimulated trade in contraband tobacco, resulting in a flourishing black market that now constitutes an estimated 27 per cent share of the overall tobacco market.*

Higher taxes on goods that have ready substitutes in illicit markets can have drastic immediate effects on tax revenues too

Higher taxes on goods that have ready substitutes in illicit markets can also have drastic immediate effects on tax revenues. For instance, when taxes on cigarettes were increased in New York City in 2002, the combined state and local taxes were $3 a pack. But, during the four months that followed, sales of taxed cigarettes fell by 50 per cent compared to the same period the previous year.[627] Worse still, a study conducted by a small business trade association found that there was a loss of $127 million for small businesses and 10,000 job losses.[628] There is also strong evidence in America that consumers cross state borders to purchase cigarettes with lower tax rates.[629] An important 2004 study found that the tax avoidance response to tax changes is at least twice the consumption response and that tax avoidance accounted for up to 9.6 per cent of sales between 1998 and 2001.[630]

623. PricewaterhouseCoopers *Australia's illegal tobacco market: Counting the cost of Australia's black market*, February 2010
624. Geis, G. *Chop-Chop: The Illegal Cigarette Market in Australia*, Australian National University Working Paper No. 48, 2005
625. Gabler, N. & Katz, D. *Contraband Tobacco in Canada: Tax Policies and Black Market Incentives*, Studies in Risk and Regulation, Fraser Institute, 2010, pg. 38
626. *Op cit.* pg. 1
627. Fleenor, P. *Cigarette taxes, black markets, and crime lessons from New York's 50-Year losing battle*, Cato Institute Policy Analysis No. 468, 2003
628. Barret, J., Kurian, T., and Moryl, R. *How New York City's high tobacco taxes hurt small businesses, taxpayers and consumers*, Small Business Survival Committee, 2003
629. Chiou, L and Muehlegger, E, *Crossing the line: The effect of cross border cigarette sales on state excise tax revenues*, Kennedy School of Government, Harvard University, 2008
630. Stehr, M, Cigarette tax avoidance and evasion, *Journal of Health Economics*, 24, 2005

The illicit trade in alcohol is significant too. The Institution of Engineering and Technology found that seizures of counterfeit alcohol have increased fivefold in the last two years.[631] Freedom of Information requests to 82 trading standards authorities found that between June 2008 and June 2009, there were 31 occasions where counterfeit alcohol was seized. Between June 2010 and June 2011, there were 158 occasions where counterfeit alcohol was seized. The research found that efforts by local authorities to seize illicit goods was focused more heavily on alcohol, no doubt contributing to the higher seizure rate, but also that "decades of increasing taxation has made the counterfeit trade highly lucrative."

Like the entire illicit trade and shadow economy, this is an international problem. There were concerns in Indonesia that a higher rate of excise tax would lead to an explosion in the black market for alcohol.[632] In Sri Lanka, it has been estimated that there are over 200,000 illicit brew retailers, compared to 3,200 licensed shops. Along with other problems like weak law enforcement, high prices for legal liquor, in large part the result of high duty rates, encourage the huge illicit alcohol market in Sri Lanka.[633] In Turkey, there are even concerns that high taxes on alcohol can have knock-on effects on tourism. The boom in the illicit brewing of alcoholic beverages has led to the death of tourists. In response, the president of the Association of Tourism Businessmen in Side and Manavga recommended that "there should be heavier sentences for alcohol smugglers and stricter controls, and taxes on alcohol should be eased."[634]

A *Panorama* investigation for the BBC in October 2011 looked at the growing trade in illicit fuel. Around the UK there are now 'pop-up' petrol stations selling illegal fuel, and two hundred have been shut down by the authorities. There is also an increasing problem with fuel theft.[635] Illicit fuel is a particular problem for Northern Ireland, given its border with the Irish Republic.

While this is a growing problem with Fuel Duty constituting such a high proportion of pump prices, it is by no means new. Another BBC investigation for *The Money Programme* in 2002 found that fuel fraud is one of the fastest growing parts of the black market in the UK.[636] Red diesel – which has a far lower rate of duty and is only supposed to be used in tractors and off-road vehicles – is frequently used by regular drivers, and often stolen from farms.

Internationally, Turkey, which has the highest taxes on motor fuel in the world according to OECD figures, has a serious and widespread problem with illicit fuel. The Turkish government estimates that 70.5 million litres of black market petrol were seized in 2010, but that only represents a small part of the illicit fuel being sold in the country.[637]

It is important not to overstate the overall scale of the problem with evasion and avoidance though. The UK's tax system is so complicated and opaque that those on incomes in the middle quintiles perceive benefit fraud at the bottom end of the distribution, and the rich hiring expensive lawyers and accountants to avoid taxes at the other end. As a consequence, some think small scale avoidance or evasion is acceptable. That attitude is wrong, but also why it is important not to overstate the extent of the problem. Exaggerating how many people avoid their taxes only adds

---

631. Bodhani A et al., *The A–Z of fakes*, Engineering and Technology Magazine, January 2012
632. Tisnabudi, I. Indonesia's Tax Hike on Alcohol 'to Fuel Black Market', *The Jakarta Globe*, 24 March 2010
633. Dayaratne, G. Alcohol Policy in Sri Lanka needs a rethink, *The Island*, February 2011
634. Seibert, T. Deadly bootleg alcohol placing Turkey's tourist trade at risk, *The National*, July 2011
635. Panorama, *The Great Fuel Robbery*, BBC, 17 October
636. The Money Programme, *Blackmarket Britain: Fake Fuel*, BBC, 2002
637. Seibert, T. As economy booms, demand for black market fuel soars in Turkey, *The National*, 23 September 2011

to the senspropertiese that it is a normal, and to some extent, acceptable thing to do. Some campaigns have, for instance, argued that there is a "tax gap" of £120 billion. That estimate is unhelpful as it is almost certainly incorrect, and by a large margin. In 2011, Treasury Minister David Gauke noted in parliament that this estimate: "does not take into account those reliefs and allowances that Parliament has determined should be available", including "double taxation relief".[638] Malry has written about a number of critical problems with this estimate:[639]

- It fails to take account of double tax relief. As a result, the amounts which have been relieved as a deliberate part of government tax policy are treated as if they were part of the tax gap.
- An invalid methodology to analyse companies into 'small' and 'large' is used. As a result, erroneous conclusions are drawn as to the tax avoidance behaviour of small and large companies.
- All late payments are incorrectly considered to be part of the tax gap. As a result, the offsetting impact of taxes paid in one year that related to previous years is ignored, thereby overstating the tax gap.

The HMRC's own estimate of around £40 billion appears to be far more reliable. Even so, the Treasury Select Committee argued in 2012 that it may not even be beneficial to work out what this figure might be. In its report *Closing the Tax Gap: HMRC's record at ensuring tax compliance* the Committee concluded:[640]

> *We recognise that it is useful for HMRC's employees to have some idea of the difference between what HMRC should be collecting and what is collected, particularly in the case of criminal activity. However, in other areas it would be more useful for it to identify ambiguities in tax law rather than employ resources in calculating how much tax would be collected if everyone shared its interpretation of the law. Separate reports on how much tax was lost through criminal activity and areas where HMRC had encountered different interpretations of tax law would be a better use of resources.*

At the same time, companies do not only underpay tax. Others are paying too much in tax by not taking advantage of allowances to which they are entitled. One example is the tax relief on the fixtures and fittings in commercial properties. The saving to the Exchequer from firms not claiming that relief has been estimated to run into billions of pounds.[641]

7.1.2. Governments have struggled to contain avoidance, evasion and exploitation of consumption taxes

A critical consideration in designing a consumption tax is how easily it can be avoided or evaded. Concerns about avoidance of consumption taxes have mounted with an increase in online shopping. There have been two recent examples: "Amazon" laws in the United States and controversy over Low Value Consignment Relief in Britain. The

638. *Parliamentary Debates*, House of Commons, Vol 513, col 706, 12 July 2010
639. Malry, C. *The four fatal flaws in "Why HM Revenue & Customs have got the tax gap wrong*, FCA Blog, July 2010
640. House of Commons Treasury Committee *Closing the Tax Gap: HMRC's record at ensuring tax compliance*, March 2012, pg. 32
641. Kollewe, J. UK firms losing billions on capital allowances, *The Guardian*, 19 March 2012

potential for evasion is often cited as a critical reason why VAT is preferable to a sales tax but evasion is still a major issue, with billions lost each year to carousel fraud.

7.1.2.1. Amazon laws in the United States

After introducing sales taxes in the 1930s, many US states were concerned at the potential for people to avoid the tax by making purchases in other states. They responded by introducing "use" taxes on the use of an item upon which a sales tax has not been paid. That was challenged in the Supreme Court as a protectionist measure that violated constitutional restrictions on interference in inter-state trade. The Court upheld their constitutionality so long as they were "compensating", designed to equalise taxes on goods produced in and out-of-state.

In later cases the Court found that a state would have to collect the use taxes directly from consumers. It couldn't require companies to collect them unless those companies had a significant connection with the state, either property or employees located there. The decision was intended to stop companies having to keep track of thousands of different sets of tax rules and to place a geographical limit on the powers of an individual state. But at the same time it made use taxes impossible to enforce in practice.[642]

In April 2008, New York became the first state to impose an "Amazon" law requiring retailers that have contracts with "affiliates" – independent people or organisations within the state who post an internet link to an out-of-state business and get a share of any resulting revenues – to collect the state's sales taxes. Arkansas, Connecticut, Illinois, North Carolina, Rhode Island and California have since put in place similar laws, and the Tax Foundation reports that 21 states have considered them.[643] Essentially they are using a very thin excuse to force out-of-state companies to collect taxes for them.

Amazon laws have not proved successful in practice. The fiscal impact statement produced by the Virginia Department of Taxation found that the measure could fail to raise additional revenue, as online companies respond to the new laws by closing their affiliate programmes:[644]

> *When similar legislation was enacted in Rhode Island and North Carolina, large online retailers ended their affiliate programs. If this were to happen as a result of this bill, there would be no additional revenue from the enactment of this bill. In fact, by ending the affiliate program with Virginia vendors, such vendors would likely lose business and remit less Retail Sales and Use Tax to Virginia. Ending affiliate agreements in Virginia would also reduce or eliminate the commissions and profit that the affiliates receive from these agreements. Although there is only very limited publicly available data, the reduction or elimination of such commissions and profits would likely have a negative impact on those businesses' profits.*

There has also been a lengthy legal battle over the legality of the measure in New York.

---

642. Henchman, J. *"Amazon Tax" Laws Signal Business Unfriendliness And Will Worsen Short-Term Budget Problems*, Tax Foundation, Special Report 176, 8 March 2010
643. Henchman, J. *California Becomes Seventh State to Adopt "Amazon" Tax on Out-of-State Online Sellers*, Tax Foundation, Fiscal Fact 276, 1 July 2011
644. Virginia Department of Taxation *2010 Fiscal Impact Statement: Retail Sales and Use Tax; Out-of-State Dealers Soliciting Business through "Affiliate Agreements" with Residents*, Bill Number SB 660, 18 February 2010

More recently, Amazon agreed to start collecting the taxes in California from September 2012, having previously strongly opposed such laws and shut down affiliate programmes to avoid complying with them. And a group of United States Senators have introduced new legislation that would allow states to require most online retailers and mail order companies to collect sales taxes from their customers.[645]

The challenge now is that the measure reverses the competitive position. Businesses trading only in their home state will now only need to understand and comply with a single set of tax rules and regulations, whereas those trading across a number of states will need to understand and comply with the rules and regulations of every state in which they trade.[646] That may be practical for a big business like Amazon, but it could create serious problems for smaller traders.

Amazon laws are a good example of how governments are struggling to adapt consumption taxes so they can be levied on online retail markets, where there is no simple point of sale with both seller and customer necessarily in the same jurisdiction. When it comes to international trade, and a national VAT like Britain's, the same constitutional obstacle to simply applying VAT at the border does not exist. But doing so can make compliance and administration more expensive for international trade, particularly for small businesses and small transactions.

Low value consignment relief was supposed to be a response to that problem, but has created other issues.

7.1.2.2. Low Value Consignment Relief in the United Kingdom

Article 23 of the European Council Directive 2009/132 requires that imported goods of a total value less than €10 are exempt from VAT. Member states can increase the limit up to €22 and the United Kingdom had set a limit of £18 below which imported goods are exempt from VAT under Low Value Consignment Relief. That limit was cut to £15 at the beginning of November 2011.[647] The relief is intended to reduce the administrative costs of collectiving VAT which could multiply with a large number of low value consignments to tax. Grant Thornton argue it "would be a disproportionately costly exercise if every small parcel from outside the EU had to be scrutinised by the Royal Mail and the payment of VAT collected from either the sender or the recipient."[648]

There was an extended campaign – led by small business group the Forum of Private Business and single-issue campaign Retailers Against VAT Avoidance Schemes – arguing that small online retailers based in the United Kingdom were being undercut by larger rivals able to establish an operation in the Channel Islands.[649] That campaign was successful and from 1 April 2012, Low Value Consignment Relief will be abolished entirely for goods sent from the Channel Islands. The relief had been estimated to cost £140 million each year[650] and there were clearly concerns that it would be increasingly exploited if not restricted.

That may be an incomplete response to the problem. Guernsey firm Healthspan has announced that it will challenge the legality of the measure on "the basis of discrimination against the Channel Islands" and their chief executive told the BBC that "it was likely that the group's long-term warehousing and postal operations would be moved off the island".[651] With international shipping costs very low, there are likely

645. Puzzanghera, J. Prospect of online sales tax grows, *Los Angeles Times*, 10 November 2011
646. Henchman, J. *"Amazon Tax" Laws Signal Business Unfriendliness And Will Worsen Short-Term Budget Problems*, Tax Foundation, Special Report 176, 8 March 2010
647. HMRC *VAT: Low Value Consignment Relief*, http://lowtax.es/HFBpdy
648. Grant Thornton, *Autumn Statement 2011, VAT and indirect taxes*, 24 November 2011
649. That campaign's material is archived here: http://lowtax.es/HcZNDm
650. Grant Thornton *Autumn Statement 2011, VAT and indirect taxes*, 24 November 2011
651. BBC News *Guernsey-based Healthspan to challenge VAT decision*, 9 November 2011

to be other locations close enough to exploit Low Value Consignment Relief when shipping to the UK. However, they will not be able to exploit the unique circumstances of the Channel Islands, which are outside the European Union but inside the customs union and therefore able to move goods in freely.

If it is not possible to isolate the problem by removing the relief for goods from the Channel Islands, then there will be a serious tension between ensuring that domestic producers can compete fairly and that there is no unnecessary obstacle to international trade.

7.1.2.3. Carousel fraud in the European Union

Britain in particular loses substantial tax revenues to carousel, or Missing Trader Intra-Community (MTIC) fraud. HMRC reported to the House of Lords European Union Select Committee in 2007 that it believed the amount lost to carousel fraud was substantial and rising, though the extent of fraud is necessarily difficult to establish:[652]

Table 7.5: HMRC estimates of Missing Trader Intra-Community fraud

Year	Estimated size of MTIC fraud (£bn)
1999–00	1.5–2.4
2000–01	1.3–2.5
2001–02	1.7–2.5
2002–03	1.5–2.3
2003–04	1.1–1.7
2004–05	1.1–1.9
2005–06	3.5–4.75

In May 2007, a background document for the Economic and Financial Affairs Council of the European Union estimated that "VAT fraud costs the EU more than €100 billion every year".[653] HMRC has described how these often complicated frauds operate:[654]

> *VAT intra-community missing trader fraud (sometimes known as 'carousel' or 'acquisition' fraud) involves fraudsters obtaining VAT registration to acquire goods VAT-free from other EU Member States. They then sell on the goods at VAT-inclusive prices and disappear without paying over the VAT paid by their customers to the tax authorities.*

In order to maximise the return and minimise the chances of being caught, goods are often moved through a number of jurisdictions in and outside the European Union and split into a number of consignments. The House of Lords Committee noted four factors driving a growth in the extent of the fraud:[655]

652. House of Lords European Union Committee *Stopping the carousel: Missing trader fraud in the EU*, 8 May 2007, Table 1
653. Ecofin *Background: Wednesday 14 May in Brussels*, 8 May 2008
654. HM Customs and Excise *Measuring Indirect Tax Fraud*, November 2001, pg. 2
655. House of Lords European Union Committee *Stopping the carousel: Missing trader fraud in the EU*, 8 May 2007, para 7

- The increase in high value/low weight goods which make it easy and inexpensive to transport valuable consignments.
- The zero rate of taxation on intra-Community cross-border trade, which allows purchasers of goods from other EU countries not to pay VAT on purchase, although they then charge VAT on sales as normal.
- At the same time, exporters of goods are still able to reclaim VAT they have paid to other traders, thus crystallising the loss as the revenue authority refunds a payment for which it had not received a remittance earlier in the transaction chain.
- The abolition of frontier formalities within the European Community which prevents Member States from operating procedures which could impede the free flow of goods within the Union. This means that the verification of the zero-rated goods imported could only be based on an audit of the traders' transaction records – a process which at present is normally only undertaken when VAT receipts are remitted, some time after the transactions.

The European Union Emissions Trading System (ETS) has since provided a particularly stark example of a high value/low weight good, with emissions allowances that are entirely intangible and can be moved at the click of a button. Not all of the national registries that underpinned the ETS carefully checked people signing up to engage in emissions trading. The Danish registry seems to have been particularly lax: the *Daily Telegraph* has reported that "hundreds of UK companies selling anything from hair loss treatments to electronics have mysteriously registered to buy and sell carbon permits in the Scandinavian nation […] among them businesses with unreachable addresses and Hotmail, Gmail or Yahoo email accounts for company representatives."[656]

The European law enforcement agency Europol reported in December 2009:[657]

> *The European Union (EU) Emission Trading System (ETS) has been the victim of fraudulent traders in the past eighteen months. This resulted in losses of approximately five billion euros for several national tax revenues. It is estimated that in some countries, up to 90 per cent of the whole market volume was caused by fraudulent activities.*

Extensive attempts have been made to control carousel fraud. At the time of the House of Lords Committee report, HMRC reported that 1,500 staff were employed on their MTIC strategy, costing £95 million a year.[658] That effort was undermined by a decision at the European Court of Justice that HMRC could not refuse to refund VAT to firms later in the supply chain, who were not involved in the fraud, where the losses to the Exchequer are crystallised. This decision was given by HMRC as the reason for the significant rise in the fraud in early 2006. A subsequent case refined the standard and found that a trader's VAT refund was only protected where they had taken "every precaution which could reasonably be required of them to ensure that their transactions are not connected with fraud."[659]

---

656. Mason, R. "Carousel" frauds plague European carbon trading markets, *Daily Telegraph*, 30 December 2009
657. Europol *Carbon Credit fraud causes more than five billion euros damage for European Taxpayer*, 9 December 2009
658. House of Lords European Union Committee *Stopping the carousel: Missing trader fraud in the EU*, 8 May 2007, para 22
659. House of Lords European Union Committee *Stopping the carousel: Missing trader fraud in the EU*, 8 May 2007, para 23–24

After the ECJ ruling, HMRC focused on a "means of knowledge" test via "lengthy and far-reaching enquiries into every constituent part of each transaction chain, examining whether frauds have occurred and whether other participants in the trail could have known of it". At the time of the House of Lords report, up to 1,500 firms were subject to that extended verification and some may not have been complicit in any fraud. The whole process is extremely time intensive for both HMRC – the Lords committee called it an "inefficient and unsustainable use of HMRC's resources" – and legitimate business.[660]

At the same time, greater attempts are being made to disrupt criminal operations and reduce the opportunities for fraud across Europe. For some goods a reverse charge is used, which concentrates both the collection of tax and monitoring for compliance on the business selling to the final customer.[661]

Attempts to control VAT fraud are expensive and the results have been incomplete. The question is whether avoidance and evasion are more common with this tax or other alternatives, and the extent to which minimising avoidance and evasion needs to be balanced against other priorities such as simplicity and fairness for legitimate business.

7.1.3. At lower rates, a sales tax is simpler and more transparent; at higher rates a Value Added Tax is harder to evade and the resources required to combat carousel fraud are better value

The most significant sales taxes exist in the United States. There is an active debate there over whether the country should implement a VAT. The argument for doing so, and a critical argument for a VAT over a sales tax, is that it is easier to enforce and more efficient to collect:[662]

> *A credit-invoice VAT is generally easier for revenue agencies to enforce than sales taxes and therefore enables more efficient revenue collection. The method of revenue collection makes it more efficient. A sales tax is collected only when the final user of the product makes a purchase. For instance, customers buying a new pair of shoes or a new television pay the price of the item plus the sales tax, which is an additional percentage of the sales prices, at the point of purchase. However, businesses do not pay sales taxes on the items they purchase so that the sales tax does not "pyramid" inside the cost of goods and raise their prices surreptitiously. In practice, businesses end up paying sales taxes in many cases, but they should be completely exempt from paying sales taxes according to sound tax policy.*

Repeatedly taxing and refunding VAT, involving businesses throughout the supply chain in the tax, creates a substantial administrative burden on business. The cost to small businesses is particularly high. A National Audit Office study in 1994 found that, in the smallest companies, the cost of compliance was often as much as 20 per cent of the tax paid.[663]

However that paper trail does make it hard to avoid with a simple collusion between seller and customer. At the same time the broad base from which the tax is directly taken reduces the chances that the tax will distort the market by falling

660. *Op. cit*
661. *Op. cit*
662. Dubay, C. *The Value-Added Tax Is Wrong for the United States*, Heritage Foundation, 21 December 2010
663. National Audit Office *HM Customs and Excise: Cost to Business of Complying with VAT Requirements*, 1994

particularly on one part of the value chain. But within the complexity of VAT and the way it taxes value added are opportunities for very large scale fraud, as we can see with the €100 billion lost to carousel fraud each year in Europe. These are not just temporary problems but fundamental to the way the tax works, as the House of Lords Select Committee puts it:[664]

> *Our concern about MTIC fraud is heightened by the fact that it occurs because of a fundamental flaw in the design of the VAT system. This is not the plain evasion and fraud – such as under-reporting or mis-reporting of sales, or failing to register with the tax authority – that is also seen in other tax regimes. There is no evidence that the VAT evasion rate is higher than that for other forms of taxation: approximately 12 per cent of the hypothetical VAT revenue is being lost each year, but a third of this loss is attributable to MTIC fraud.*
>
> *[…]*
>
> *Value Added Tax (VAT) has a key strength: the government effectively collects a proportion of the tax at each stage in the sales chain, rather than concentrating the potential revenue, and the risk of evasion, in the final seller. This "fractionated" nature is also VAT's principal weakness: many more transactions have to be logged and reported by traders, raising both the regulatory burden and the difficulty of monitoring compliance. In addition, the seller of an item is collecting the tax on behalf of the revenue authority, rather than the revenue authority collecting it directly from the taxpayer. This extra link in the chain increases the opportunity for fraud. A tax authority considering claims for VAT repayment has to maintain a balance between not being so restrictive that legitimate claims are denied and the tax effectively becomes a tax on production inputs, and not being so lax that fraud continues unchecked.*

The critical difference seems to be that VAT is better adapted to raise a large amount of revenue

The critical difference seems to be that VAT is better adapted to raise a large amount of revenue. In Europe, Britain's 20 per cent VAT rate is normal, whereas in the United States the highest state sales tax rate was, at 1 July 2011, California's at 7.25 per cent, and the highest combined state and local tax rates were Tennessee's at 9.43 per cent.[665]

The use of VAT to levy higher rates – around 20 per cent – and sales taxes to levy lower rates – under 10 per cent – could simply be a historical accident. Other countries do operate VAT or similar systems at much lower rates, but there is good reason to believe a VAT is associated with growth in public spending:[666]

> *Once a VAT is in place, Congress could easily increase the VAT any time it wants more taxpayer money to pay for new programs. Continually increasing the size of government would become considerably less painful because small increases in the VAT rate could raise substantial sums of revenue. An increase of just 1 per cent would raise more than $80 billion per year by the end of the decade.*
>
> *The ability of the VAT to raise money will almost certainly prove irresistible to Members of Congress. The experience of other industrialised*

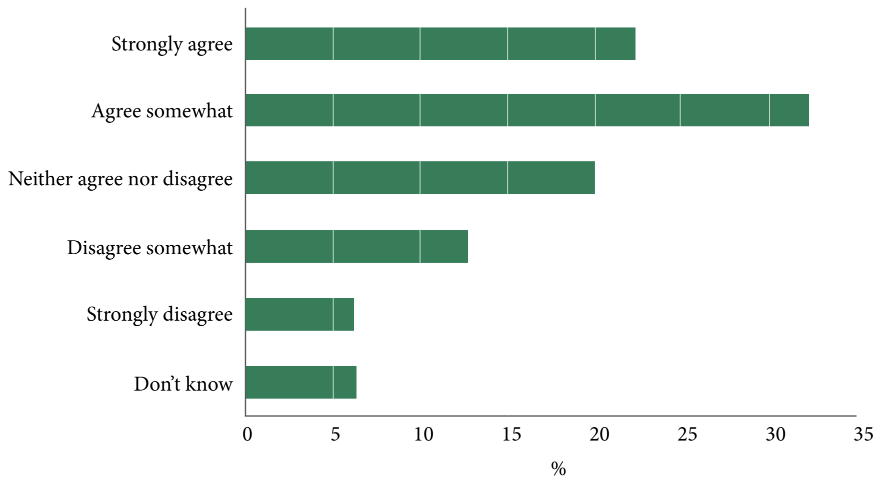
664. House of Lords European Union Committee *Stopping the carousel: Missing trader fraud in the EU*, 8 May 2007, para 3–4
665. Drenkard, S. *Ranking State and Local Sales Taxes, Tax Foundation*, Fiscal Factor 284, 22 September 2011
666. Dubay, C. *The Value-Added Tax Is Wrong for the United States*, Heritage Foundation, 21 December 2010

countries bears this out. As [the data] shows, 29 of the 30 countries in the Organisation for Economic Co-operation and Development have implemented VATs. The United States remains the lone exception. In the years since they began their VATs, 20 of the 29 have increased their rate by at least one percentage point. Denmark leads the group with a 10 percentage point increase from 15 per cent to 25 per cent. On average, the 20 countries have raised their VAT rates by 4.5 percentage points.

There are a number of reasons why VAT might be associated with high taxes and a sales tax with lower taxes:

- VAT is less transparent and less concentrated at any single point in the supply chain. That diffuses opposition to increases in the rate, to the extent that opposition may remain latent with insufficient reason for any one group to challenge them.
- At a high rate there is a greater incentive for sellers and buyers to collude and avoid a sales tax. It is more worthwhile to bear the costs of potential carousel fraud as the total amount of revenue rises.
- The administrative costs entailed in collecting a VAT, involving a much greater number of businesses, are more likely to be worth paying for a higher rate tax collecting more revenue.

Figure 7.3: Institute of Directors' Member Survey: We should consider replacing VAT with a sales tax that would apply only at the point of final retail sale



It seems very unlikely that a sales tax in Britain could collect the £86.1 billion that VAT raised in 2010–11. However as part of a longer term shift to lower taxes, such a tax could be considerably more convenient for business and transparent for consumers. Commentators in the United States who are concerned that implementing a VAT there would result in higher taxes and bigger government are probably right to worry. In a survey of its members the Institute of Directors conducted for the 2020 Tax Commission, many suggested that Britain should consider replacing VAT with a sales tax. The results are shown in Figure 7.3.

This is the only major tax which the 2020 Tax Commission does not propose to substantially reform. While the tax is important, and there are reforms which could improve it substantially, it is hard to do that while the rate is so high and raises so much revenue.

There is an existing European Union programme of reforms to Value Added Tax which appears likely to improve the situation to a certain extent but still leaves a number of problems. The Institute for Fiscal Studies has summarised the results and argues that:[667]

> *[If] the Commission's proposals are fully realised, complying with VAT procedures, particularly when trading across borders, would be considerably simpler, and the system should be more robust to fraud: hence, the plans represent a genuine improvement over the existing system. However, although the plan envisages some reduction in the scope of VAT exemptions and reduced rates, here significant problems look set to remain. This reflects the fact that responsibility for the use of reduced rates of VAT and exemptions largely lies with the Member States themselves, rather than the Commission.*

Compliance costs will still be substantial though, and consumption taxes will continue to fail a critical test: transparency. VAT is hidden in prices but to fix that and make it less of a burden the rate needs to be substantially cut. That will not initially be possible while also making necessary changes to the income and capital tax system. Over time though, and as the dynamic returns to more efficient direct taxes are felt, the objective should be to cut the tax to the extent the base can be widened without substantially increasing benefit dependency. Ultimately, it can be replaced by a simpler consumption tax, or it can be abolished entirely.

7.1.4. Removing the reduced and zero rates of Value Added Tax would make the system more efficient, but at the current rate would lead to an unacceptable rise in poverty or benefit dependency

There are a number of goods for which reduced or zero rates apply. HMRC estimates that those lower rates reduced revenue by over £35 billion in 2010–11.[668] The largest of these are the zero rates for food, the construction of new dwellings and domestic passenger transport and the reduced rate for domestic fuel and power.

Table 7.6: HMRC estimates of the fiscal impact of differential VAT ratings (2010–11)

Tax expenditure	Cost (£m)
Zero-rating of:	
Food	14,250
Construction of new dwellings	5400
Domestic passenger transport	3,250
International passenger transport	150
Books, newspapers and magazines	1600
Children's clothing	1,300
Water and sewerage services	1700

667. Phillips, D. *Reforming VAT: a promising proposal, but much more still to be done*, Institute for Fiscal Studies, December 2011

668. HMRC *Tax expenditures and ready reckoners*, Table 1.5 – Main tax expenditures and structural reliefs

Tax expenditure	Cost (£m)
Drugs and supplies on prescription	1,850
Supplies to charities	200
Certain ships and aircraft	550
Vehicles and other supplies to disabled people	450
Reduced rate for:	
Domestic fuel and power	4,250
Certain residential conversions and renovations	200
Energy-saving materials	50
Women's sanitary products	50

Britain has one of the narrower consumption tax bases in the developed world.[669] A number of earlier reviews of the tax system have proposed broadening that base in order to improve the efficiency of the system. For example, the think tank Reform proposed to end the zero and reduced rates and compensate low income families by "increasing all cash benefits by 7.5 per cent" in *Reality Check: Fixing the UK's tax system*.[670] It expected that would increase revenue by £15 billion in 2008–09, and hoped it would reduce the complexity of the tax system, reduce economic distortion and allow reductions in more economically harmful taxes.

Tolley's tax guide would certainly be substantially shorter if exceptions were reduced (Section 2.4). Reform cites the example of New Zealand:

> *While it is difficult to quantify the gains from having a broad-based VAT with a uniform rate, the New Zealand experience suggests that there can be significant administrative cost savings. GST, unlike the UK VAT, does not require hundreds of pages of classifications of goods, services, providers, interpretations and rulings. Further, GST has been a "low maintenance tax", requiring the time of only one and a half professional policy staff out of a total Inland Revenue tax policy team of 45 for ongoing administration.*
>
> *It is difficult to accurately quantify the benefit in compliance costs, but independent analysis suggests that "the wider base of the New Zealand tax… could be expected to reduce compliance costs compared with the United Kingdom".*

The requirement that businesses operating in all of the new sectors to which VAT might be applied would, if the base of the tax were widened, then have to administer VAT as well, must at least partly offset that. While the margins between different goods produce some of the most amusing complications in the tax system – such as the question of whether Jaffa Cakes are cakes or biscuits – for most products their status is reasonably clear.

The economic distortion may be significant at the margins, as it might encourage someone to buy a certain snack over another. The change in categorisation of a number of products at Budget 2012 was quite controversial. The wider importance

669. OECD *Consumption Tax Trends 2008*
670. Bassett, D., Haldenby, A., Nolan, P. & Parsons, L. *Reality check: Fixing the UK's tax system*, March 2010

seems overstated. Demand for food as a category is inelastic as it is an essential, and the distortion is therefore likely to be limited.

There are regulatory burdens or existing taxes that already add to the cost of many of the items subject to reduced or zero rates of VAT. New dwellings are subject to Council Tax once they are built. The Common Agricultural Policy increases food prices. Domestic fuel and power prices are substantially inflated by climate regulations. Citigroup expects that electricity prices would have to rise by over 50 per cent by 2020 to pay for the over £200 billion of investment needed in the energy sector to meet current environmental targets.[671] Even with improvements in efficiency, it expects that will mean a rise in dual fuel bills of more than one third. Additional taxes on top of those burdens could create real hardship. For example, the Hills Fuel Poverty Review estimated that fuel poverty causes 2,700 deaths a year.[672]

If those burdens were removed, on the other hand, then it might be more practical to charge the standard rate of VAT on the relevant goods.

The best case for these changes is that they would allow a reduction in other taxes, or in the overall VAT rate. However, as the zero and reduced rates are progressive, most reforms require an increase in benefits which uses at least part of that revenue. The only other way to compensate low earners would be to cut tobacco or alcohol taxes, which may not be politically feasible. An increase in the extent to which people pay taxes and then get the money back in benefits will create a number of problems:

- It may lead to very high withdrawal rates, depending on the structure of the benefits.
- There is substantial waste, complexity and potential for fraud in the process of taxing people and returning the money in benefits.
- There is a moral problem with removing people's ability to support themselves and their family, and pushing them into reliance on benefits.

Widening the base of VAT may improve the efficiency of the tax system, but the potential consequences are serious

Widening the base of VAT may improve the efficiency of the tax system. But the potential consequences are serious, particularly when the rate is so high. The 2020 Tax Commission does not propose to widen the VAT base.

7.2. Externalities rarely justify taxes as high as they are already, let alone higher

Pigovian or Sin taxes raise substantial amounts of revenue. In 2011–12, fuel duties raised £26.9 billion; tobacco duties raised £9.5 billion; spirits duties raised £2.8 billion; wine duties raised £3.4 billion; beer and cider duties raised £3.8 billion; Air Passenger Duty raised £2.7 billion; the Climate Change Levy raised £0.7 billion; and Vehicle Excise Duty raised £5.8 billion. That is a total of £55.6 billion. There are also other green taxes, such as the EU Emissions Trading System and the Carbon Reduction Commitment, that function somewhat differently but also effectively constitute Pigovian taxes.

Anything done by an individual or a company within an economy will have positive and negative effects on others for which they are not charged or compensated by the market. Someone going to university will pay a certain fee and gain a certain

671. Citi *The €1trn Euro Decade – Revisited*, 29 September 2010
672. Hills, J. *Fuel Poverty: The problem and its measurement*, CASE Report 69, 19 October 2011

reward in the form of skills and credentials they can exchange for a higher income. Their studies may also produce positive social effects for which no one is charged. The students' education may make them better citizens who are better able to hold politicians to account through the ballot box. That would mean there was a positive externality to going to university.

By contrast, someone who burns petrol in order to power their car pays a price for the petrol and the car and gets a certain return in the form of greater mobility. They will also create pollution and congestion, having a negative effect on wider society. That means there are negative externalities to burning petrol in order to drive.

If government intervenes and places a tax on an activity that creates a negative externality, or provides a subsidy to an activity that creates a positive externality, then it can theoretically improve efficiency by better aligning private incentives with the social good. The taxes or subsidies should be equal to the harm or benefit that is placed on society so that each individual's actions reflect the costs and benefits to society.

People should then produce an efficient amount of the positive or negative externality. There are problems with that idea even in theory. Nobel Laureate Ronald Coase pointed out the biggest problem.[673] He established that, in a hypothetical world with zero transaction costs, the market would perfectly correct for externalities. If someone suffered as the result of a negative externality they would offer to pay the person creating it to stop. If they placed a greater value on preventing the externality than the person producing the externality did on pursuing the activity that created it, then they would pay the person producing the externality enough that they would stop. On the other hand, if the value they placed on stopping the activity was less than the value the person creating the externality placed on being able to continue to do so then they would not offer enough, and the externality would continue to be created.

Coase identifies the limits of this reasoning himself. The Coase Theorem, as his theory has since become known, only works in a world of zero transaction costs. There are innumerable reasons why it is often extremely difficult, if not impossible, for the rest of society to pay someone for producing a public good or not producing a negative externality. Global warming offers a clear example: the potential harms to each individual created by someone else burning a litre of petrol are infinitesimally small, but the externality could be significant on a global scale. It would be utterly impractical for everyone to club together and put in their tiny fractions of a penny in order to pay someone to drive less.

However, attempts to correct for externalities through Pigovian taxes are also subject to transaction costs.

There are a variety of reasons why politicians might get interventions intended to correct for externalities wrong. They have to work out the right level for the tax or subsidy; they need to ensure the intervention itself is efficient (administering a tax may be costly, for example, or it could hurt the economy); they may need to balance a series of positive and negative externalities created by a single activity; rent seekers may distort an intervention so that it serves their private interests rather than the social good. With those problems, governments need to avoid rushing to subsidise every public good and tax every negative externality.

The taxes are often set at too high a rate to be justified by the externalities they are supposed to address. Motorists are charged billions in excessive tax (Section 7.2.1).

673. Coase, R. H. The Problem of Social Cost, *Journal of Law and Economics*, October 1960

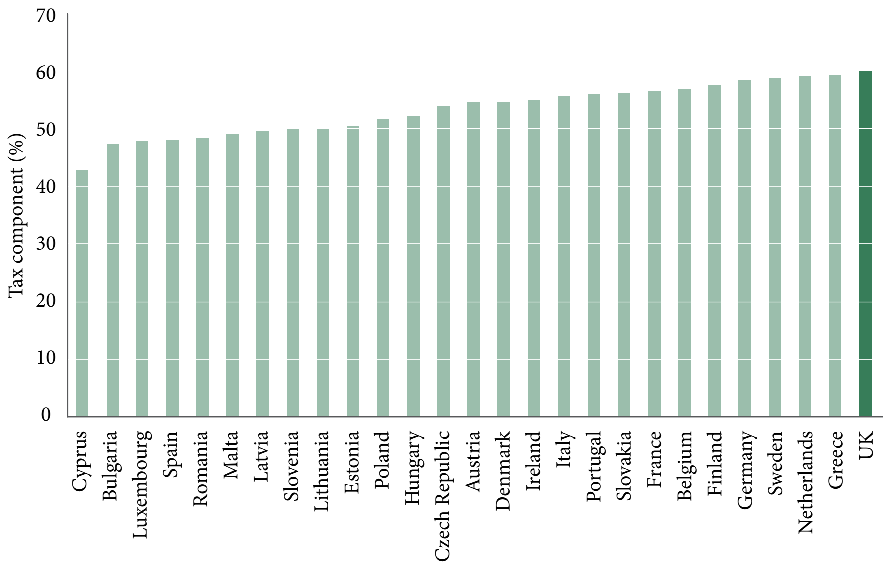
Tobacco taxes are justified on the basis of supposed externalities that are mostly not even really external costs (Section 7.2.2). And Air Passenger Duty is excessive, redundant and ineffective (Section 7.2.3).

The fundamental problem with these taxes is that they are generally either a substantial source of revenue but do not change behaviour, or they change behaviour and that shrinks the base and undermines their ability to raise revenue (Section 7.2.4). Given that many of the Pigovian taxes are among the most regressive, when they are ineffective or poorly justified they are a particularly unpleasant and unfair burden on families (Section 7.2.5).

7.2.1. Britain's motoring taxes are extremely high by international standards and not justified by the costs of climate change or road building and maintenance

British motoring taxes are very high not just by international standards but even by comparison with other countries in Europe. In September 2011, tax accounted for 60 per cent of the pump price of petrol in the UK, a greater percentage than in any other EU country.[674]

Figure 7.4: Tax component in pump price of unleaded petrol in EU – 27 countries, %, September 2011



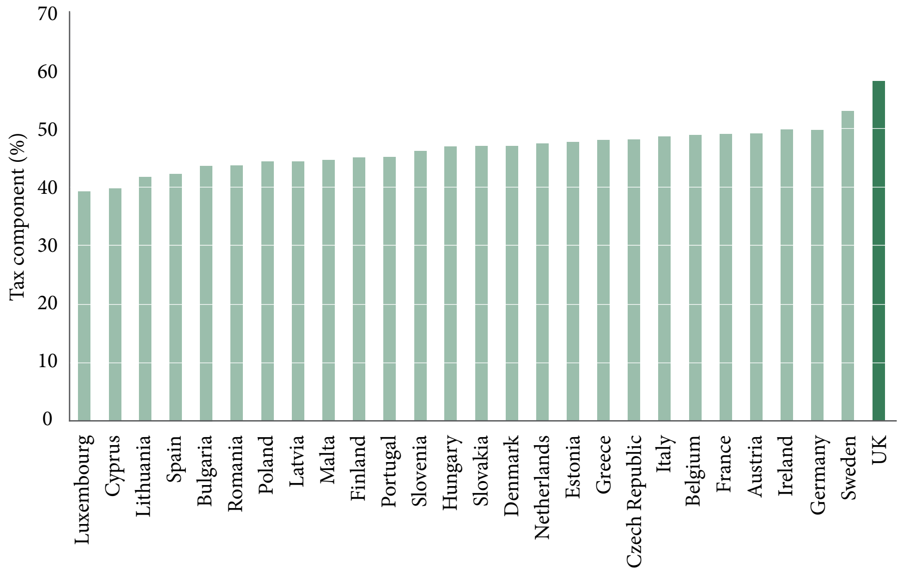
Tax accounted for 58 per cent of the pump price of diesel, again the highest share in the EU.[675]

With non-European developed countries like the United States charging considerably less, and many developing countries subsidising motor fuel, the UK's motoring taxes are among the highest in the world. Only Turkey appears to charge more.

VAT is also paid on motor fuel and the purchase of new cars so both Fuel Duty and Vehicle Excise Duty, in their entirety, constitute a premium on the level of taxation judged fair across a range of other products. Fuel Duty and Vehicle Excise Duty are therefore entirely green taxes except to the extent they compensate for other externalities such as the need for road building and maintenance.

674. DECC *Quarterly Energy Prices*, Table 5.1.1
675. *Op. cit*

Figure 7.5: Tax component in pump price of diesel in EU – 27 countries, September 2011 (%)



These taxes have been explicitly aimed at reducing emissions. For example when the Fuel Duty escalator was introduced, it was described as a part of Britain's strategy to meet objectives agreed at the Rio Earth Summit:

> *I have now decided to strengthen the March commitment by increasing road fuel duties on average by at least five per cent in real terms in future Budgets. This will complete Britain's strategy for meeting our Rio commitment.*
> *– Ken Clarke, Statement to the House of Commons, 1993*

It has been suggested in earlier studies that Fuel Duty is not set arbitrarily high as it corrects for a number of other externalities, including noise and air pollution, road injuries and fatalities, and congestion, as well as greenhouse gas emissions. That approach has been used by the Department for Transport in assessing the external costs of various forms of transport.[676]

Table 7.7: Estimated marginal external road costs, p/vehicle km, 1998

Externality	Low estimate	High estimate
Operating costs	0.42	0.54
Accidents	0.82	1.40
Air pollution	0.34	1.70
Noise	0.02	0.05
Climate change	0.15	0.62
Congestion	9.71	11.16

676. Department for Transport *'The NATA Refresh: Reviewing the New Approach to Appraisal'*, October 2007

An estimate of that kind is reproduced in Table 7.7,[677] but it shows how such analysis often ignores the range of existing regulations designed to control externalities:

- Noise and air pollution are created by a vast spectrum of industrial activity. They are controlled by regulation which limits acceptable levels of noise and particle emissions in different geographical areas. New roads are subject to stringent planning controls based on the amount of traffic they are likely to carry. Equally, regulatory standards and the requirement to fit catalytic converters control particle emissions.
- There is extensive regulation designed to control road traffic accidents: driving tests, speed limits, speed cameras and installations such as speed bumps. Many of these impose substantial costs on drivers and others are paid for as part of the process of building and maintaining roads.
- The costs of congestion, except for the costs of building and maintaining roads, are internalised within the body of road users and create an incentive to use other methods of travel or travel less. Fuel Duty is also probably not the best measure to correct for the externality of congestion. Evidence to the Institute for Fiscal Studies' Mirrlees Review described it as a "very blunt instrument" for addressing the problem of congestion.[678]

Pigovian taxes and regulation are substitutes as different methods of achieving the common objective of controlling externalities. Putting regulations and taxes in place to correct for the same externality is clearly disproportionate.

Studies that aim to assess comprehensively the external costs of driving too often focus purely on the negative externalities and ignore the positive externalities that are also associated with driving. These positive externalities include the following:

- Most people do not live close enough to their place of work, or all the services they need to access, to be able to walk or cycle. That means that if they did not drive they would need to use public transport. Many rail and bus services are already struggling to cope with demand, despite the fact that trains only account for seven per cent of passenger travel and buses and coaches six per cent, against 85 per cent who travel by car and van.[679] By relieving congestion on public transport networks, motorists do a significant public good.
- Motorists also encourage the development of greater road transport infrastructure. Just as motorists may be inconvenienced by other drivers who create congestion on the roads, those other drivers also support a network of services that make all motorists' lives easier. If there were fewer motorists the broad network of service stations, roads, mechanics, driving instructors and other services that support driving would be less comprehensive. This kind of social benefit is known as a network effect in the economic literature.
- By driving, people enable economic activity to be more geographically dispersed. That eases pressure on public services such as water and sewerage.

677. Leicester, A. 'The UK Tax System and the Environment', *Institute for Fiscal Studies*, November 2006. http://lowtax.es/HicNES,p. 25
678. Institute for Fiscal Studies, *'Don't expect much extra revenue from green taxes, says study prepared for the Mirrlees Review'*, July 2008
679. Department for Transport, *'Transport Statistics Great Britain: 2007 Edition'*, 2007, Table 1.1

- If motorists can travel further to look for work, they are less likely to claim unemployment benefits and are more likely to find a job that makes full use of their skills.

The net social cost of driving is likely to be significantly lower than that estimated by studies focusing purely on the negative externalities. Driving might even produce net social benefits.

Driving necessitates public spending to build additional roads, in order to alleviate congestion, and repair wear and tear. That spending is an externality for which motorists can reasonably expect to pay. A similar analysis of the externalities associated with road transport has been used when forming policy:

> *I firmly believe that motorists should bear the full costs of driving – not only wear and tear and congestion on the roads, but also the wider environmental costs. Even those of us who frequently have to drive can take steps to cut fuel consumption and we all ought to consider carefully the use of our cars.*
> *– Ken Clarke, Budget Speech, 1996*

For those reasons, the only externality other than greenhouse gas emissions that it is right to make an allowance for is road spending.

Fuel Duty and Vehicle Excise Duty raised £31.5 billion in 2009. Road spending in 2009–10 was £9.9 billion and the social cost of road transport emissions was £3.5 billion in 2009. As a result, excess green taxes were £18.1 billion, or £293 per person.

Those living in the suburbs and rural areas pay far more than those living in cities. Excess motoring taxes varied starkly between urban areas like Camden, where they were £64 per person, and rural areas like Maldon, where they were £566 per person.[680]

Excessive motoring taxes increase the cost of working relative to staying at home; make it more expensive to look further afield for work; increase costs to industry; and directly depress living standards. The 2020 Tax Commission recommends cutting the rate of Fuel Duty by 5p a litre.

7.2.2. Tobacco duties have been justified on the basis of externalities that are mostly either dubious or actually private costs

Taxes on tobacco are frequently justified by the perceived economic costs. For example a Policy Exchange report looked at healthcare costs, a loss of productivity, absenteeism and lost output.[681]

Table 7.8: Policy Exchange estimates, total societal costs of smoking (£bn)

Costs of smoking	Lower margin	Middle margin	Upper margin	Preferred value
Healthcare costs	2.700		5.2	2.70
Loss of productivity	0.915	2.90	3.2	2.90
Absenteeism	1.100		2.5	2.50
Output loss		4.10		4.10

680. Sinclair, M. *Excessive taxes on motorists in each council area in the UK*, TaxPayers' Alliance, 11 November 2011

681. Nash, R. & Featherstone, H. *Cough up: Balancing tobacco income and costs in society*, Policy Exchange, March 2010

Costs of smoking	Lower margin	Middle margin	Upper margin	Preferred value
Passive smoking		0.70		0.70
Environmental costs		0.34		0.34
Fire damage		0.50		0.50
Total				**13.74**

There are problems with many of the entries in the table.

The finding on healthcare costs is based on work by the taxpayer-funded political campaign Action on Smoking and Health.[682] While the report is quite vague about its data and method it compares rates of "hospital admissions, outpatient visits, GP and practice nurse consultations and prescriptions". That is problematic because healthcare spending is dominated by treatment at the end of life and smokers do not die more often than non-smokers, we all die once, just of different conditions. Any study of the net costs needs to include the greater cost of non-smokers being treated for chronic conditions like Alzheimers, which they are more likely to survive and need treatment for. Research supported by the Dutch Ministry of Health, Welfare and Sports has found that "lifetime health expenditure was highest among healthy-living people and lowest for smokers".[683] Viscusi found that the "estimated health risks from smoking have significant external financial consequences for society. Studies at the national level indicate that cigarettes are self-financing since external costs such as those due to illnesses are offset by cost savings associated with premature death, chiefly pension costs."[684]

The estimated loss of productivity is even less reliable. It is based on an estimate that smokers spend ten minutes a day smoking. But, of course, most people spend some time at work doing things other than working. There is no evidence presented that non-smokers do not waste just as much time in other ways, such as browsing the Internet.

The same flawed logic that says we should tax to reflect greater absenteeism would also imply imposing greater taxes on public sector workers, who take more time off sick than private sector workers. Beyond that, absenteeism at a private sector employer will often not be a pure externality. If a worker is regularly and unnecessarily off work sick, it would be reasonable to assume they will undermine their career progression and pay a price for it at some stage.

The statistic for lost output is a measure of the time people aren't in work before retirement. There are a couple of big problems with that. First, the loss is clearly mostly to the smoker themselves (the income they miss out on), which means it is not a societal cost but a private one and cannot justify Pigovian taxation. Second, if you take the logic of the healthcare costs entry in their table then smokers save society a huge amount of money by being less likely to claim a pension.

There is an alternative argument for tobacco taxes: that they are sin taxes which are good for the smokers themselves as it encourages them to quit.[685] However that is both paternalist and unfair on those smokers who do genuinely prefer to smoke and are made worse off without good cause.

682. Action on Smoking and Health The cost of smoking to the NHS, research for *Beyond Smoking Kills*, 8 October 2008

683. Baal, P. H. M. et al. Lifetime Medical Costs of Obesity: Prevention No Cure for Increasing Health Expenditure, *PLoS Medicine*, 5 February 2008

684. Viscusi, W. K. The Governmental Composition of the Insurance Costs of Smoking, *Journal of Law and Economics*, 42, 2, October 1999

685. Gruber, J. & Mullainathan, S. *Do Cigarette Taxes Make Smokers Happier?* NBER Working Paper No. 8872, April 2002

7.2.3. Air Passenger Duty is excessive and inefficient as a means of reducing greenhouse gas emissions and duplicated by a number of other policy interventions; it should be abolished

Few countries tax flights particularly heavily. As airports are paid for through charges to airlines, there is not the same need for governments to pay for infrastructure. At the same time, it is often easy for passengers to choose routes for long-haul flights that avoid aviation taxes, which creates an incentive for countries to keep their taxes relatively low.

Britain does charge specific taxes on flights though. Air Passenger Duty rates vary between £12 and £85, depending on the distance, on each passenger flying from a UK airport for a standard economy ticket. Passengers in first or business class pay between £24 and £170. Rates are continuing to rise despite the Department for Transport releasing a study in 2008 which showed the taxes crossed the line in February 2007 and became excessive even on the DEFRA Shadow Price of Carbon, which is much higher than most academic estimates of the social cost of carbon. That study concluded that:[686]

> *Government took action in February 2007 to double the Air Passenger Duty rates, which reflects the framework now in operation in the UK; this will therefore be in the actual data of future emissions cost assessments. As demonstrated in the illustrative scenario B, this has a marked impact on the results of the emissions cost assessment. Under this scenario, aviation would cover its climate change costs with an excess of some £0.1 billion.*

Those taxes are also not an efficient means of cutting emissions. While there have been attempts at reform recently, when the tax was doubled in 2007, it did more to cut the difference in price between flying to New York or Sydney than to actually put people off flying. As a result, Mayor and Tol found it had "the perverse effect of increasing carbon dioxide emissions, albeit only slightly", while reducing the numbers travelling to Britain.[687]

In addition to those dysfunctions, the tax is now also redundant following the inclusion of aviation in the EU Emissions System. That further contributes to the cost of flying and has provoked a trade dispute with other countries whose airlines are being included against their wishes.

Discouraging tourists and business passengers from travelling to Britain is a bad idea in itself and the reduction in the number of international travellers is likely to lead to fewer flights and fewer routes, and thereby further reduce the attractiveness of Britain as a location to invest.

In a 2009 report for the Airport Operators Association, the economics consultancy Oxera found that increasing Air Passenger Duty, as the Government since has, could create a wide range of economic harms if it continued to 2030. It could reduce the sector's annual gross value added by £450 million, while reducing the value added in the wider economy by £500 million thanks to reduced connectivity, £2.6 billion thanks to reduced trade and £8.3 billion thanks to reduced investment. By contrast, phasing out the tax would increase the aviation sector's gross value added by £300 million a year and produce much larger gains in the wider economy of £340 million thanks to improved connectivity, £1.6 billion

686. Department for Transport *Aviation Cost Assessment 2008*, pg. 9
687. Mayor, K. & Tol, R. S. J. *The impact of the UK aviation tax on carbon dioxide emissions and visitor numbers*, Working Paper FNU-131, April 2007

thanks to increased trade and £5.5 billion thanks to increased investment, which would offset much of the reduction in revenue.[688]

The 2020 Tax Commission recommends that Air Passenger Duty should be abolished.

7.2.4. With inelastic demand, green and sin taxes are ineffective; with elastic demand, they do not raise significant revenue

The critical problem with many Pigovian taxes is that they are being levied for two reasons:

- To produce revenue and fund public spending
- To discourage behaviour felt to be socially harmful

To the extent any tax achieves the second of those objectives, it will fail to produce revenue. If politicians achieve their objective of driving the adoption of electric cars through taxes, subsidies and regulations, for example, that could cause a collapse in Fuel Duty receipts.

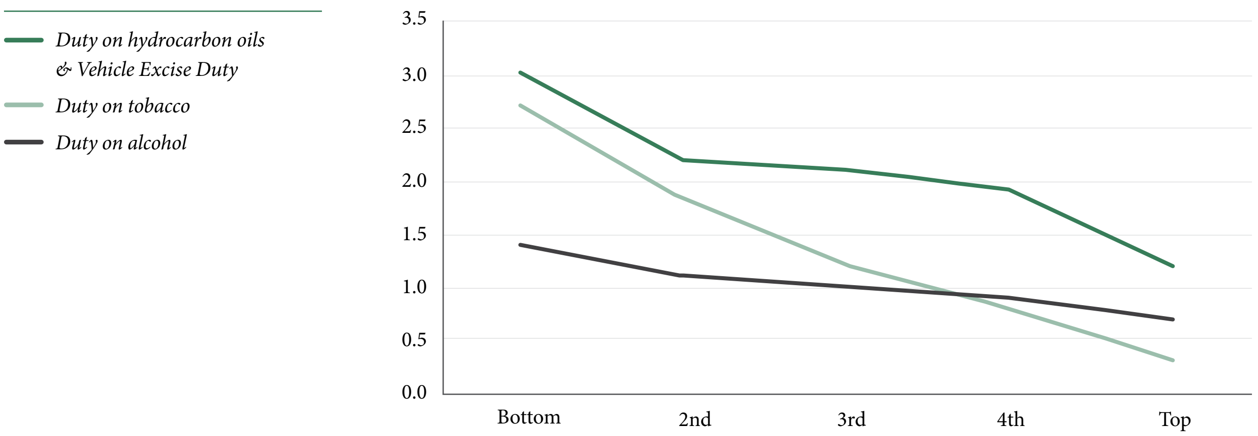
On the other hand, if a tax does raise revenue, it is failing to discourage the behaviour being taxed. IMF calculations suggest that oil demand could be highly inelastic with respect to price. Researchers there found that a 50 per cent rise in the price could only lead to a 0.35 per cent decrease in consumption.[689] There are other studies that suggest the elasticities could be significantly higher, but given that Britain's Pigovian taxes raise a very substantial amount of revenue it suggests that they are ineffective in achieving their objectives as green or sin taxes.

If these taxes do not change people's behaviour, they are effectively a transfer: to the urban well-off from the rural, suburban and small-town poor.

7.2.5. Those on low and middle incomes pay the most in sin and green taxes

Whether measured as a percentage of gross income, disposable income or expenditure, Pigovian taxes tend to hit low and/or middle income families harder than those on relatively high incomes, particularly alcohol and tobacco duties.[690]

Figure 7.6: Pigovian taxes as a percentage of gross income, by quintile



688. Oxera *What is the contribution of aviation to the UK economy? Final report prepared for the Airport Operators Association*, November 2009
689. Drum, K. *Raw Data: Everyone Loves Oil*, Mother Jones, 22 April 2011
690. http://lowtax.es/HicU3r

Figure 7.7: Pigovian taxes as a percentage of disposable income, by quintile

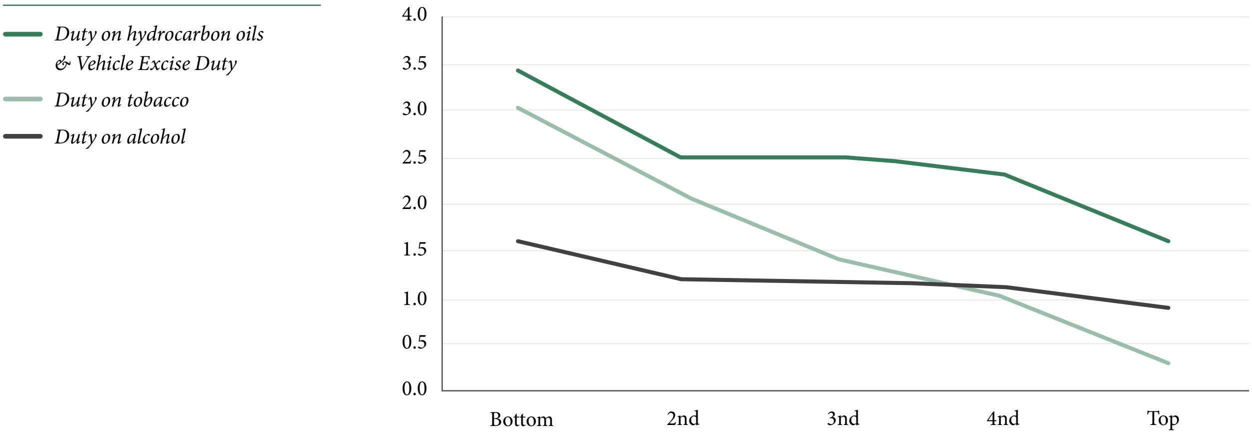
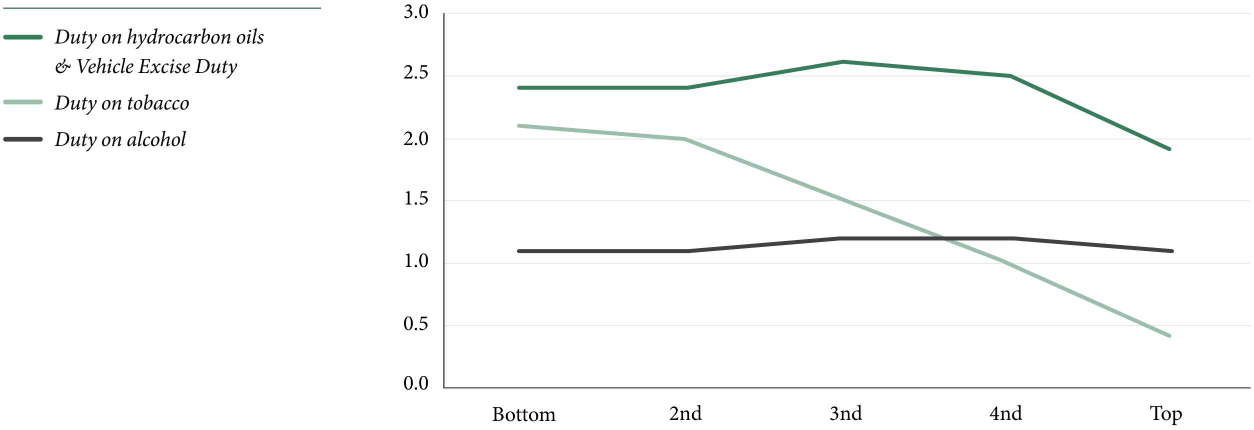


Figure 7.8: Pigovian taxes as a percentage of expenditure, by quintile



Motoring taxes are more likely to reflect the divide between rural areas, small towns and the surburbs where driving is a necessity for many people, and inner cities where dense populations mean public transport can be a more practical alternative (as shown in Section 7.2.1.). While they do affect the rich less than those on low and middle incomes, the pattern is not as stark as with the other Pigovian taxes.

Alcohol and particularly tobacco duties are extremely regressive. The idea is that those taxes operate in the interests of the people taxed by reducing the amount they smoke and drink but, to the extent people continue to smoke and drink, they will not be any healthier for paying these taxes but simply poorer. That will increase benefit dependency or poverty.

Chapter eight

Local authorities should raise half of their spending power from local taxes

8. Local authorities should raise half of their spending power from local taxes

8.1. Competition between local authorities leads to better value for money

Over recent years there has been an increasing focus on the economic arguments for decentralisation. The OECD has launched a major cross-country study which for the first time allows us to make proper international comparisons.[691]

The quantified evidence is still emerging, but the OECD study has already confirmed that our local authorities have a markedly lower degree of tax autonomy than their counterparts elsewhere. Across the G7, they have the least autonomy.

And there has been a growing stream of research papers seeking to examine and quantify the benefits of decentralisation.

Raising money directly from local taxpayers is not enough on its own. For the incentives to work properly, it is important that local authorities are free to compete with each other on tax rates. In the words of a recent research paper from the OECD:[692]

> *There is a general view that more tax competition leads to more efficiency in the public sector, both by making public providers more responsive to consumers' tastes and by raising the quality and lowering the cost of publicly-funded services. Tax autonomy provides voters with an additional lever in shaping the public sector, namely to decide on tax levels, making them more aware of public service outcomes.*

And the incentive effects of tax competition go beyond simply providing a local authority's voters with an external yardstick against which to measure performance. Competition also pitches authorities against each other in attracting households and businesses to locate in their areas in the first place. If they are to prosper, with a growing tax base, authorities are forced to offer competitive tax rates relative to their service levels.

There's a broad parallel here with the way market competition drives business efficiency and value. Indeed, one of the seminal academic papers on the subject set out a framework in which local authorities effectively compete for customers (Section 3.1.1.2). Authorities offer a bundle of public services to residents and prospective residents in exchange for a given rate of tax, and the customers choose between them, effectively voting with their feet. And just like with, say, supermarkets, each authority can decide whether it wants to offer high tax and a premium service, or lower tax and a more value-oriented service. Different customers will choose different offers, but whatever they choose, the onus will be on each authority to offer value for money or risk losing them (that is, its residents and tax base).

---

691. See OECD Fiscal Federalism Network and Fiscal Decentralisation Database
692. Blöchliger, H. & Pinero Campos, J. M. *Tax Competition Between Sub-Central Governments*, Economics Department Working Paper No. 872, OECD 2011

By pursuing a low tax and value-oriented fiscal policy, poor areas can attract entrepreneurial individuals and firms with the ability to kick-start the local economy

Tax rates are critical to this competition, and individual authorities have to ensure their rates stack up against neighbouring jurisdictions. But just like with supermarkets, businesses and households do not make their location decisions solely on the basis of price. As well as tax rates, they also consider a whole range of other factors, including the quality of local infrastructure and public services: for example, the availability of good schools is well known to influence household location decisions.

So while fiscal competition drives local authorities to bear down on tax rates, they cannot do so at the expense of valued public services. Instead, they have to find ways of delivering those services for less. They have to strip out services that are not valued by their businesses and households, and become more efficient at providing those services that are. They are driven to stay on their toes.

In terms of economic growth, this same OECD research points out that tax competition may be particularly powerful in helping poor areas catch up with their richer neighbours. By pursuing a low tax and value-oriented fiscal policy, poor areas can attract entrepreneurial individuals and firms with the ability to kick-start the local economy. That may account for the fact that countries with a high degree of fiscal decentralisation have been much more successful at evening out differences in regional income levels than centralised states such as Britain. In that respect, decentralisation could have a particularly big payoff for taxpayers, given the abject failure of top-down interventionist development policies to lift the performance of our depressed regions (Section 3.6.1).

Some argue that this market process must be disastrous for public services. They argue that tax competition must inevitably result in a "race to the bottom"; that local authorities will constantly undercut each other in setting tax rates, and that there will not be sufficient revenue to fund good public services, however efficient they become.

But in practice that does not happen. The OECD's research has specifically looked for the effect across its member states and concludes:[693]

> *A "race to the bottom" cannot be observed. This tends to contradict the view that tax competition may result in taxation levels too low to sustain adequate public service levels.*

In practice, while competition drives individual authorities into mimicking the tax rates charged by competitors, the direction of travel is by no means always downwards. In fact, the OECD finds that "tax rates have tended to converge and to go up rather than down in the last decade".

The reality is that households and businesses do not relocate purely to chase the lowest tax rate, and they really do balance the attraction of low taxes against the quality of local services and other factors. Far from undermining public services, tax competition is a necessary driver towards public sector efficiency and growth.

8.1.1. Fiscal decentralisation delivers lower spending

There is a recurring argument in the literature that fiscal decentralisation leads to smaller government. For instance, evidence is provided by Deacon (1979), Mehay (1984), Mehay and Gonzales (1985), and Marlow (1988). Other studies have looked at cross-national data and have also found that more decentralised structures

693. *Tax Competition Between Sub-Central Governments*, Hansjörg Blöchliger, José Maria Pinero Campos, Economics Department Working Paper No. 872, OECD 2011

are inversely related to the size of government (Cameron, 1978; Saunders, 1986; Schneider, 1986; Mueller and Stratmann, 2002).

More recent studies have built on this work. Cheikbossian found that a decentralised provision of services may lead to a higher surplus than a centralised provision does. This is despite the fact that localities usually have similar – if not identical – preferences. The study also finds that free-riding costs associated with decentralisation can be lower than the costs of rent-seeking under a more centralised system.[694]

Another study by Buser measured the impact of public sector decentralisation on per capita income. She found that in 20 high-income OECD nations, decentralisation was positively related to income over the years 1972 to 2005.[695] Baskaran looked at the link between decentralisation and debt in 17 OECD countries from 1975–2001, finding that spending decentralisation significantly reduced public indebtedness.[696]

Finally, Crowley and Sobel used panel data from Pennsylvania to show that fiscal decentralisation resulted in stronger intergovernmental competition and lower tax rates. They compared property tax rates to the revenue-maximising rates for municipalities, school districts, and counties. After obtaining point estimates of the tax rates that would maximise tax revenues for each jurisdiction, they were then able to calculate how far the actual rates for each were below 'Leviathan' rates (Section 3.3.3). All of the local jurisdictions studied set tax rates well below the revenue-maximisation point.[697]

8.1.2. Fiscal decentralisation delivers more efficient public services

Decentralisation can only yield its benefits if both responsibility and power are devolved to the local level. Authorities must be free to make their own decisions both over what they spend, and over how they raise the funds to pay for it.

On the spending side, that requires an end to ring-fencing central government grants for specific programmes. And although much remains to be done, the current government has already begun to relax some of the restrictions there.

But, as has been powerfully argued by a number of successful local authority leaders,[698] the decentralisation of public spending ought to go much further than that. Local authorities are responsible for a much lower proportion of total public spending than their counterparts overseas. And that's because various services that are seen as local elsewhere have ended up under central government control here.

Centrally driven spending on what are essentially local services is highly inefficient. It offers one-size-fits-all "silo services", where delivery is not joined up at local level, and there is little or no flexibility to address local conditions, or to experiment. Large areas of central government spending on public services – such as employment support – could be much more efficiently delivered if control were devolved to local councils.

However, decentralisation of spending – regardless of how extensive – is only one side of the reform programme. To capture the full benefits of decentralisation it

694. Cheikbossian, G. Rent-seeking, spillovers and the benefits of decentralization, *Journal of Urban Economics*, 63, 2008
695. Buser, W. The impact of fiscal decentralization on economics performance in high-income OECD nations: an institutional approach, *Public Choice*, 149, 2011
696. Baskaran, T. On the link between fiscal decentralization and public debt in OECD countries, *Public Choice*, 145, 2010
697. Crowley, G. & Sobel, R. Does fiscal decentralization constrain Leviathan? New evidence from local property tax competition, *Public Choice*, 149, 2011
698. Barrow, C., Greenhalgh, S. & Lister, E. *A Magna Carta for Localism*, Centre for Policy Studies, 2010

is vital to make corresponding changes on the tax side, because the key performance incentives depend on local government having to raise its own money.

The most obvious of these incentives is electoral accountability. As the Layfield Report put it back in the 1970s:[699]

> *[The] first requirement of a financial system for local government is accountability: whoever is responsible for incurring expenditure should also be responsible for raising the necessary revenue.*

By making local councils responsible for raising more of their own funds, they are made directly accountable to their own local communities. Financial dependence on local taxpayers means authorities are incentivised to deliver value to their voting customers, rather than ticking boxes laid down by paymasters in Whitehall.

An econometric study from the German CESifo group focuses on the efficiency issue. Analysing 21 OECD economies over the period 1970–2000, it concludes:[700]

> *Our main finding is that government efficiency increases with the degree of fiscal decentralisation. This result appears to be robust to a number of different specifications and fiscal decentralisation measures.*

Specifically, on the basis of the study's main measure of tax decentralisation, the authors find that a 10 percentage point increase in local and regional governments' share of total national tax revenue improves public sector efficiency by around 10 per cent.[701]

On that basis, with the UK's annual public spending now running at £700 billion, increasing local governments' share of taxes from its current five per cent up to say, 15 per cent, would save around £70 billion a year. Or to put it another way, if we reverted to a system in which our local authorities raised around half their own funding (as they did up to the mid-1960s), the prospective efficiency gains would make it possible to get the same overall standard of public services for around £70 billion a year less than they currently cost.

Of course, the savings wouldn't be as much as that because local authorities currently account for a smaller share of public spending than is the case among our more efficient competitors. But on the other hand, we have considerable scope for increasing savings by making local authorities responsible for running and funding some of the local services currently run by central government. For example, in other countries, local government runs elements of healthcare and welfare, which are run here via a vast array of central government quangos.[702]

Either way, the key point is that across the OECD, tax decentralisation is strongly associated with greater public sector efficiency – being able to do more for less.

---

699. *Report of Layfield Committee on Local Government Finance*, HMSO, 1976

700. Adam, A., Delis, M. D. & Kammas, P. *Fiscal Decentralization and Public Sector Efficiency: Evidence from OECD Countries*, CESifo Working Paper No. 2364, 2008

701. The study estimates that a one percentage point increase in Sub-Central Government's own tax revenue as a share of General Government total tax revenue increases Public Sector Efficiency (PSE) by 0.005–0.007 (depending on which of two PSE measures is used). The scaling on the PSE measures is 0–1, with an average of 0.58 for PSE measure 1, and 0.61 for PSE measure 2. So a one percentage point increase in Sub-Central Government's own tax revenue share improves PSE by approximately one per cent. Hence our statement that a 10 percentage point increase in SCG's share of total tax revenue improves public sector efficiency by around 10 per cent.

702. For an overview, see *ACA-to-YJB: A Guide to the UK Semi-Autonomous Public Bodies*, TaxPayers' Alliance, 2009

8.2. Local authorities can more flexibly respond to local priorities and circumstances

Decentralised systems deliver superior results for a number of very good reasons:[703]

- Responsiveness – local government is more responsive to local choices and local needs: it can focus resources on the services that are most valued by the local community; top-down, one-size-fits-all, policies set by central government cannot do that.
- Cost efficiency – local government can organise its services to reflect local cost conditions; organisational structures and pay scales dictated from the centre cannot do that.
- Incentivisation – when local government raises its own revenue from local taxes, it has a strong financial incentive to encourage local economic growth; these effects are strongest where authorities are able to set their own tax rates in competition with other authorities.
- Accountability – when local government raises its own revenue, it ensures that service delivery on the ground can be closely scrutinised by those who actually have to pay for it.

Experimentation is also easier at the local level, allowing local authorities to discover through diversity what works

Experimentation is also easier at the local level, allowing local authorities to discover through diversity what works, much more quickly and cheaply than relying on top-down direction from Whitehall. And properly empowered local government is likely to attract better quality candidates into local politics, improving the overall direction and management of public services.

8.2.1. Fiscal decentralisation delivers stronger economic growth

A recent study looks at the relationship between fiscal decentralisation and economic growth. The Spanish Institute for Fiscal Studies analysed 23 OECD countries over the period 1972–2005, and concludes:[704]

> *… economic growth … has been adversely affected by decentralisation of expenditures but encouraged by revenue decentralisation … reducing expenditure decentralisation, and simultaneously reducing the fraction which is financed centrally would be growth-enhancing.*

Specifically, the study estimates that increasing the share of local and regional government tax in total national tax revenue by one percentage point increases long-run GDP growth by about 0.06 per cent a year. In contrast, on the spending side, *reducing* local government's share of spending by one percentage point increases long-run GDP growth by about 0.07 per cent a year.

As the study highlights, these two effects have to be seen together. What the analysis tells us is that when local government spends a lot more than it has to raise in tax for itself, it tends to depress economic growth. Funding from central government grants means that local authorities do not have a strong incentive to grow their own local economy and tax base, and that feeds through directly to lower GDP growth at the national level.

703. For further discussion, see Carswell, D., & Hannan, D., *The Plan*, 2008

704. *Fiscal Decentralization And Economic Growth In OECD Countries: Matching Spending With Revenue Decentralization*, by Gemmell, Kneller, and Sanz, Instituto de Estudios Fiscales 2009

The study tells us that the worst of all worlds is decentralised spending coupled with centralised tax raising. Unfortunately, that is precisely the arrangement we currently have in place. Local government accounts for around 30 per cent of public spending, but raises only five per cent of tax revenues. It is one of the biggest local tax shortfalls anywhere in the OECD.

The Spanish Institute for Fiscal Studies study suggests that narrowing the shortfall could yield considerable economic benefits, reflecting both public sector efficiency gains, and the greater vibrancy of local economies. Again, if local government reverted back to its traditional position of raising half its revenue from its own local taxes, we might expect a boost to long-run GDP growth of around 0.5 per cent a year, a huge uplift compared to the meagre 1.9 per cent a year average growth rate we've achieved since 1997.

8.2.2. Richer authorities should become entirely self-funding and support for poorer authorities through central government grants should be scaled back substantially

The 2020 Tax Commission proposes that at least 50 per cent of all tax-funded expenditure by local authorities should be raised from their own local taxation. That's roughly the historic ratio of self-funding mentioned earlier, and it's also the ratio proposed by Chartered Institute of Public Finance and Accountancy, the public finance accountancy body. Longer term, with the new arrangements bedded in, we believe the ratio should be increased further, to around 75 per cent or beyond.

The structure of grant funding would also change. Ring-fenced grants would end, so that authorities could decide their own spending priorities. Grants would be focused purely on the equalisation of resources against assessed needs.

Because the taxable base varies considerably between rich and poor areas, and because needs also vary between areas, central government has developed a complex system of resource- and needs-based grants. In pursuit of equity, the biggest grants go to the poorest areas with the biggest needs.

All developed countries have some form of fiscal equalisation, and we do not propose its abolition here. But it's a question of degree, and our current grant system extends much further than those found elsewhere. Our system has gone way beyond equalisation, with even the richest authorities getting huge grant allocations to fund needs identified and prescribed by central government.

The figures for England make that clear. According to the Department for Communities and Local Government[705], taxpayer funding for English local authorities in 2009–10 amounted to £129.3 billion. But of that, just 17 per cent was raised from local taxation. The other 83 per cent came in one way or another from central government – in other words, national taxes.

Out of the more than 350 local councils in existence, well over half were dependent on central government money for more than 90 per cent of their tax funding. Not a single council raised more than 40 per cent of its own tax funding, and only five raised more than 30 per cent.

Equalisation on this scale comes at a heavy cost in terms of efficiency. For one thing, central government is collecting taxes from each individual area, churning the money through its own convoluted and expensive bureaucracy, and then returning it back to those same areas to fund local services provided by the local authority. It is a process guaranteed to generate waste and inefficiency.

705. *Local Government Financial Statistics England No.21 2011*, DCLG

And beyond that, equalisation grants undermine the very incentives that are vital to boost local authority efficiency and commitment to growth. If authorities can get along on grant handouts from central government, any competitive pressure to provide an efficient service to their real customers comes a distant second.

Under the 2020 Tax Commission proposals, the richest authorities would become largely self-funding. The poorest authorities would continue to receive some support, but on nothing like today's scale.

There's one further point to make here, which relates to our proposed Local Income Tax. One argument against such a tax is that it exposes local council finances to the risk of economic recessions. At present, it is said, they are protected by central government, which takes the hit on its own books when income tax receipts dip with a downturn. In effect they provide revenue equalisation across the different phases of the economic cycle.

This argument is not convincing. Historically, central government has done little to protect council grant funding through recessions. During the difficult 1970s and into the 1980s, grants were subject to a prolonged squeeze, and that process is under way again now. Indeed, if anything, central governments have shown themselves capable of squeezing grants more than other elements of their spending. The idea that national taxes protect local councils from the economic cycle is an illusion.

8.2.3. Local sales taxes, local income taxes and greater control over business rates should be allowed to supplement Council Tax and enable local authorities to double the share of their spending they finance, with commensurate further cuts in national taxes

A 50 per cent self-funding target means we need to approximately triple the amount of tax local authorities raise for themselves. We'd need to decentralise a further £50 billion of tax revenue, taking local taxes to something like £75 billion annually. That would be around 15 per cent of total national tax revenues – still significantly less than the corresponding percentage in many other countries, including the US, Japan, and Switzerland.

Local authorities would lose £50 billion a year of central government grant funding. They would gain new tax powers sufficient to raise at least that amount, but it would be up to each local authority to decide what rates to set for each of its taxes. There would be no requirement for them to stick to the rates previously levied by central government.

8.2.3.1. Council Tax capping should be ended

Council Tax should remain in place as a practical existing means for councils to generate substantial revenue.

Rates should no longer be capped by central government. Individual authorities should once again be free to impose whatever rate they decide, but fully answerable to their local electorates. They are, and should continue to be, required to hold a referendum on any proposed increase above a certain level. Over time, with greater local responsibility, even that should become less necessary.

There is also a case for rationalising the system of property valuations (Section 6.2.3). At present, Council Tax in England is operating on the basis of valuations that were last updated in 1993, even though property prices have surged since then. That's because the timing of revaluations is entirely at the discretion of Westminster politicians, and successive governments have shied away from risking what could be significant tax increases for some individual households, and involve considerable administrative cost.

But if councils are to be properly encouraged to nurture their local economies, they need to know that they will benefit from the uplift in local property values. That could be done by putting valuations on a fixed regular cycle. Business Rate valuations are conducted on a five year cycle by the central Valuation Office Agency. That pattern could also be applied to Council Tax valuations.

Any revaluation exercise should not give rise to an overall change in Council Tax bills. And clearly, given how long has elapsed since the last valuation, care would be needed to ensure that the first of the fixed five year rounds did not give rise to one.

At the national level, it ought to be possible to achieve that by calibrating the new banding ranges to generate the same overall tax revenue as at present. At the individual authority level, there would be winners and losers, but it would be perfectly possible to equalise them through the grant settlement.

However, at the level of individual households there would need to be transitional arrangements to prevent excessive increases. In each of the first two of these regular five year revaluations, no property should be moved up by more than one Council Tax band. That would prevent a repeat of the situation during the Welsh revaluation exercise, when some properties were moved up by two or even three bands in one fell swoop.

8.2.3.2. Business rates should return to local authority control

Business rates are another existing and functioning local tax.[706] Indeed, until they were centralised in 1990, local business rates were the second major pillar of independent revenue funding for local authorities. They currently raise about £25 billion annually, roughly the same as Council Tax.

In order to reconnect local authorities with the growth and prosperity of their local economies, it is vital that business rates are once again returned to local control. We therefore propose that they should be decentralised.

Local authorities should be free to set their own rate – possibly subject to some upside limit as described below – with valuations determined by the central Valuation Office Agency, as now. Collection of the tax would continue to be in the hands of the local authorities, as it is now, but they would keep the proceeds rather than handing them over to central government.

Tentative steps are already being taken in this direction: from 2013–14 onwards individual authorities will be able to keep the bulk of any growth in the local revenue from business rates (albeit still subject to possible clawbacks). But welcome though that is, we believe it should go much further. Local authorities need to have a direct and substantial revenue stake in local business success.

There is of course, a common objection. Because businesses do not vote, there is a risk that they will be excessively taxed by local authorities with no regard for the financial health of the companies themselves, and the area's long term economic future. During the 1970s and 1980s, some so-called "loony left" councils were seen to do precisely that, which was a key driver behind the centralisation of the tax in 1990. That is certainly a legitimate concern, and that is why some reformers have even proposed the broader introduction of a business vote, as already exists in the City of London, where businesses are able to nominate a number of their staff as voters, the number depending on company size. Other ideas include the appointment of Local Business Commissioners to hold councils to account, or Area Growth Boards, with

706. Economic theory suggests that the business rates are a bad form of tax because they apply to a business input, thereby distorting production decisions, that is discussed in Chapter 16 of the Mirrlees Report. The 2020 Tax Commission proposals do not address that broader issue, but equally do not make it any worse.

strong business representation and powers over economically important elements of local spending.[707]

There are also more direct ways of addressing the concern while still retaining the flexibility for authorities to compete. One idea is that increases in an individual authority's business rate should be limited to the corresponding increase in the Council Tax rate. Authorities would be free to set a lower increase – or even a reduction – in their business rate, but they couldn't go higher. That would offer a good measure of protection from the "loony left", while offering maximum scope for more progressive councils to compete for growth.

Over time, the hope and expectation would be that such controls would become unnecessary. All councils and their electorates would come to recognise the benefit of nurturing local businesses, rather than taxing them to death. With central grant funding cut back substantially from current levels, even the "looniest" councils would be forced to strike a balance between bumping up tax rates to maximise revenues in the short term, and cutting rates to stimulate business growth over the long term.

A second objection is that decentralising business rates would be unfair. Richer councils whose areas host a concentration of businesses would instantly become better off at the expense of poorer ones. And removing business tax revenue from the central pot might not leave enough for central government to redress the balance through equalisation. This was why the Lyons Inquiry rejected the idea, even though it accepted that "the nationalisation of business rates in 1990 was not a positive change".[708]

There is no doubt that decentralising business rates would throw up winners and losers. But by simultaneously abolishing the ring-fencing of grants (not proposed by Lyons), our proposals would leave plenty in the central pot for equalisation.

And if that weren't thought enough, there could be additional transitional arrangements whereby the biggest winners had a slice of their winnings redistributed to the biggest losers. However, any such arrangements would be limited to a few years. The whole point of decentralising business rates is to encourage each council to build its own tax base rather than looking to tap its more prosperous neighbours.

8.2.3.3. Local Income Tax should be a new source of local revenue

A British Local Income Tax (LIT) has been under consideration in one form or another for over a century. In the 1970s the authoritative Layfield Report[709] concluded it was the only serious possibility for raising more local tax revenue. More recently, having re-examined all the key issues (including administrative costs), even the very cautious Lyons Inquiry agreed that it was indeed a "viable" option.

Local income taxes are in common use across developed economies, including the three public sector efficiency leaders – the United States, Japan, and Switzerland

However, unlike many previous proposals for LIT, the 2020 Tax Commission proposal is not for it to be an *addition* to the existing Income Tax. Our proposal is that LIT should *replace* a portion of national income tax.

Local income taxes are in common use across developed economies, including the three public sector efficiency leaders – the United States, Japan, and Switzerland. So, far from taking a step in the dark, introducing them here would be bringing us into line with widespread international practice.

LIT has a number of attractions. To start with, it is more buoyant than property tax, allowing local councils to share in economic growth directly, without the need

707. Barrow, C., Greenhalgh, S. & Lister, E. *A Magna Carta for Localism*, Centre for Policy Studies, 2010
708. *Lyons Inquiry into Local Government*, HM Stationery Office, 2007
709. *Report of Layfield Committee on Local Government Finance*, HM Stationary Office, 1976

for revaluations or higher tax rates. Local councils are given a clear and substantial stake in promoting the prosperity of their residents.

LIT is also more progressive than residential property tax, which tends to bear disproportionately on lower income groups such as pensioners. Used in conjunction with Council Tax and business rates, it allows councils much greater control over the incidence of their taxes.

The 2020 Tax Commission proposal is that councils should be given power to levy a local income tax. Their individual rates would be applied equally to all earnings above the personal allowance, with the tax collected by HMRC alongside national income tax and given to the authority. Each income tax payer would then be paying a standard national rate of tax, plus a local tax depending on where he or she lived.

Initially, this would be no more than a simple switch of existing income tax revenue. Instead of funnelling the entire revenue into central government's coffers, a portion would be distributed to local councils. Distribution would be determined by HMRC in line with the residence of individual taxpayers.

At the same time, councils overall would lose an equivalent amount of grant funding from central government. Thus the whole exercise would balance financially – local authorities would get more tax revenue but less grant, and central government would get less tax revenue but have less to pay out in grants. There would be no overall change in tax for individual taxpayers, at least initially. Overall marginal tax rates would not be higher than 30 per cent.

For example, if LIT were set at an average of around the equivalence of six per cent, which would be redesignated as LIT, and the prior national rate were 30 per cent, then the national rate would be reduced to 24 per cent. Individual taxpayers would see their income tax payments split between LIT and national tax, but the overall amount would be unchanged on average.

Based on HMRC statistics and adding such a rate to the current basic rate of Income Tax, as opposed to the new system proposed by the 2020 Tax Commission this new six pence LIT would yield revenue of around £27 billion a year.[710] Central government would lose that amount, with the national basic rate falling to 14 per cent plus National Insurance (before our proposed merger of Income Tax and National Insurance), and local authorities would gain it.

After the initial creation of the LIT at a certain rate, from the following year, each authority would have power to vary its own local rate annually within an agreed national range.

The minimum should be set at zero, allowing authorities maximum scope to compete for new residents with the lowest possible taxes. The maximum should be set at eight pence, giving existing residents, who may find it expensive to move in the short term, some protection against the predations of "loony" councils.

There is a case for assigning these LIT powers to identifiable economic areas, such as large metropolitan areas, unitary authorities and existing counties, rather than district councils. And regardless of the tier of government, it would be vital to align the tax authorities with existing local authority areas. Giving LIT powers to a new layer of regional authorities – especially if they were unelected – would not deliver the efficiency and growth for which we are aiming.

In terms of administration, the LIT would be collected and distributed by HMRC. Most of the collection would be done through the PAYE system, with the self-employed and those with complex tax affairs captured through their existing

710. *Tax Expenditures*, HMRC, March 2011, Table 1.6

self-assessment tax returns. However, small savings and investment income would be best excluded from LIT, remaining on a composite national rate. Most savers have tax deducted at source, and to bring that into the LIT net would require them all to complete individual tax returns for the first time, which is not realistic.

Clearly, LIT would impose new administrative requirements and there would be costs attached. However, widespread computerisation has cut the prospective costs considerably over recent years, and compared to the prospective gains, they are now quite modest. The Lyons Inquiry estimated HMRC's set-up costs at £125 to £200 million, with annual running costs of just £10 million.[711] The costs to business are more difficult to estimate, but Lyons quotes a set-up cost of around £100 million, estimated by Chartered Institute of Public Finance and Accountancy. Given the prospective benefits to the public purse, there would be a strong case for government help with these costs, especially for small businesses.

Finally, it would be vital to ensure a high degree of transparency.[712] For the scheme to generate the right incentives, individual income tax payers would need to know how much they were paying to their local authorities as distinct from what they were paying to central government. It certainly should not be hidden away inside an amorphous total figure.

We propose two measures to address this. First, those paying the tax via PAYE would have their national and local payments separately identified on their payslips, with a corresponding annual statement for those on self-assessment. Second, each local authority would have to provide each of its LIT payers with an annual statement, setting out how much they paid in the previous fiscal year, what rate was charged, how that local rate compared to the national average, and what local rate has been set for the current year. That could be combined with existing Council Tax statements or new national tax statements.

8.2.3.4. Local Sales Tax should be a new source of local revenue

Taxes on goods and services (consumption taxes) have often been proposed for decentralisation.[713] Other countries, including the US, have local sales taxes, and there is a good case for Britain following suit.

For one thing, a local sales tax could provide individual authorities with the funding to maintain and improve their town centres, many of which have come under increasing competitive pressure from out-of-town stores. A local sales tax would also give authorities a further incentive to nurture local business, in this case retail business. And in areas with a large amount of tourism, it would give authorities a direct compensation for investing to support that industry.

More broadly, there's a strong argument based on fairness, which is that *every* adult in the community ought to be contributing something to the cost of local services. A sales tax could ensure that, since everyone buys things. In contrast, Council Tax only applies to householders, business rates only apply to businesses, and Income Tax only applies to the around 60 per cent of adults who actually pay it.[714]

For these reasons, we propose that local authorities be given power to raise a new local sales tax. They would be a permitted to raise a tax of up to five per cent on goods and services already subject to VAT at the standard rate, although for the

---

711. *Lyons Inquiry into Local Government*, para 7.229. Note that the figures quoted relate to the preferred Tax Tables method of collection.
712. For a critique of LIT on this point, Carswell, D. *Paying for Localism*, Adam Smith Institute, 2004
713. See for example Carswell, D. & Hannan, D. *The Plan*, 2008
714. For an full exposition of this point see Carswell, D. *Paying for Localism*, Adam Smith Institute, 2004

reasons outlined below, the power would need to be restricted to county councils and large metropolitan authorities.

This new tax would be entirely optional, and not all authorities would choose to deploy it. But it would significantly enhance their fiscal flexibility, allowing them to further shape the incidence of their taxes in the light of local circumstances. For example, an authority keen to attract new businesses to its area might decide to raise its sales tax in order to fund a cut in its Business Rate.

Applied at the maximum rate across the entire country, this new sales tax would raise something over £25 billion a year.[715] It is unlikely that there would be anything like full take-up immediately, but a sum like that would be enough to fund a one-third reduction across all three of the other devolved taxes.

Of course, a local sales tax faces some well-known objections. First, it may be prohibited under the current terms of our EU membership. Some member states (e.g. Germany) do share VAT revenues among their sub-national authorities, but the rates and tax base are uniform across the country and set centrally. We certainly could not decentralise VAT itself, even if the EU allowed us to, because in our hugely interconnected economy that would be an administrative nightmare and rife with opportunities for fraud. A decentralised consumption tax has to be a sales tax.

Second, even if we disregard the EU rules – which are disputed – a local sales tax could run into a serious avoidance problem. If residents are easily able to do their shopping in a lower tax jurisdiction next door, they could opt to avoid the taxes imposed by their own authority – the one that provides the services they consume. As the OECD notes:

> *In general, efficient [decentralised] consumption tax systems are confined to large countries with large regional jurisdictions.*

Given Britain's small size and dense population, even confining tax raising powers to county councils and large metropolitan areas could still leave scope for substantial avoidance, a problem exacerbated by the growth of internet shopping.

Yet although this could be a serious problem, until we try it nobody actually knows. In practice, modest differences in sales tax may not pose much of a problem at all. Once we take account of travel costs, there's no fundamental reason why authorities offering a convenient and attractive local shopping environment shouldn't be able to make a modest supplementary charge stick. There are already substantial differences in prices across the country, and across different stores, after all. But many people still shop in places like central London where prices tend to be higher.

In the spirit of experimentation mentioned earlier, authorities should be able to try a local sales tax if they wish. Depending on how the early adopters got on, the experiment would either be copied by others – leading over time to an increasing reliance on sales tax – or demonstrate that local sales taxes were untenable here.

8.2.4. Other proposed means to finance local services are not good alternatives

8.2.4.1. Local profits taxes are not an effective way of raising revenue

The 2020 Tax Commission's proposals for decentralising business rates and a new local sales tax would together give authorities a substantial stake in the prosperity

715. *Tax Expenditures*, HMRC, March 2011, Table 1.6

of their local businesses. It would be possible to make the stake even bigger in theory by decentralising tax on corporate profits.

In principle, competition on profits tax could be a vital tool for local authorities – especially poor ones – in attracting and nurturing business enterprise in their local economies. In particular, young firms and start-ups are known to have a higher mobility than mature companies, and to care a lot about tax. They would likely respond well to tax competition.

Unfortunately, decentralised profits taxes can be complex and costly to administer. Many companies operate across multiple locations inside a country, and ascribing profits to specific local jurisdictions is fraught with difficulty. Moreover, within a single country many businesses have scope to shift their profits into lower tax jurisdictions, irrespective of where they have actually been earned. So decentralising our company taxes could result in profits being shifted from authority to authority with no pay-off in terms of public sector efficiency or economic growth.

The OECD research finds that decentralised profits taxes are mainly confined to federal countries, including Canada, the US, and Switzerland. But even they have experienced growing problems with profit shifting, necessitating significant changes in tax rules. Indeed, in the US, most states have now effectively abandoned profits tax in favour of apportionment formulas based on sales and turnover.

For these reasons the 2020 Tax Commission is not proposing the decentralisation of company profits tax, even leaving aside the earlier objections to a tax on profits in itself. It would also be difficult to fit in with the new proposed system for taxing capital income.

8.2.4.2. Higher charges may be fair in some circumstances, but not alongside a rising overall tax burden

The 2020 Tax Commission proposals have focused on the structure of local authority tax funding. However, there is another source of local authority revenue: user charges for services such as car parking and planning applications. And these have increased substantially over recent years, with English authorities alone now raising about £12 billion a year from this source.

In principle, higher charges can be fairer, as those who benefit from a service pay for it. And on that basis, user charges could well have an increasing role in future local authority funding.

However, there are two important caveats.

To some extent, if a local authority is charging for a service, then that raises the question of whether it should be providing it in the first place

First, local authorities should not be charging twice for services that have already been paid for through taxation. In the decade to 2007–08, local authority charges more than doubled, yet there was no sign of an offset in lower Council Tax bills.[716] That is unacceptable.

Second, user charges are never going be a complete replacement for taxation. The very essence of taxation is that it obliges us all to contribute for services from which we all benefit, but for which we might not all want to pay as individual users. Local authorities provide many such services, such as street cleaning and lighting.

To some extent, if a local authority is charging for a service, then that raises the question of whether it should be providing it in the first place, or leaving that provision to the private sector. This is particularly true for any service where there are multiple private providers already in the market. Murray and Lehrer report that, "as mayor of Indianapolis, Stephen Goldsmith applied what he called the 'Yellow

716. Denham, M., Pirie, G., Sinclair, M. & Taylor, C. *The Great British Taxpayer Rip-Off*, TaxPayers' Alliance, 2008

Pages Test' to the government of America's 12th largest city: If at least two firms advertised in the local Yellow Pages to provide a service, he would work to see if the city could turn that service over to the private sector."[717]

For both those reasons, still higher user charges have not been incorporated in the 2020 Tax Commission proposals.

8.2.4.3. Any decentralisation of powers to borrow should be introduced cautiously and only after local authorities take greater responsibility for their own financing

Local authority borrowing powers are not directly affected by the proposed increase in their powers of taxation.

For many years local authority borrowing was heavily restricted, reflecting a concern that authorities could borrow recklessly against an implicit guarantee from HM Government. But over the last decade, restrictions have been eased somewhat, recognising that authorities do need some flexibility in funding capital investment projects.

First, the previous government allowed them to borrow in order to fund fixed capital investment, as long as such borrowing could be shown to be prudent, affordable, and sustainable. More recently, the current government extended those powers, allowing authorities to borrow against predicted growth in their locally raised business rates (known as Tax Increment Financing – TIF).

In principle, greater local authority borrowing powers could be an important element of true fiscal decentralisation. But in practice, there are legitimate concerns about reckless borrowing, especially after a long period during which authorities have not enjoyed substantial borrowing powers.

The prudent approach is to decentralise taxation first and return to the issue of increased borrowing powers once the reality of fiscal decentralisation has had a chance to bed in. Both borrowing authorities and their creditors need time to understand that a defaulting authority will never be bailed out by central government.

717. Lehrer, E. & Murray, I. *The Continuing Value of Privatization: A Primer on How to Do It Right, and What to Avoid Doing Wrong*, Competitive Enterprise Institute OnPoint No. 123, 26 October 2007

Chapter nine

Conclusion

9. Conclusion

The Single Income Tax could deliver a fair, efficient, simple and honest tax system

At the moment taxes and spending are an intolerable burden on families and businesses. Britain's economy is growing less; not as innovative; less productive; more indebted and is less attractive as a location to invest and build a business. We are all paid lower wages; are more likely to be unemployed; more likely to be tempted to avoid or evade tax; and less aware of how much we are paying than we should be. The poorest are being taxed down to poverty wages; the middle classes are being squeezed extremely hard; and the richest are paying absurdly high rates that drive too many out of the country altogether. No one is getting a good deal except the rent seekers and special interests who exploit loopholes and special deals.

The Single Income Tax could deliver a fair, efficient, simple and honest tax system. We should move to a system where, as far as possible, each stream of income is taxed once. Lower marginal rates of tax on labour income, and not repeatedly taxing capital income, will produce dramatic economic results.

The results of our reforms would be apparent immediately in rising share prices, giving a new lease of life to embattled pension funds. Within a few years the improvement in economic growth would mean greater prosperity for everyone and new revenue, allowing further tax cuts. In the longer run the increase in investment would leave British business more technologically advanced and in a much better position to succeed in increasingly competitive global markets.

Serious tax reform is an essential part of any meaningful plan for growth. In turn that is the only way we can effectively respond to the scale of the fiscal crisis confronting Britain, and avoid being locked into an indefinite period of austerity.

Finally, greater transparency can start to end the atmosphere of poisonous suspicion that surrounds our tax system. Citizens who cannot understand their own tax bills, let alone why other people and businesses pay what they do, suspect they are the ones picking up bills dodged by everyone else. That undermines social cohesion; provides an illegitimate but powerful excuse for low level evasion; and ends in angry protests.

There is no reason to be complacent or defeatist about the political prospects of such a reform. Radical tax reform has been undertaken in the past both in Britain and in other countries with huge disadvantages we do not share. But it will take political leaders of vision and serious work convincing the public that a much better system is possible.

Appendix

Earlier tax reviews

Appendix – earlier tax reviews

Dimensions of Tax Design. The Mirrlees Review for the Institute for Fiscal Studies (OUP: Oxford, 2010) and Tax by Design. The Mirrlees Review for the Institute for Fiscal Studies (OUP: Oxford, 2011)

The Mirrlees Review revisits an appraisal of the taxation system by the Institute for Fiscal Studies thirty years before. Like its predecessor, the Review criticises the tendency to make tax policy on an ad hoc basis and argues for a strategic redesign of the tax system, an "overarching vision",[718] to make British taxes more progressive, more neutral, and more coherent. Most of the report is an analysis of specific areas of taxation in Britain, but the conclusion identifies what the reviewers see as the characteristics of a good tax system, weighs up the UK against that ideal, and proposes reforms that would bring the UK closer to it.

The Review argues that a tax system should have a "coherent structure based on clearly defined economic principles".[719] Although costs will be imposed beyond the actual sums raised, economic and administrative inefficiencies should be minimised, transparency and simplicity prioritised, and arbitrary tax differentiations across people and forms of economic activity avoided. It argues that taxation should be progressive, neutral and coherent. Policy aims should be pursued across the whole system – not all taxes need to address these aims as long as they are advanced more generally. Some taxes can be geared towards efficiency and others towards progressivity. This system should be broadly neutral, with similar economic activities treated in similar ways. A lack of neutrality creates complexity, and defining and policing the boundaries between activities creates extra costs and perverse incentives. Although some actions, like smoking, can be efficiently discriminated against by the tax system, the advantages of departing from neutrality must be weighed against the disadvantages of complicating the system.

The report highlights an inevitable trade-off between redistribution and efficient work incentives, and argues for minimising the efficiency loss associated with achieving progressivity. It also argues that progressivity should ideally be measured against lifetime resources rather than an annual snapshot of income.

Against this ideal, the Mirrlees Review identifies several major flaws in the UK tax system. Rather than a single tax on income combined with a single benefit to support those with low incomes and high needs, the UK system's complexity and jumble of rates "creates serious disincentives to work for many with relatively low potential earning power".[720] The system is disjointed and lacks integration. The treatment of savings and wealth transfers is inconsistent and inequitable. No consistent tax base is identified, saving is discouraged, and different forms of savings are taxed differently. Environmental taxes do not coherently address congestion or climate change, and the effective price of carbon varies dramatically according to source. Corporation Tax discourages business investment, favours debt over equity financing, and creates distortions over choice of legal forms. Land and property

718. Institute for Fiscal Studies *Dimensions of Tax Design*, 2010, pg.viii
719. Institute for Fiscal Studies *Tax by Design*, 2011, pg. 470
720. *Ibid*. pg. 480

taxes are inefficient and inequitable, based on a transaction tax (Stamp Duty) and 20-year old property valuations (Council Tax). Progressivity is pursued inefficiently and inconsistently. Zero-rating of VAT is not targeted at those with low overall resources but those with certain tastes, and Council Tax is regressive for no obvious efficiency reasons.

The Review proposes a number of measures which it argues will remedy these flaws: a merger of Income Tax and National Insurance (as National Insurance is "just another tax on earnings");[721] significant simplification and integration of the benefits system to prevent high marginal tax rates for some individuals; reductions to effective tax rates for low and high earners; and readjusting redistributive taxes across the life cycle to improve incentives when people are most responsive to them.

The Review recommends removing nearly all VAT zero rates and exemptions, offset by a package of income tax cuts and benefits increases. VAT should also be extended to annual housing consumption, replacing Council Tax and Stamp Duty. It argues VAT zero rating and exemptions cause administrative complexity, arbitrary distortions and inequitable treatment of consumers with different tastes.

Several problems are identified with the current tax system for savings and wealth. The Review recommends an end to differential treatment of different kinds of saving and the exemption from taxation of normal returns on savings. Inheritance Tax is faulty because it does not tax lifetime gifts and penalises the underprepared. It should be replaced with a wealth transfer tax. The authors also argue that business rates should be replaced with a land value tax. Corporation Tax rates should be aligned for large and small businesses, and preferences for debt financing removed through the introduction of an allowance for corporate equity. Any rise in Corporation Tax rates would reduce the amount of capital per worker, therefore restricting labour productivity and long-term real wage growth. Taxing workers' earnings directly is more efficient.

The Review makes general points about the practicality of tax reform. It argues that reform must be undertaken over the long-term to overcome practical and political difficulties. Although it says some changes (like applying VAT to a wider range of goods and services) are particularly important, that importance does not predicate timing and these changes may require considerable development, investment and consultation to ensure success. The importance of long-term strategy is emphasised by the report's insistence that many current taxation problems are caused by lack of planning and a failure to address issues that require such planning. Certain groups would lose out from the Mirrlees proposals, but the report argues that is less important than the burden of the status quo – "complexity, unfairness and significant economic costs".[722]

Final Report: Blue Ribbon Tax Structure Commission (Vermont's Blue Ribbon Tax Structure Commission, 2011)

The Vermont legislature set up this commission in 2009 to recommend changes to the state's tax policies to make the system more simple, sustainable, equitable and economically competitive. The commissioners acknowledge that reform will create winners and losers but argue that change will be ineffective unless every aspect of

721. *Ibid.* pg. 482
722. *Ibid.* pg. 501

the tax system is critically examined. Their analysis of Vermont's tax system finds a remarkably even distribution of taxes, a sales tax being eroded by changing patterns of consumption, and low effective rates of income tax (but high marginal rates). The commissioners condemn tax expenditure as a "shadow budget"[723] costing the state $1 billion annually. Proposed reforms to income tax include the end of standardised and itemised deductions, the evaluation of remaining income tax expenditures for removal, and the implementation of a lower, flatter rate and bracket structure. Sales tax should be broadened by levying it on all consumer-purchased services (except limited health and education exemptions), and the rate cut from six per cent to 4.5 per cent. Finally, scrutiny of tax expenditures should be enhanced by insisting on formal legislative intent for each of them; a requirement to report foregone revenue biennially; and by continually reappraising their worth through sunset clauses.

2010 Special Council on Tax Reform and Fairness for Georgians. Recommendations (Special Council on Tax Reform and Fairness for Georgians, 2011)

The Governor of the State of Georgia asked this Council to review the state's tax system and recommend a new structure that would encourage greater growth and employment. Future reform was felt necessary to confront slow employment growth, a decade-long decline in real earnings per worker, and significant damage caused by the recent recession. The Council finds that the state's business and personal income taxes are low compared with other states but rate structures and exemptions prevent Georgia from being as friendly a location for business as it could be. According to the report, economic growth is most likely under a tax system that minimises distortions in economic decision making, has broad taxes and low rates, allows few exemptions and special provisions, and promotes equity through targeted expenditure rather than through a progressive tax rate.

The Council recommends shifting taxation away from income and investment towards consumption. Income tax should be gradually reduced from six per cent to four per cent by 2014, and held at parity with corporation tax to maximise efficiency and minimise distortions. Fairness requires that many exemptions should be removed from the state sales tax. Food for home consumption should no longer be zero rated and all personal and household services should be fully taxed. However, the Council does not recommend broadening completely, arguing that Georgia's economy requires sales tax exemptions to be retained for energy used in manufacturing, mining and agriculture.

Eslake, S., Australia's Tax Reform Challenge (Australian Parliamentary Library Lecture, 2011)

Saul Eslake, Director of Productivity Growth for the Grattan Institute, an Australian think tank, assesses the Australian taxation system against fundamental precepts of a good tax system inspired by those set out by Adam Smith and against the Henry Review in 2009. Eslake adds a further two principles – the system should be neutral and internationally competitive.

723. Vermont's Blue Ribbon Tax Structure Commission *Final Report: Blue Ribbon Tax Structure Commission*, 2011, pg. 7

He argues that Australia needs to improve. Its tax system penalises the accumulation of wealth through working and saving while encouraging accumulation through risky behaviour. Similarly, high marginal rates seriously affect some groups' willingness to work (especially women with children). The system is not simple as over two thirds of taxpayers require the help of an agent to comply with tax law.

Eslake criticises Australian politicians for not taking up the Henry Review's proposals, which recommended broadening the base and increasing the rate of GST. He argues that this would reduce administrative costs, as they mainly arise from policing exemption boundaries, and would not be regressive, as one third of GST revenue lost to exemptions goes to the top 20 per cent of earners.

Eslake argues that comprehensive tax reform in Australia is essential. Inaction will lead to increasing dysfunction in the tax system, including overreliance on income tax, and will do nothing to solve Australia's productivity problem – productivity growth per annum declined from 2.1 per cent in the 1990s to 1.5 per cent in the 2000s.

Daniel, P., De Mooij, R., Matheson, T., & Michielse, G., Iceland: Advancing Tax Reform and the Taxation of Natural Resources (IMF, 2011)

This report was produced by the IMF in response to a request from the Icelandic Minister of Finance to advise on future tax policy and reform of environmental and natural resources taxes. It praises the success of previous revenue-stabilising reforms, but argues that the tax system should now shift towards promoting efficiency and stimulating growth. The authors contend that it is now necessary to broaden tax bases, rationalise anomalies (especially those that have crept in since 2009), and rebalance the tax effort towards stimulating investment.

To this end, it proposes that taxes on mobile financial assets should be relaxed by allowing the net wealth tax to expire, and by preventing any increase in capital income taxes. Instead, the authors argue that the emphasis should be on higher taxation of less mobile tax bases, including consumption and property. Iceland's top rate of VAT is the highest in the OECD, so the authors suggest a reduction in the headline rate alongside the removal of non-standard exemptions. Similarly, the lower rate should rise, with tax credits to compensate lower income groups. Finally, the report suggests extensions of various environmental taxes and more efficient means of raising revenue from Iceland's plentiful natural energy sources.

Tax Reforms in EU Member States 2011. Tax policy challenges for economic growth and fiscal sustainability. European Economy 5 (2011) (Economic and Financial Affairs, 2011)

This research paper, published by the Directorate-General for Economic and Financial Affairs in the European Commission, charts changes to taxation across Europe (with a particular focus on the Eurozone), and then proposes a tax system it says would be ideal for European countries to encourage growth and healthier public finances. A "growth-friendly tax structure is particularly important to cope with today's policy challenges".[724]

While the paper considers cutting taxes a "reasonable option to promote employment and economic growth",[725] its suggestions have been made on a revenue neutral basis due to the need for fiscal consolidation. It describes a general move towards increasing taxes in 2011, accompanied by a shift away from particularly distortionary direct taxation to less distortionary indirect taxation. It argues this is right because income tax, social security contributions and corporation tax are "more detrimental to economic growth"[726] than indirect taxes.

It also recommends continued reductions in corporation tax to encourage stronger productivity and economic growth. A reduction in labour taxes would also increase economic growth and remove barriers preventing low skilled workers from entering the labour market. The paper also recommends the removal of tax incentives to cut compliance costs for small and medium sized firms. The money saved could pay for a general rate reduction. The report singles out deductions and loopholes as distortionary, complex, and opaque, and argues that they should be scrutinised and removed where necessary. Tax expenditure is a "costly second-best"[727] option compared to more direct policy levers like increasing personal allowances or reducing taxation rates.

The report disputes the assumption that indirect taxation is necessarily regressive by using evidence of spending over a whole lifetime rather than an annual snapshot. Richer households may save more of their income during working years but tend to spend much of their savings after retirement. On that basis, it considers a shift in the tax burden towards VAT (alongside the removal of lower or zero rates) the best way to increase economic growth without endangering the fiscal consolidation. This argument is combined with criticism of unharmonised VAT rates across the EU. It argues that coordination could lead to efficiency gains by "removing the obstacles imposed by uncoordinated tax measures on the Single Market".[728]

The Report on Tax Reform Options: Simplification, Compliance and Corporate Taxation (The President's Economic Recovery Advisory Board, 2010)

President Obama's Economic Recovery Advisory Board was instructed to consider possible reforms to simplify the tax system, improve compliance with existing tax laws, and improve corporation tax. Its proposals are lists of options rather than firm proposals and were required to be cost neutral for taxpayers earning less than $250,000 per annum. It is not a major tax reform programme, but the report looks at the costs of complexity, non-compliance, and unreformed corporation tax.

The report argues that a complex tax code imposes "significant costs on affected taxpayers",[729] estimated at about one per cent of GDP, or about 10 cents per dollar of income tax receipts. These costs fall heaviest on lower-income families or households with complicated living arrangements who either cannot afford tax account-

724. European Commission *Tax Reforms in EU Member States, 2011: Tax policy challenges for economic growth and fiscal sustainability,* Economic and Financial Affairs, 2011, pg. 9
725. *Ibid.* pg. 52
726. *Ibid.* pg. 10
727. *Ibid.* pg. 55
728. *Ibid.* pg. 69
729. The President's Economic Recovery Advisory Board *The Report on Tax Reform Options: Simplification, Compliance and Corporate Taxation*, 2010, pg. 3

ants or who have to spend longer on their returns. Complexity has arisen because new provisions have been added to achieve particular policy goals with "inadequate attention to how they interact with existing provisions".[730] Complexity is worse due to the use of tax provisions rather than spending programmes to achieve social policy objectives, and is linked to problems with compliance, high administrative costs, and to perceptions that the tax system is unfair.

The authors estimate that $290 billion of tax was unpaid and uncollected in 2001. They saw an unacceptable level of noncompliance which has unfairly forced compliant taxpayers to shoulder a disproportionate burden. Most contributors advocated a few "broad and general principles to promote compliance",[731] including simpler, more transparent taxes, a more easily understood tax code, and stable, consistent tax law. Unintentional errors are more common in complex sections of the tax code, and temporary or expiring tax provisions increase the cost of compliance and create unpredictability. The report argues that simplification and stability should be accompanied by extra resources for the IRS.

The most detailed proposals are for corporate tax reform. The USA has the second highest statutory corporate income tax rate in the OECD behind Japan, at just over 39 per cent, but an average effective rate of about 29 per cent. This is the consequence of a narrow tax base compared to the size of the business sector, with numerous provisions for special deductions, credits and other tax expenditures. This has created an inefficient tax system that distorts corporate behaviour in a number of ways. The high statutory rate reduces investment returns; debt is favoured over equity; and differential tax rates drive capital out of the corporate business sector into the non-corporate. The report argues for a move from a narrow-base-high-rate status quo to a lower-rate, broader-based tax system. It estimates, for example, that elimination of the accelerated depreciation allowance could fund a five per cent cut in the headline rate. Similarly, an end to the domestic production deduction would allow a cut of 1.4 per cent. The report concludes that business owners commonly regard deductions and incentives "as a less attractive or powerful incentive for investment than a reduction in the tax rate on their business income".[732]

The Moment of Truth. Report of the National Commission on Fiscal Responsibility and Reform (2010)

The "Moment of Truth" refers to the challenge for the United States in needing to close its fiscal gap, reduce debts, and ensure that future economic growth is not undermined by unsustainable spending. This bipartisan report proposes a series of measures to tackle long-term debts through aggressive expenditure cuts and tax reform.

It argues a tax system "rife with inefficiencies, loopholes, incentives, tax earmarks and baffling complexity"[733] is a serious hindrance to any deficit reduction plan. The report proposes significant rate reduction, base broadening, tax code simplification, and the reduction of tax expenditures. Similarly, it proposes reform of corporate taxes to make America more competitive. Tax expenditures cost about $1.1 trillion a year and mean statutory rates are unnecessarily high. Similarly, they provide

730. *Ibid.*
731. *Ibid.* pg. 56
732. *Ibid.* pg. 72
733. *The Moment of Truth: Report of the National Commission on Fiscal Responsibility and Reform*, 2010, pg. 12

special treatment for special interests and ensure "perverse economic incentives, [not] a level playing field".[734] Full elimination of tax expenditures could allow for a reduction of income tax rates to eight per cent, 14 per cent and 23 per cent. Corporation tax could be lowered to between 23 per cent and 29 per cent. The report also proposes the end of uncompetitive domestic taxation of the foreign subsidiaries of American companies.

Domenici, P., & Rivlin, A., Restoring America's Future. Reviving the Economy, Cutting Spending and Debt, and Creating a Simple, Pro-Growth Tax System (Bipartisan Policy Centre, 2010)

This plan was developed to tackle the interlinked challenges of recovery from the recession and the restraint of soaring federal debt. The authors argue that the federal budget is on a dangerous and unsustainable path, a problem that will worsen with population ageing and increasingly expensive health care, and that only bipartisan agreement can successfully pass unpopular measures avoided by both political parties.

The budget cannot be balanced by eliminating waste, fraud and abuse, by cutting discretionary spending, by hoping that America will grow its way out of its deficit, or by raising taxes on wealthy Americans. Instead, the authors propose a radical and comprehensive programme of tax and spending reform. Spending measures include changes to entitlement programmes and a freeze in federal budgets.

Tax reform would consist of dramatic simplification "by eliminating years of accumulated tax preferences – allowing major tax rate reductions, while raising additional revenues to reduce the debt".[735] It would "cut tax rates; broaden the tax base; boost incentives to work, save and invest; and ensure, by 2018, that nearly 90 million households […] no longer have to file tax returns".[736] This would be achieved by cutting individual income tax rates and replacing the current six bands (up to 35 per cent) with only two at 15 per cent and 27 per cent. The corporation tax rate should be reduced from 35 per cent to 27 per cent, funded by eliminating most deductions and credits, and simplifying those that remain. Tax expenditure cuts could save $17 trillion between 2012 and 2040. Finally, the report proposes a 6.5 per cent National Debt Reduction sales tax. This reform package would make the tax system more progressive, according to the authors.

Ryan, P. A Roadmap for America's Future. Version 2.0. A plan to solve America's long-term economic and fiscal crisis (2010)

Representative Ryan uses this report to highlight an alternative to "the heavily government-centred ideology now prevailing in Washington" which "threatens to overwhelm the budget and smother the economy".[737] It hopes to make health and

734. *Ibid.* pg. 28
735. Domenici, P. & Rivlin, A. *Restoring America's Future. Reviving the Economy, Cutting Spending and Debt, and Creating a Simple, Pro-Growth Tax System,* Bipartisan Policy Centre, 2010, pg. 10
736. *Ibid.* pg. 16
737. Ryan, P. *Roadmap for America's Future. Version 2.0. A plan to solve America's long-term economic and fiscal crisis,* 2010, pg. iii

retirement benefits permanently solvent, improve job training and substantially reform taxation to promote US job creation and competitiveness. The plan explicitly opposes America's "unprecedented levels of spending, deficits and debt".[738] The current US tax system is heavily criticised and Ryan argues that it cannot be fixed through tinkering. Instead, a thorough, broad but achievable restructuring of tax laws is required. Criticism is levelled at faulty assumptions made by the original proponents of existing taxes (especially the Alternative Minimum Tax), at needlessly complicated personal income taxes, "riddled with special provisions that manipulate individual taxpayers […] reduce economic efficiency"[739] and cost more than $875 billion a year, and at the corporation tax, which hinders US competitiveness by making the country a less desirable destination for investment and jobs.

Similarly, Ryan argues that the tax code lacks consistency and predictability and imposes high tax rates on investment and capital. Instead, Ryan proposes to eliminate the Alternative Minimum Tax (which was only ever intended to apply to a small number of super-rich taxpayers); end double taxation of interest, dividends, capital gains and the estate tax; and broaden the tax base through the removal of nearly all existing tax deductions, exclusions and other special provisions. This last measure would allow for lower income tax rates. Most strikingly, Ryan argues that income taxpayers lack control over their financial lives and that they should have a choice between using the existing tax code or a new simplified version. This simplification would involve a reduction of the six rates of income tax to just two – 10 per cent on income up to $100,000 for joint filers and 25 per cent on anything above.

At the same time, Corporation Tax would be gradually phased out. In its place, Ryan proposes an 8.5 per cent business consumption tax on goods and services, imposed on the difference between total purchases and total sales. It would not be levied on US exports when they leave the US but on foreign imports when they enter. Critical to Ryan's vision of an alternative to growing federal government, the total federal tax burden would be held at around 19 per cent.

Wyden, R., & Gregg, J., Bipartisan Tax Fairness and Simplification Act (2010)

Senators Wyden (Democrat) and Gregg (Republican) introduced this bill to "amend the Internal Revenue Code of 1986 to make the Federal income tax system simpler, fairer, and more fiscally responsible".

They propose the repeal of the Alternative Minimum Tax; reduction of income tax bands from six to three; an increase in the basic standard deduction; a permanent extension to various credits; termination of some exemptions; deductions and credits; and a simplification of the tax return process. The three income tax rates would be 15 per cent, 25 per cent and 35 per cent.

Corporation tax would be levied at a flat 24 per cent, while the corporate Alternative Minimum Tax would be repealed and special tax preferences which favour particular types of business or activities eliminated. The Senators hope that these reforms would "partially offset the Federal budget deficit through […] increased fiscal responsibility".

738. *Ibid.* pg. iv
739. *Ibid.* pg. 35

A Tax System for New Zealand's Future. Report of the Victoria University of Wellington Tax Working Group (Centre for Accounting, Governance and Taxation Research, 2010)

This report presents the conclusions of a Tax Working Group set up by the University of Wellington with the support of the New Zealand Ministries of Finance and Revenue. It identifies the major issues the country will face in tax policy over the medium term, and highlights an urgent need for structural reform. It is concerned that the country's competitive advantage in 1989 (when its tax system was one of the least distortive and most competitive in the world) has since been eroded by international competition, reliance on elastic tax bases (highly mobile capital and skilled individuals) and subsequent changes.

It particularly argues that changes to personal, corporate and trust tax rates have created new distortions and led to heavy reliance on corporate and income taxes. The current system lacks coherence, integrity and equity due to differences in the treatment of different corporate entities and sources of income. The report also argues that previous tax modifications have not considered the interplay between welfare and taxation and that the working tax credit system, in particular, has led to marginal tax rates so high that they are a serious disincentive for growth and work. Comprehensive reform is needed. These problems are unlikely to be solved "by small changes to the rates or thresholds of the current system".[740]

The report's recommendations are revenue neutral and include aligning the top rates of corporate, personal and trust taxes; making corporate taxes internationally competitive; and reducing tax rates on individuals. It argues those taxes are most harmful to New Zealand's future economic growth. It suggests broadening the tax base to address some of the existing biases in the tax system and allow reductions in the headline rate. This would be achieved partly through the introduction of a comprehensive capital gains tax, but also by taxing some areas the report argues are not taxed enough, including returns from residential rental properties. The tax base would also be broadened through a low rate land tax and the removal of exemptions (especially on depreciating assets). The working group argues that the rate of GST (a value-added-tax with few current exemptions) should be raised in order to pay for reductions elsewhere. Finally, it proposes a review of welfare policy with a view towards reducing high effective marginal tax rates.

Thomas, S., Lifting the Bucket. Tax Policy and economic growth (Maxim Institute, 2010)

The Maxim Institute is a think tank in New Zealand and the title of its report refers to Winston Churchill's aphorism that a nation which tries to tax itself into prosperity is like a man standing in a bucket who attempts to lift himself up by the handle. Thomas argues that New Zealand's current tax policies reduce the chance of economic growth in the future. He contends that the government takes too much money out of the economy; misdirects spending in a way that reduces the productive capacity of the economy; and fails to uphold the principle that taxation should

740. Centre for Accounting, Governance and Taxation Research *A Tax System for New Zealand's Future. Report of the Victoria University of Wellington Tax Working Group*, 2010, pg. 13

allow "the government to take the money it requires, while doing the least amount of damage to the economy".[741]

He argues that the need for reform is urgent because New Zealand's economic outlook is poor and will get worse because of an ageing population and highly-skilled workers moving overseas due to high tax rates. He goes on to argue that low productivity is a particularly important problem as New Zealand has a very low level of GDP per hour worked.

Thomas recommends that the tax mix should be shifted from direct taxes to indirect taxes. Income tax should be made flatter and simpler over the medium term, with a two-step progressive rate structure levied at a maximum of 27 per cent. There should be no tax-free threshold but a lower income rate should be retained for taxpayers who earn up to a certain threshold. Corporation tax should be reduced from 30 per cent, aligned with the top rate of personal income tax and reduced whenever income tax is reduced. Savings and investment taxes should also be brought into line with corporate and income tax rates. To make up lost revenues GST should be increased from 12.5 per cent to 15 per cent. The government should not introduce a land tax, a capital gains tax or a capital income tax. Finally, New Zealand should set an upper-limit on government spending at around 30 per cent of GDP. Social welfare spending is least conducive to economic growth and should be limited to about 15 per cent.

Pina, A., Towards a Less Distortive and More Efficient Tax System in Portugal (OECD, 2010)

Pina reviews the Portuguese tax system in the context of substantial fiscal consolidation and in light of limited reforms to property taxes, motoring taxes and social security contributions. He makes recommendations for further reforms he argues will encourage economic growth, make the system more efficient and rebalance the economy. In particular, he focuses on measures to regain eroded competitiveness by switching taxes from labour to consumption and property, simplifying the system and reducing compliance costs, and increasing efficiency in revenue collection.

Given tight budgetary pressures, Pina argues that any reform would need to be revenue neutral. Therefore, those taxes he sees as the most distorting taxes should be cut first, while taxes on consumption and property should rise. The main measure he advocates to achieve that objective is removing reduced rates for various goods and services and thereby broadening the VAT base; 40 per cent of Portuguese VAT is levied at reduced rates. He argues that ending exemptions, special measures and tax expenditures is also essential for reducing tax complexity and compliance costs. The author argues that "voluminous and unstable tax rules" act as a deterrent to entrepreneurship and investment and act as an "additional implicit tax, strongly regressive relative to firm size".[742]

Although Pina favours increased use of property taxes, he dislikes the current use of estate transaction taxes, which have a negative impact on the performance of the housing market and produce volatile revenue. Finally, the report advises that corporation tax should be streamlined. Portugal has a high statutory rate, by international comparison, but with numerous provisions that narrow the base.

---

741. Thomas, S. *Lifting the Bucket. Tax policy and economic growth,* Maxim Institute, 2010, pg. v
742. Pina, A. *Towards a Less Distortive and More Efficient Tax System in Portugal,* OECD, 2010, pg. 18

Evaluation of the 2006 Tax Reform. Report No.11 to the Storting (Norwegian Parliament, 2010)

This report evaluates the 2006 Norwegian tax reform for the country's parliament. The reform was intended to solve the growing problem that income from labour was being camouflaged as income from capital due to the country's split taxation model. Labour income was taxed at a top rate of 64.7 per cent and provided the main element of progressivity and redistribution in the system, whereas capital income was taxed at only 28 per cent on efficiency grounds. It was felt that this tax loophole undermined redistribution and threatened the system's moral legitimacy.

The proposed reform broadened the tax base, increased allowances for labour income, and more closely integrated Norway's split taxation model by evening out the highest tax rates on capital income and labour income. This included the introduction of a dividend tax and a series of rule changes to more effectively police the boundaries between labour and capital income. The report argues that the reforms had positive effects by making income shifting for tax purposes harder, ensuring the affluent paid considerably more, and increasing labour supply. It argues that the tax system now appears more unified than before the reform. It estimated that 20 per cent of the revenue cost from cuts to labour taxes would be returned with increased revenues from higher labour supply.

Tax Policy Study No. 20 – Tax Policy Reform and Economy Growth (OECD, 2010)

This OECD study considers the links between taxes and economic growth, the implications of these links for tax policy, and concludes by discussing how obstacles to fundamental tax reform might be addressed.

It argues that, given the necessity for economic growth to help reduce budget deficits, tax reform is essential. It argues that corporate taxes are the most harmful to economic growth, followed by personal income taxes, consumption taxes and finally recurrent taxation of immovable property. Therefore it argues that reform must shift part of the tax burden away from income towards consumption and property, and that shift should include levying tax on a broader base (for example a single rate VAT) and consequent cuts to headline rates. The study notes common trends across OECD countries in recent years. Top rates of personal income and corporation tax have been cut and bases broadened while social security contributions have increased in relative importance.

The report acknowledges serious obstacles for policymakers in the design and implementation of tax reforms that can boost economic growth. These include complex trade-offs between efficiency and distributional impact, and potential effects on revenue, tax avoidance, and compliance costs.

To best overcome these obstacles, the report suggests framing reform as an interlinked programme rather than focusing on isolated elements. This allows policymakers to better communicate equity and efficiency trade-offs, to advance reform "via broad packages that reduce distortions in the system while spreading both benefits and adjustment costs widely".[743] Similarly, broad aspirational goals clarify the meaning of reform for taxpayers and voters while making it easier to resist special interest lobbies. Timing is also essential. A crisis provides a useful opportu-

743. *Tax Policy Study No.20 – Tax Policy Reform and Economy Growth,* OECD, 2010, pg. 12

nity to overcome political and economic obstacles because of increased pressure to raise more revenue and the pressing need to stimulate economic growth. "A sense of urgency [...] creates a 'window of opportunity' for reform which otherwise would have been blocked".[744]

Enhancing Texas' Economic Growth Through Tax Reform (Texas Public Policy Foundation, 2009)

The Texas Public Policy Foundation argues that Texas can improve its tax system through the repeal of property taxes and their replacement with increased revenues from a reformed sales tax. Although Texas has no personal income tax, one of the lowest overall tax burdens in the country, higher economic growth and lower unemployment than most other states, improvements can still be made. Texas relies disproportionately on property taxes. The authors consider property taxes to be less stable, more complicated to administer, liable to create larger economic distortions, and more likely to discourage capital intensive industries than sales taxes. Property sales should be included in a sales tax levied on a broader base and, if various exemptions were removed, the rate could be set as low as 6.5 per cent. The authors predict such a reform would create between 127,700 and 312,700 new jobs in five years.

Australia's Future Tax System. Report to the Treasurer (Commonwealth of Australia, 2009)

This report was commissioned by the Australian government as a comprehensive review of Australia's tax system. The authors were asked to propose a tax structure that would position Australia to deal with the "demographic, social, economic and environmental challenges of the 21st Century and enhance community wellbeing".[745] They were also asked to consider the tax system's relationship with transfer payments and other social support.

Central to the report's proposals is the belief that the tax and transfer system should be oriented towards supporting strong and sustainable economic growth. While redistributing income is important, more important is the promotion of growth of incomes at all levels. It proposes, for example, that personal income tax should be the sole means of delivering progressivity in the tax system, and argues that progressivity can be improved by rationalising deductions and introducing a higher tax-free threshold. Economic growth should be encouraged by reduction in the number of taxes, including the abolition of insurance taxes, payroll taxes, and property transfer taxes. Income tax should have a comprehensive base, potentially allowing cuts to the headline rate.

The report suggests that Corporation Tax should be kept at the lower end of the small to medium OECD economy average and reduced to 25 per cent over the medium term. This would increase the level of business investment. Similarly, productivity should be encouraged through more efficient and neutral taxation. It also argues that the Australian GST has a potentially efficient and robust tax base. However, it must be reformed to remove operational complexities, and narrow

744. *Ibid.* pg. 13
745. *Australia's Future Tax System. Report to the Treasurer*, Commonwealth of Australia, 2009, Preface

local state taxes on consumption (for example on insurance) should be abolished or subsumed within GST.

The report aims to encourage higher workforce participation. Although various spending policies are proposed, for example better support for childcare, it argues that it is more important to build clear work incentives into the levels of income support payments. High marginal tax rates are criticised and the authors conclude that the transfer system must be made more supportive of those willing to work to support themselves.

Finally, the report recommends that tax policymaking and administration needs to be more responsive to problems experienced by taxpayers. This could be achieved by making the system more transparent and understandable, by giving citizens access to comprehensive information on their tax and transfer affairs, and by publication of tax data and analysis to encourage public debate about the system's performance.

Commission on Taxation Report 2009 (Irish Government publications, 2009)

The Commission was tasked with proposing measures to strengthen the Irish economy, sustain employment and provide stable tax revenues. Given recent revenue instability in Ireland, it is principally concerned with finding a "broader and less volatile"[746] tax base at the same time as maintaining low rates.

The Commission was not asked to look at Ireland's 12.5 per cent corporation tax rate, which is still considered a key factor in Ireland's earlier economic success and important in supporting long term economic growth. Rather it recommends that low taxation should be paid for and stabilised through expansion of the tax base, and that "lower tax rates on a broad base are better than higher rates on a narrow base".[747] Broad structural reform would allow the government to collect a set amount of revenue with less distortion to the economy, in a more equitable manner, and with an eye to Ireland's long term competitiveness.

As well as a shift from income to property taxes, the report recommends that Ireland's four parallel systems for collecting tax on income (including a health contribution levy and PRSI, a social security payment) should be combined into a single system. The Commission also criticises tax expenditures for lacking transparency in how they allocate resources and treating taxpayers unequally, it suggests that direct government expenditure should be used in their place.

The Commission makes a number of further proposals, including a carbon tax, a tax on welfare payments and efforts to tackle tax avoidance. It warns that there will be "a natural tendency for all who will be affected […] to argue that they are a special case and should be exempted"[748] but argues that its proposals support overall economic activity over encouraging specific sectors, will make the government's finances more stable and secure, and would result in healthier fiscal balances over the economic cycle.

746. *Commission on Taxation Report 2009,* Irish Government publications, 2009, pg. iii
747. *Ibid.* pg. 2
748. *Ibid.* pg. iii

Danish Tax Reform 2010. Paper to the OECD WP2 Meeting November 2009 (Danish Ministry of Taxation, 2009)

This paper details the reform measures adopted in May 2009 by the Danish Government in an attempt to reduce marginal income tax rates across the income distribution. The reform aims to increase labour supply in the long and medium term at the same time as softening the effects of the global economic crisis, and involves tax cuts of around 1.5 per cent of GDP. The pre-reform Danish system was characterised by relatively high tax rates applied at relatively low income levels. The reform reduced the lowest income tax level from 5.26 per cent to 3.76 per cent, abolished the middle level, and increased the top threshold. This was accompanied by a reduction in the tax ceiling from 59 per cent to 51.5 per cent.

The Danish Government financed this broad tax cut through reductions in the value or removal of tax reductions and fringe benefits. It also ended certain VAT exemptions "to prevent distortion of competition".[749] It cut the number of exemptions and special arrangements for businesses in order to finance the abolition of the middle rate of company taxation and a decrease in the top rate. Finally, there was a harmonisation of taxation on income from shares.

Shlush, S., Tax Reform for Israel. (Koret Milken Institute, 2007)

Shlush proposes that the best way to increase state tax revenues, remove disincentives for work and investment, and end penalties for the most productive, is to implement a comprehensive flat tax. He cites evidence from flat tax reforms in Eastern and Central Europe, which eliminated graduated tax rates and subsequently led to significant increases in economic growth, foreign investment and tax revenues. Israel should follow this lead and switch to one low tax rate on business and personal incomes, with a single tax-free exemption. This one exemption, however, would be exceptional and only allowed to ensure progressivity. Other exemptions should be eliminated to remove impediments to entrepreneurship and investment which depress labour supply and economic growth. Reform would also help remedy the estimated $8 billion cost of compliance with the Israeli tax system.

Carone, G., Schmidt, J., & Nicodeme, G., Tax revenues in the European Union: Recent trends and challenges ahead (Economic and Financial Affairs, 2007)

This research paper, published by the Directorate-General for Economic and Financial Affairs in the European Commission, charts changes made by and challenges facing EU member state tax systems. It suggests that European tax systems face two major problems – ageing populations (which increase social spending while reducing tax bases) and globalisation (which makes capital and highly-skilled workers more mobile and therefore less reliable as a source of income). It also highlights

749. Danish Ministry of Taxation *Danish Tax Reform, 2010. Paper to the OECD WP2 Meeting November 2009*, 2009, pg. 13

the issue of the tax wedge, the gap between the cost of an employee to the employer and the reward received by the employee.

The paper surveys broad changes to taxation in Europe. It reports that between the early 1970s and late 1990s the total tax burden as a percentage of GDP soared but it has subsequently declined. Britain is an exception – the tax ratio has stabilised.

Reforms to labour income taxation have recently been enacted in attempts to increase employment. The paper cites empirical evidence demonstrating the economic harms associated with marginal labour income tax rates. By comparison with other European economies, the tax wedge is smaller in Britain than in other countries, but increasing while it is cut elsewhere.

A further trend has been towards tax simplification. The paper warns against complications resulting from accumulated tax reforms, the hidden costs of deductions and special treatments for certain groups or activities. There is the potential that complexity could reduce the progressivity of the tax system. It argues the common route to simplicity is a "base-widening-cum-tax-cuts-strategy",[750] which uses the removal of exemptions and reliefs to fund reductions in tax rates.

Finally, the paper considers the implementation of a flat tax in five EU member states. Across Europe, income tax is "increasingly [...] perceived by public opinions as too complicated"[751] and, combined with a trend towards reducing the size of government, the "belief that simple taxation is necessarily good taxation has emerged".[752] There are some benefits to flat taxation, notably increased tax revenues and improved transparency in some countries after implementation. However, the report argues that research has not found evidence of a sizeable Laffer effect and, given the level of public spending in some European countries, a flat tax would require a relatively high rate and small personal allowances to be revenue neutral. It concludes that this would not necessarily be a benignly progressive scenario.

Tax Matters, Reforming the Tax System. The Report of the Forsyth Tax Reform Commission (Tax Reform Commission, 2006)

Lord Forsyth of Drumlean, and the Tax Reform Commission he chaired, was asked to examine the impact of tax policy on Britain's international competitiveness, to prepare policy options for flatter and simpler direct taxes, to investigate the feasibility of a flat tax, and to recommend policies to improve efficiency, transparency, and fairness in the tax system by the Conservative Party in 2005. The Commission was asked to provide politically feasible solutions and so its proposals are predicated on incremental measures rather than more radical reforms. It was also told to focus on direct personal, corporation and capital taxation, and not VAT, Council Tax, business rates or environmental taxes.

The report starts from the premise that increasing tax complexity, a rising tax burden and over-complex tax laws are making Britain uncompetitive. Britain's tax system is not entirely unattractive but failure to reform in the last decade has let Britain lag behind its rivals. Successful tax simplification, broadening the base and reducing rates, in Australia, New Zealand, the Netherlands and Ireland are analysed to find lessons for the UK.

750. Carone, G., Schmidt, J. & Nicodeme, G., *Tax revenues in the European Union: Recent trends and challenges ahead*, Economic and Financial Affairs, 2007, pg. 16
751. *Ibid.*
752. *Ibid.*

While other developed nations are cutting personal and corporate tax rates and simplifying their tax systems, "in the UK, the Government is increasing taxation and rendering the system ever more complicated".[753] The report argues that must be reversed. It cites empirical evidence for the harmful effects of high taxes on economic growth. Economies with higher taxes tend to grow more slowly, see business transactions distorted, and be unfair due to limited comprehensibility of the tax system to those who aren't experts. While Britain compared well against OECD averages in 1997, by the time the report was published it was converging with Europe's historically high tax burden. High marginal tax rates are of particular concern – they are some of the highest in the world for people moving from part to full-time work.

Tax reform would have a "dynamic effect on the growth of the economy of a whole".[754] It may be expensive in the short term (abolition of stamp duties on UK shares would then have cost £3 billion, for example), but the report cites international evidence that tax reform programmes can have a positive effect on economic growth and increase tax revenues in the medium term. They argued there is only limited research into a British Laffer effect and the economy's response to tax cuts is not empirically clear, but the UK would most likely behave similarly to the USA and experience a substantial increase in economic growth if it cut taxes.

The Commission proposes a programme of tax reform designed to achieve simple, stable, fair and low taxes and raise "predictable revenues to fund necessary government expenditure with minimal impact on wealth creation".[755] Those reforms would lower tax rates, raise thresholds, and simplify and broaden the tax base.

The report compliments existing flat tax regimes, dismissing the arguments that a flat tax could not be progressive (with a relatively high personal allowance) or significantly improve work incentives. It argues though, that it is difficult to compare the British tax system with those in Eastern European countries, and that high levels of public spending in Britain would mean the single tax rate would need to be too high – the medium term potential of reducing spending and cutting taxes was outside the report's remit. And providing generous personal allowances to ensure the tax system remained progressive was not fiscally feasible.

This criticism does not preclude the Commission from arguing for other reforms often implemented alongside flat tax rates. It wants scrutiny of exemptions, reliefs and allowances to broaden the tax base. It also proposes removing some taxes, lowering the rates of others, and raising personal allowances across the board.

Heath, A., Flat Tax Towards a British Model (The TaxPayers' Alliance & The Stockholm Network, 2006)

Heath, Chairman of the 2020 Tax Commission, defines flat taxation as when "all income earned by individuals and companies, other than a tax-free personal allowance, is taxed at a single, low rate".[756] No exemptions are allowed; sometimes a flat tax proposal will align the VAT rate with rates on direct income; and often reform will be accompanied by the elimination of double taxation of income. He argues that flat tax is close to Adam Smith's conception of the ideal efficient, transparent, simple and fair tax system.

753. Tax Reform Commission *Tax Matters, Reforming the Tax System. The Report of the Tax Reform Commission*, 2006, pg. 23
754. *Ibid.* pg. 10
755. *Ibid.* pg. 53
756. Heath, A. *Flat Tax. Towards a British Model*, 2006, pg. 11

Heath surveys the academic literature on flat taxation and cites evidence that a flat tax would provide a significant boost to economic growth. It would end high marginal rates, reward hard work, increase the labour supply, facilitate risk taking, remove distortions that encourage businesses to make too many decisions on the basis of the tax implications, and send a powerful signal "that there is nothing morally wrong with hard work and success".[757]

As a further moral argument for flat taxation, a high personal exemption would take many low income earners out of direct taxation and improved compliance would ensure that the better off pay a larger share of the overall tax burden. Flat taxation is a reality in many parts of the world. Versions in Jersey and Guernsey have existed since 1940 and 1960 respectively, in Hong Kong since 1947, and flat taxation has been implemented recently in Eastern Europe. These practical examples do more than show that flat taxation has moved beyond theory. They illustrate how tax competition in a globalised economy requires every nation to radically reconsider its tax system to attract capital and labour. "The race to be the first Western country with a flat tax is on; the rewards for the winner will be immense".[758]

Heath proposes his own flat tax model for Britain. Income Tax and Employees' National Insurance contributions would be merged and levied at a drastically lower single rate of 28 per cent on all earnings above £9,000 a year. All loopholes would be repealed, as would taxation of inheritance, capital gains, dividends and interest. Taxation of corporate profits would also be imposed at 28 per cent, above a generous allowance. Pensioners would only pay 22 per cent on their income, however, because income from pensions is currently exempt from National Insurance contributions.

A flat tax at 28 per cent would only be the first step and the aim would be to lower this rate over time. Heath's proposals go as far as he believes is feasible in the short-term, given political constraints, the current tax system, and existing levels of public spending. "It is better to start moving in the right direction, albeit rather too modestly, rather than remaining stuck in a variant of the current damaging system through excessive ambition".[759] These changes would also have to be modelled against welfare reform and, although specific welfare proposals are outside Heath's purview, he does argue that tax credits should be abolished and partly replaced by traditional welfare benefits.

Heath quantifies the costs and potential economic effects of his flat tax plan. It would be equivalent to a £59.7 billion net tax cut if measured statically, but Heath estimates that 40 per cent of the revenue loss could be recovered through stronger economic growth and less avoidance over three years. He estimates the remainder could have been funded through restraining nominal public spending growth to 2.5 per cent a year for three years, through reductions in wasteful spending, and the transition could be cushioned through privatisation and selling government assets.

Heath argues that a conservative estimate for the resulting increase in economic growth would be 0.5 per cent a year.

Finally, the book considers potential difficulties in enacting a flat tax reform and formulates some responses. Reform is always more difficult the higher the ratio of taxes to national income, the higher public spending, the fewer the number of loopholes that can be swept away to fund tax cuts, the greater a country's reliance on direct taxes, the greater the existing differences between tax levels, and the worse the state of public finances – all bad news for the UK. But Heath argues a reform

757. *Ibid.* pg. 12
758. *Ibid.* pg. 155
759. *Ibid.* pg. 133

programme will have a greater chance of success if it provides widespread benefits (particularly for the poor), if it is well-founded in academic research, and as long as it is supported by a strong political campaign over a number of years.

Nyberg, M., Flat Tax for Finland (EVA, 2006)

Written by an economist at the Finnish Business and Policy Forum (EVA), this report builds on earlier work by Hall and Rabushka to argue for a proportionate tax in Finland. It argues that a tax system should be built around simplicity, fairness and economic growth and contends that the Finnish system fails to match these ideals in a number of ways. It argues the Finnish taxation system is complex; based on a hybrid of income and consumption taxation; strongly geared towards income redistribution rather than efficiency; distorts behaviour; penalises saving; provides unfair exemptions and benefits to certain activities and groups; and increases the size of the grey economy.

Nyberg proposes that Finland should adopt a single flat tax at 29 per cent for business and personal income, over a €7,000 tax free exemption. The plan would radically simplify the existing system; abandon the capital income tax and double-taxation of dividends; remove exemptions and depreciation deductions for businesses; and treat all businesses the same regardless of type or form. Central to his analysis is the argument that "tax authorities should collect the revenue needed to cover public expenditure in a manner that does minimal damage and distributes the tax burdens as fairly as possible".[760]

Nyberg is concerned about the political attractiveness of a Finnish flat tax, but emphasises its progressivity (in particular the effect of a €7,000 exemption on marginal tax rates), and how it would reduce the tax burden for both wage earners and pensioners. Similarly, he argues that it is fair, noting that everyone would understand the simple tax rules, that business profits would no longer be taxed twice, that tax planning by the well-advised would be limited, and that tax deductions for favoured groups would be removed. He rejects the argument that fairness and efficiency should inevitably be in conflict. He also argues that, although it is always difficult to implement a major tax reform, a flat tax would not necessarily provoke more opposition than any other. He provides a list of essential requirements for a flat tax reform to be passed, including strong leadership by politicians and a coherent reform programme.

Leibfritz, W. & O'Brien, P., The French Tax System. Main Characteristics, Recent Developments and Some Considerations for Reform. OECD Economics Department Working Papers No. 439 (OECD, 2005)

This survey of the French tax system reports recent efforts at reform and provides ideas for future changes. France has relatively high levels of tax (about 44 per cent of national income) but regularly fails to raise enough revenue to fully cover its spending. Many activities or items are subject to specific taxes or specific exemptions, the tax system imposes high administrative costs on both taxpayers and the tax administration, and it is increasingly reliant on direct tax revenues. One particular concern

760. Nyberg, M. *Flat Tax for Finland,* EVA, 2006, pg. 24

for the report was personal income tax, which was highly progressive but levied on a narrow base. That base had been progressively eroded through large allowances for families with children, and only Denmark had a higher top marginal rate.

Overall effective tax rates on labour income are high, especially when combined with a generous welfare system, which costs 20 per cent of GDP. A combination of income tax, the GSG (a flat-rate income tax earmarked for social security) and generous welfare benefits undermine the incentive to work.

Even if French politicians have recognised these problems (among others), the authors argue that the best direction for reform is unclear. French governments are still inclined to use the tax system to try and achieve specific social goals and are unlikely to move away from high levels of public spending. Therefore, tax reform must be a zero-sum game dedicated to minimising disincentives to employment and investment. Priority must be given to reducing labour tax distortions through smaller social security contributions for low paid workers. Personal income tax must be simplified, its base widened to allow for lower top rates, and France must consider merging income tax with the CSG if it can be achieved efficiently. Capital tax distortions can be reduced by reducing the number of special incentives within the corporate tax system for favoured activities, in turn allowing a cut in the headline rate. Duplication of tax administrations should be addressed through progressive mergers where possible. Finally, the authors suggest increased use of green taxes, but only if they provide efficiency gains. They argue green taxation should not be a significant source of revenue.

Bernardi, L., 'Tax Reforms in Italy and in Europe', Giornale degli Economisti e Annali DI Economia 64 (2) (November, 2005), pgs. 139–158

Bernadi reviews Italian tax reform since the end of the 1990s, specifically the Visco reform by the centre left government in 1997 and the Tremonti reform by the centre right government in 2004.

He suggests that these were the first major efforts since 1972 to reform the tax system and previous attempts were merely minor corrections that had "confused the tax code", increased almost all effective rates and reduced tax bases.[761] He regards recent reform attempts as part of a cross-European trend to reform taxation driven by budget constraints, a desire to reduce fiscal pressures (especially tax wedges on labour costs and profits), attempts to boost European growth, and by fiscal competition in an increasingly integrated world economy.

These European trends have seen rates cut and bases broadened, particularly for income and corporation tax, and a proliferation of incentives designed to promote tax competitiveness, employment in blue-collar sectors, preservation of environmental standards, and boosting of research and investment. Bernardi discusses the two Italian reform programmes but notes that they largely failed due to changes of government during their implementation. He concludes by suggesting a specific reform programme, including the removal of various exemptions (to broaden the tax base), a progressive set of income tax schedules, and allowances for those with tiring work or serious illness.

761. Bernardi, L. Tax Reforms in Italy and in Europe, *Giornale degli Economisti e Annali Di Economia* 64, 2, November, 2005, pg. 141

The Fundamental Tax Reform, December 2004 (Ministry of Finance of the Slovak Republic, 2005)

The Ministry of Finance describe the 2004 tax reforms as some of the most important initiatives the Slovak government has taken towards the creation of a highly competitive, less distorted market economy. The implementation of a flat tax transformed Slovakia into one of the most competitive economies in the EU and the OECD, through lowered taxes and marked improvements in efficiency, transparency, and neutrality. The aim was to eliminate existing weaknesses and distortions in tax law and to achieve a higher degree of tax fairness through horizontal and vertical equity. It also involved a shift of the tax burden from direct to indirect taxes, away from production and towards consumption.

The reform introduced a flat 19 per cent personal income tax, corporation tax and VAT while eliminating all exceptions, exemptions and special regimes. This ended the distorting use of tax policy to achieve non-fiscal goals. Income tax remained progressive due to an exemption on all income up to 1.6 times the poverty line while the new single marginal tax rate was designed to increase labour productivity. Dividend taxation was eliminated to limit double taxation. These reforms lowered the significance of direct taxation in the tax mix and the revenue loss was compensated by a unification of VAT rates. A standard rate at 20 per cent and a reduced rate at 14 per cent were replaced with a 19 per cent rate on all goods and services, aligned with income and corporation tax rates. As an adjunct to these changes, the reform abolished real estate transfer tax, donation tax, and inheritance tax as unnecessary and distortive.

Brook, A-M., & Leibfritz, W., Slovakia's introduction of a flat tax as part of wider economic reforms (OECD, 2005)

Brook and Leibfritz consider the impact of Slovakia's 2004 tax reform alongside a wider package of economic reforms. They argue that the changes considerably improved simplicity and efficiency by eliminating exemptions and special regimes and lowering tax rates. Economic efficiency should improve over the longer term as the tax burden shifts to consumption, and human capital formation should be stimulated through flattened rates.

They argue that the single rate has reduced the problem of tax evasion by removing incentives for people to declare labour income as capital income. Demand for labour should increase thanks to a more flexible labour market, and the labour supply has been boosted by cuts in average tax rates and the marginal tax wedge.

At the same time, some employment has shifted from the informal to the formal sector. Tax reform has also made capital formation easier due to significant reductions in statutory taxes on capital. The allocation of capital should be more efficient because of the removal of special treatment for certain sectors. The authors show that reform was revenue neutral, despite lowering rates and a generous income tax-free allowance, and that the tax system remains broadly progressive. The reforms, however, could be strengthened by equalising the taxation of projects financed by retained profits and by reducing the cost of employing low skilled workers. Although reform was combined with significant changes to welfare, and cuts to social security benefits (which enhanced incentives for unemployed workers to seek work), taxation of labour remains high. Payroll taxes impede business development and continue to add around 35 per cent to the average wage. The authors recommend cutting employers' social security contributions.

Moore, D., Slovakia's 2004 Tax and Welfare Reforms (IMF Working paper, 2005)

Moore reviews Slovakia's 2004 comprehensive reforms to its taxation and welfare systems. He notes that reforms were undertaken within a "tight expenditure envelope"[762] and needed to be revenue neutral and place a tight lid on expenditure to fulfill Maastricht deficit targets. He describes the reform programme and notes the importance of concurrent welfare reform, which addressed benefit dependency and disincentives to work. Social assistance had previously been high relative to wages. Moore's analysis of the short-term results of these reforms centres on efficiency gains; reduced distortions and greater simplicity; and improvements in tax administration. Resources will be allocated more efficiently and the single rate of VAT will help to address long-standing problems with excessive VAT refunds. Work incentives have also improved significantly.

Moore, however, attributes this to welfare reform rather than changes to the tax system. Labour taxes only fell modestly for many taxpayers and the tax burden has been shifted away from capital and towards labour. Welfare reform, in contrast, has curbed abuse and brought welfare spending down significantly. Moore is more encouraging about the effects on revenue. Although tax revenues fell by 0.7 per cent as a percentage of GDP, from 2003 to 2004, this was disproportionately due to one-off measures linked to EU accession. In fact, income tax collections were significantly better than projected and wages grew strongly across the economy. Corporate tax receipts were similarly robust. Slovakia's reforms were particularly effective for being eye-catching and they "gained widespread attention from investors and policymakers alike".[763]

Rao, M.G., Tax System Reform in India: Achievements and Challenges Ahead (Indian National Institute of Public Finance and Policy, 2005)

Prepared for the 2005 International Symposium on tax policy and reform in Asian countries, this study surveys reforms to the Indian tax system since 1991 and recommends a series of measures to strengthen India's economic liberalisation.

It reports that India's 1991 tax reform replaced a system built to support a public-sector-dominated, import-substituting economy. Rao emphasises how far the tax system served a certain political vision of India's economy. Prior to 1991, it was directed towards raising resources for large scale public consumption and investment with little regard for efficiency. Socialist objectives necessitated a steeply progressive tax structure, and the pursuit of multiple objectives through the tax system led to complexity and encouraged large scale evasion and avoidance.

Subsequent reform stemmed from a different vision of the purpose of taxation – that it should minimise distortions while raising adequate revenue. Rao paints a

762. Moore, D. *Slovakia's 2004 Tax and Welfare Reforms,* IMF Working paper, 2005, pg. 3
763. *Ibid.* pg. 27

broadly positive vision of reform in India. It may have "borne the domestic brand"[764] and failed to solve lopsided reliance on revenue from taxes on motor fuel, but in many ways it broadened the base, reduced rates and rate differentiation and simplified the system.

As a result, Rao argues that efficiency improved. The 1991 comprehensive reform programme created three rates of personal income tax at 10 per cent, 20 per cent and 30 per cent and the result has been improved revenue, even when economic growth has decelerated. Reductions in corporate tax rates and the removal of certain exemptions have led to an increase in corporate tax revenue as a share of total revenue from 0.9 per cent in 1990–91 to 2.7 per cent in 2005–6.

Unfortunately, he also says that the system is still not consistently broad-based, productive or efficient. Greater simplification is needed, especially the withdrawal of tax exemptions and concessions for certain activities. Rao argues for a single rate of corporate tax above a certain level. He also argues import and export duties should be rationalised and a coordinated national consumption tax should be introduced to increase revenues, minimise price distortions and ensure a common market in India.

Teather, R., A Flat Tax for the UK – a Practical Reality (Adam Smith Institute, 2005)

Teather argues that a flat tax in Britain is not only achievable but necessary if the country is to improve its international competitiveness and attract foreign investment.

He argues that the benefits would include reduced compliance costs; less avoidance, evasion and distortion; stronger incentives to work; and a smaller gap between the cost of taking on an employee and the rewards that employee receives, a smaller tax wedge.

He argues a flat tax would have a larger positive impact on the economy than a simple tax cut and draws on evidence that flattening the rate schedule in the past (for example, in the 1980s) has demonstrated the potential to increase economic activity. The research also provides a moral case for a flat tax by arguing that a higher personal allowance could take 10 million people out of income tax altogether, reduce evasion and avoidance tilting income tax towards the rich, and that stronger incentives to work make it easier for the poor to gain greater security through work.

The report proposes a flat tax at a rate of 22 per cent with a personal allowance of £12,000 to prevent low income groups from paying more during implementation. Companies should also be taxed at this rate, but no clear plan is provided. Teather acknowledges a high initial cost to implement it – a reduction in revenue of around £50 billion in the short-term.

Removing allowances and deductions at the same time would bring in around £12 billion, and crude cost-benefit analysis does not account for increased revenues from decreased tax avoidance or the likely benefits of growth. Nevertheless, Teather recognises that his proposal would require significant cuts to public spending and he cites 2005 TaxPayers' Alliance research that £81 billion of taxpayers' money was wasted each year.

764. Rao, M.G. *Tax System Reform in India: Achievements and Challenged Ahead,* Indian National Institute of Public Finance and Policy, 2005, pg. 2

HM Treasury Report on Flat Taxes (2005)

This internal Treasury report considers the arguments for a flat tax in a developed country. It suggests that the introduction of flat tax systems in Eastern Europe has encouraged debate elsewhere about their potential benefits and about potential losses from failure to maintain competitiveness. It says flat tax is "an attractive remedy for administration and economic challenges which are common to transition economies".[765] The report is, however, sceptical of application to Britain.

Although it recognises that a flat tax might boost the labour supply, increase investment and compliance, and although research from Russia shows that tax revenues had increased by 50 per cent over inflation since 2001, it argues that it is hard to disentangle the causes of those improvements from other concurrent changes.

The report also argues that compliance benefits in Britain would be limited because the country already has a mature tax system with an established culture of compliance. Similarly, the report notes differences between countries in their reliance on income tax and the size of their black market economy. It argues that Western countries are still "wedded to the principle of progressive taxation"[766] and that other flat tax regimes are expensive (due to the cost of the substantial personal allowances needed to maintain progressivity), or operate alongside other taxation (mostly social security payments or property taxes) that make the system less than proportional.

Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System. Report of the President's Advisory Panel on Federal Tax Reform (2005)

This report details the conclusions of a panel set up by President Bush to identify major problems in the US tax code and to recommend options to make the code simpler, fairer and more conducive to economic growth. Its premise is that the current system's flaws are unacceptable, that since the last major tax reform in 1986 the code has been rewritten 15,000 times to meet multiple policy goals, and that these frequent changes have ultimately undermined the code's integrity. Complexity, the use of tax provisions to favour certain activities, distorting tax benefits, and frequent volatility are all harmful to the economy. The report singles out additional compliance costs, inefficient allocation of resources, and unfairness as areas that must be tackled urgently. There is a difficulty in making trade-offs between simplicity, fairness and encouraging growth, and simplicity is usually sacrificed in any bargain. As such, the authors warn that tax reform should not be undertaken by further tinkering but only through effective fundamental change. Politicians should not forget that the ultimate aim of the tax system is to raise revenue to fund government.

Two options for reform are recommended. The first is the Simplified Income Tax Plan and the second the Growth and Investment Tax Plan. These are similar and include dramatic simplification of the tax code, cleaning out targeted tax breaks, and lower headline rates. They propose streamlined tax filing (preferably on one page), rationalisation of tax provisions and elimination of phase-outs. Tax benefits should be easily understood (thereby increasing confidence) and available to all taxpayers, marriage penalties should be reduced, progressivity should be maintained, and

765. *HM Treasury Report on Flat Taxes*, pg. 3
766. *Ibid.*

loopholes, which allow the well-advised to avoid paying their fair share, should be closed. Proposals for promoting economic growth differ slightly. Both plans suggest broad changes, including eliminating the Alternative Minimum Tax, reducing double-taxes on corporate profits earned in the USA, equalising the tax treatment of corporate financing, and lowering top marginal rates on individuals and businesses. However, the Growth and Investment plan goes further and argues that the corporation, small business, and top rate of personal income tax should all be aligned at 30 per cent to successfully target economic growth.

Saxton, J. et al., Reforming the U.S. Corporate Tax System to Increase Tax Competitiveness (Joint Economic Committee United States Congress, 2005)

This report criticises the US corporate tax system as a "patchwork of overly complex, inefficient and unfair provisions that impose costs on corporate business".[767] The US system encourages businesses to engage in elaborate tax planning, has contributed to structural declines in manufacturing and weakened the competitiveness of US firms in the global economy. Unless broad reform is enacted, competitiveness will continue to suffer, jobs will move overseas, and US companies will be sold to foreign multinationals – all eroding the corporate tax base. Reform is also critical because corporations do not themselves bear the tax burden. It penalises individual workers, consumers and investors.

The report identifies several weaknesses. First, taxation of worldwide incomes imposes "an uncompetitive cost burden on U.S. based corporations that have foreign operations".[768] Second, there are substantial biases against corporate investment over non-corporate investment, and in favour of debt financing over equity financing. Finally, profits are effectively taxed twice (once at the corporate level, and again at the individual level if those profits are disbursed to investors). Ultimately, these flaws have caused tax revenues to decline as profits are shifted overseas in complex efforts to minimise tax payments.

The authors cautiously suggest changes that can be made to remedy these problems. First, the US could move towards a territorial system of corporate taxation to significantly reduce the inefficiencies, inequities and complexities that arise from tax planning and avoid burdensome taxation on worldwide income. This could have substantial economic benefits. Second, the US could replace the corporate income tax with a corporate consumption tax, exempting savings and investment from taxation. This would remove the bias against reinvestment of profits and provide a long-lasting boon to economic growth and domestic job creation.

Third, the report suggests integrating individual and corporate income taxes. However this is done, it would end double taxation of companies profits and remove economic distortions which favour non-corporate investment, for example in owner-occupied housing. The report considers further reforms, including immediate expensing of depreciable capital assets, large reductions in headline corporate rates, the elimination of the corporate alternative minimum tax, and even the removal of corporate income tax itself.

767. Saxton, J. et al. *Reforming the U.S. Corporate Tax System to Increase Tax Competitiveness,* Joint Economic Committee United States Congress, 2005, pg. 1
768. *Ibid.* pg. 4

Final Report of the Tax Policy Review Committee to the Government of Jamaica (2004)

The Jamaican Government launched this commission to conduct the first review of Jamaican taxation in 20 years. The Committee reports that comprehensive reform occurred before trade and foreign exchange liberalisation and subsequent piecemeal changes were made without any emphasis on the internal consistency of the system. They argue the need for reform is pressing because of long-term indicators that Jamaica is internationally uncompetitive, with slow productivity growth and continuing fiscal problems. Per capita incomes declined during the 1990s. The Committee's proposed reforms seek to rebalance the tax system away from reliance on income and payroll taxes to indirect taxation, improve weak tax administration, remove complicated rate and base structures (which make enforcement difficult), remedy unfairness, and improve revenue stability.

Critically, they argue that Jamaica faces a "special problem"[769] with tax incentives. There are nearly 200,000 of them and they cause serious horizontal inequities; complicate the system; narrow the tax base; and lead to high efficiency costs. The Committee recommends the removal of nearly all zero-ratings in the general consumption tax, alongside a rate rise from 15 per cent to 16 per cent. The special consumption tax would also be simplified and raised. Property tax would be simplified by applying a flat one per cent rate over a J$300,000 threshold and stamp duty eliminated.

Income tax would undergo the most substantial reform. They argue the tax-free threshold should be increased by 128 per cent and two earmarked taxes for education and health (described as second and third income taxes) subsumed within the single income tax rate. Payroll taxes would be broadened while the rates would be lowered and the corporation tax aligned with the top rate of income tax (25 per cent) – an effective cut of 8.3 per cent. Although the reforms would be broadly regressive, the commission argues that direct expenditure is a more effective way to help the poor.

Gassner, W., Need and Principles for a Tax Reform in Cyprus (Wirtschaftsuniversität, Vienna, 2004)

Professor Gassner prepared this review of the Cypriot taxation system for the country's Minister of Finance. He draws on his experience analysing the consequences of Austria's accession to the EU to propose measures that would both bring Cyprus into line with EU tax treaties and improve the country's ability to compete internationally. He argues that Cyprus' tax system is antiquated and increased revenues from previous VAT reforms could fund an ambitious series of further changes. Other countries have cut income tax, broadened tax bases and reduced rates to make their taxes more transparent, easier to administer and more efficient. Use of the tax system to intervene in society "may be efficient for less developed countries but [have] proved to be inefficient for highly developed economies."[770] Gassner's proposals fit closely with these international trends. He recommends the elimination of taxes uncommon in most OECD countries, including the defence contribution and stamp

769. *Final Report of the Tax Policy Review Committee to the Government of Jamaica,* 2004, pg. 22
770. Gassner, W. *Need and Principles for a Tax Reform in Cyprus,* Wirthschafts Universitat, 2004, pg. 3

duty. Stamp duty is singled out for particular opprobrium as a "British disease which spread to all countries of the former British Empire".[771]

Business taxation requires considerable reform because it is unpopular among foreign investors and costly for municipalities to manage. It should be replaced by a transfer to local authorities of some part of the centrally-raised income tax. Given rising VAT revenues, a 30 to 40 per cent cut in the effective income tax burden is possible. The zero bracket allowance should be doubled and multiple rates replaced with just two at 10 per cent and 20 per cent. Additional revenue can be raised through the elimination of most personal allowances and deductions. Corporate tax reform should follow a similar path, including the removal of deductions for international business and depreciation allowances, and the imposition of a single corporation tax rate at 10 per cent. Dividends should also be taxed at 10 per cent.

Spengel, C., & Wiegard, W., Dual Income Tax: A pragmatic tax reform alternative for Germany (CESIFO, 2004)

This academic article reviews various tax reform programmes proposed by political parties in Germany. Spengel and Wiegard describe a widespread agreement that German taxation has become too complicated, that the tax burden is too high, and that income and business taxes are distorting decisions. However, they question the effectiveness of previous simplification measures and the value of the parties' proposals.

They believe insufficient attention has been paid to Germany's lack of competitiveness in the taxation of internationally mobile capital. Although Germany may appear attractive in European comparisons of tax as a share of national income, the country's marginal effective tax burden on investments is very high.

Their key suggestion is that Germany should adopt a dual income tax, where capital and earned income are taxed separately and at different rates. They argue this is a second best solution and would prefer a 30 per cent flat tax levied on corporate and personal income above €10,000. However, a flat tax is deemed politically impractical since it would entail a large loss of revenue and they believe richer households would benefit more than poorer households. A German dual income tax would involve a continuation of current taxation on earned income and the adoption of a maximum flat 30 per cent tax on capital income. The authors believe this would advance tax neutrality (and therefore simplicity), lead to increases in productivity, GDP and household consumption, and would satisfy the need for German tax reform in the context of fierce international tax competition.

Philadelphia Tax Reform Commission. Final Report (Philadelphia Tax Reform Commission, 2003)

The City of Philadelphia launched this Commission to propose tax reform to reverse the city's economic sclerosis. It reported that Philadelphia had lost more than 250,000 jobs and 430,000 residents since 1970, partly due to its unusual tax mix and high rates, and tax reform could fundamentally transform the economy and increase prosperity throughout the region. The Commission proposes a shift away from an

771. *Ibid.* pgs. 3–4

overreliance on business and personal income taxes towards property taxation. The commissioners call for more accurate measurement of property values alongside incremental reductions in income tax and net profits tax. It also argues that income tax reduction should be prioritised over sales tax reduction.

McLeod Tax Review (New Zealand Treasury, 2001)

McLeod and his colleagues were asked by the New Zealand Treasury to consider whether the country's tax system is adequate for its needs. Their report argues that the tax system is broadly sound and compares favourably with international competitors. McLeod's positivity is explicitly contrasted with the conclusions of the 1982 McCaw Report, which argued that New Zealand needed a major structural overhaul. McLeod sees post-McCaw reforms as successful and argues that reversals are not needed. As a result, he believes, most potential gains from tax reform have already been realised and those remaining will be difficult to achieve.

The 1980s saw the introduction of a GST, the removal of personal income tax concessions and a broader corporate tax base. Base broadening and a more diverse tax mix permitted lower headline rates. Similarly, declining government spending allowed for significant further tax cuts. He says these measures were successful because a "well-functioning tax system works best the lower the revenue level it is required to collect, the broader the base to which it applies, and the lower the rates at which it is levied".[772]

McLeod considers areas where New Zealand could widen its tax bases further. The country does not have comprehensive taxation of capital gains but McLeod does not believe it would make the system fairer or more efficient, lower tax avoidance or raise substantial revenue that could be used to reduce rates. Instead, it would increase costs and complexity.

Similarly, although he argues the tax-exempt treatment of owner-occupied housing is another major anomaly, McLeod could not find a feasible way of ending it in a fair and non-distortionary way. McLeod rejects a general wealth tax, the reintroduction of estate duty, a cash-flow tax, and a financial transaction tax.

He says no great change is needed to GST, but McLeod criticises excise duties on alcohol, tobacco, gaming and fuel. They raise significant revenue but "seem out of step with the low rate, broad base approach taken in respect of our other tax bases".[773] They cannot be justified on tax efficiency or tax equity grounds and only alcohol duty effectively corrects market mispricing. McLeod prefers the transparent approach to taxation exemplified by GST, which makes "tax burdens independent of how New Zealanders spend their money".[774] He says excise duties should be subsumed within an increased GST rate. Indeed, any future tax increase should be made through increased GST rates because it is broadly less distorting than income tax. Income tax should take priority in any future tax decrease.

The report discusses environmental taxation in the context of New Zealand's Kyoto commitments. He argues a future environmental tax should not raise predetermined levels of revenue and should try to achieve a measurable environmental impact. Similarly, green taxation should not be imposed unilaterally but emerge through international agreement. A carbon tax may be practical if aligned with

772. New Zealand Treasury *McLeod Tax Review*, 2001, pg. 2
773. *Ibid.* pg. 4
774. *Ibid.* pg. 5

international carbon prices, but localised green taxes geared to resolving specific environmental problems are preferable.

More broadly, the report suggests the alignment of the top rates of income, corporate and trust tax at 33 per cent. Any alternative exposes the system to abuse, complexity and distortion. This could be combined with reliefs for non-resident investors and immigrants to ensure New Zealand does not become unattractive to internationally mobile capital or highly-skilled workers. It also finds that income tax should be capped at a total of $1 million a year.

The importance of international competitiveness is recognised in the recommendation that corporation tax should not be significantly above the corporate rate in rival jurisdictions. McCleod is sceptical of redistribution through the tax system, arguing that this is the purpose of the benefits system. He argues the small benefits accrued by low earners through redistributive taxation are heavily outweighed by resultant expensive inefficiencies. The links between welfare and taxation need attention as they cause high effective marginal tax rates for some groups. However, there is no clear solution. Less targeted benefits may be more efficient but would necessitate less assistance to the most needy.

Grubel H.G. (ed.), Tax Reform in Canada. Our path to greater prosperity. (Fraser Institute Conference, 2001)

Grubel edits a book of conference papers that consider comprehensive tax reform in Canada. The book argues that Canada's tax code is expensively cumbersome and complex, that changes in the economic environment have negated policies designed to deal with formerly pressing economic and political issues, and that new theoretical and empirical knowledge shows that the cost of the existing tax structure is unnecessarily high relative to available alternatives. Particular attention is paid to capital gains tax, which Grubel thinks is damaging Canada in increasingly integrated capital markets. Investors are highly responsive to small differences between tax rates in different jurisdictions and burdensome rates of capital gains tax have resulted in higher investment costs in Canada than abroad. Similarly, Grubel underlines that Canada's last tax reform, in the 1970s, was informed by redundant evidence about the nature and effects of taxation. It was also based on the popular belief that fairness was more important than efficiency and economic growth. He argues that reform is now necessary, particularly due to Canada's relative decline in per capita income.

The individual papers take subtly different approaches to the problem of Canadian taxation. Walker argues that the optimal level of public spending for maximising economic growth is 34 per cent of GDP, and that the tax system should be redesigned to raise the maximum amount with minimum distortion. This would entail a mix of broad-based income and expenditure taxes. Mintz argues that Canada needs a more internationally competitive tax structure, especially compared to its closest neighbours. He draws on evidence (including population ageing, thinning borders between Canada and the USA, and the superiority in efficiency terms of taxes on consumption over production) to propose a dramatic shift from income to expenditure taxes.

Clements and Emes propose a Rabushka-Hall model flat tax for Canada. It would give the country an immediate and substantial competitive advantage against the USA and would solve complexity and compliance problems.

All authors agreed on a list of key recommendations. Firstly, taxation of income from work, investment and risk-taking should be eliminated or reduced significantly and consumption taxes correspondingly increased. This could be achieved either by turning income tax into an expenditure tax, by exempting all savings from taxation, or by raising GST rates while decreasing rates of direct tax. Secondly, multiple taxation of investment income should be phased out. Capital gains tax should be abolished, capital business tax eliminated, and personal and business taxation integrated so that taxes on profits paid by business can be used to reduce personal income tax on dividends. Finally, progressive tax brackets should be replaced with constant marginal rates to simplify the system, and remove disincentives to work, invest and take risks.

Lenain, P., & Bartoszuk, L., The Polish Tax Reform. Economics Department working papers No. 234 (OECD, 2000)

Lenain and Bartoszuk review the Polish tax code, consider the success of a tax reform package enacted in 1999–2000, and propose future reforms to improve the prospects for economic growth. Several features of the Polish taxation system are considered commendable, particularly its ability to generate strong, stable revenue and the relatively few deterrents to economic growth and foreign investment until recently.

However, they argue Poland's tax system also possesses less desirable features which could hamper future growth, including high labour taxes, a large wedge between labour costs and workers' disposable income, a lack of neutrality between different investment decisions, and an increasingly complex system of allowances and reliefs.

To some extent, they argue that the 1999–00 reforms were a courageous step that will decisively modernise the tax system, make it more equitable and provide greater incentives for growth and productivity. Those reforms lowered rates while broadening the tax base. They gradually reduced corporate tax rates to 22 per cent, with the elimination of investment allowances and lower depreciation allowances. There was a shift from direct to indirect taxation with a gradual rise in VAT rates from seven per cent to 22 per cent.

However, a presidential veto prevented substantial, similar changes to income taxation. The proposed reform would have lowered tax rates from 19 per cent, 30 per cent and 40 per cent to 18 per cent and 28 per cent, with the highest band eliminated. The authors argue that this should be resubmitted, with additional base broadening into fringe benefits and contractual work. Similarly, sluggish job creation should be remedied by tackling the tax wedge on labour and social security taxes should be cut. Effective tax rates on various capital incomes should be aligned to remove biases towards different types of financing. Finally, environmental taxes should be introduced, including raising the VAT rate to the standard rate on environmentally damaging services and products.

Bond, S., & Chennells, L., Corporate Income Taxes and Investment: A Comparative Study (Institute for Fiscal Studies, 2000)

This Institute for Fiscal Studies study considers corporate income tax internationally. It argues that it is important to compare developments across countries because increasingly mobile capital and increasingly international corporations mean no country should be indifferent to developments in corporate taxation elsewhere. It describes a striking trend towards lower corporate taxes across open economies, consistent with economic analysis that corporate taxes are borne more heavily by relatively immobile workers (through their wages) than by the owners of capital. The study also notes that revenues from corporate taxes have risen while rates have fallen, partly due to the removal of exemptions and widening of tax bases.

Its analysis focuses on Germany, which until 1999 had high corporation tax rates accompanied by large depreciation allowances (for investments in plant and machinery) and generous reliefs for profits paid out as dividends. Before the 1999 reforms, the cost of capital in Germany was disproportionately high, particularly for investment in buildings and for investment financed by retained profits. It argues that by reducing the headline tax rate and removing exemptions and reliefs Germany will more broadly reduce the cost of capital. The reforms would not, however, transform the country into a low capital cost country by international comparison.

Finally, the paper considers the political economy of flat tax systems and, based on the countries which have adopted them, suggests that they are attractive to more unequal societies, countries with dysfunctional tax administrations where income tax is a relatively unimportant source of revenue, and to countries that want to make strong signals they are reforming policy to the rest of the world. Slovakia obtained a marketing advantage after the switch from its previous tax regime. The paper concludes by arguing that flat tax systems are not necessarily robust in the long run and other countries will probably not adopt them. Its analysis, however, is based on limited evidence from countries that had adopted a flat tax.

Katz, M.M. et al., Third Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa Tax Reform (Katz Commission, 1995)

Over a number of years the Katz Commission investigated and proposed measures to improve the South African tax system following the end of apartheid. It was appointed in June 1994 and presented several reports to the Minister of Finance dealing with various aspects of the country's taxation system.

This third report considers potential measures to make South African personal income tax and VAT more efficient and to improve long-term economic growth. Altogether eight interim reports were released but the final recommendations were never made public.

The report argues that direct taxation is more likely to be distorting while indirect taxes affect economic incentives less. An increased reliance on VAT, however, could potentially worsen inequality and poverty. Katz argues that it should be possible to increase VAT rates and reduce the number of zero rated items without significantly hurting the poor. In any case, "it is not in the tax system that the remedy for poverty is to be found".[775] Fiscal correction of poverty should occur through direct expenditure. Concurrent with VAT reform, South Africa should follow international trends in reforming income tax by broadening the base, reducing the number of marginal rate brackets and the maximum rate, raising tax thresholds, and adjusting brackets for inflation. Finally, Katz argues that the optimum overall tax burden for South Africa is about 25 per cent of GDP.

Agell, J., Englund P., Sodersten, J, 'The Swedish Tax Reform: An Introduction', Swedish Economic Policy Review 2 (1995), pgs. 219–228

This review describes the 1990–91 Swedish tax reforms as some of the most far-reaching comprehensive changes to a tax system in any industrialised country. Reform drastically cut marginal tax rates for high-income earners, ensured no large distributional changes, and increased economic efficiency.

The authors characterise the reforms as tax-cut-cum-base-broadening. They involved dramatic changes in the schedule for taxing earned income. 85 per cent of earners would only pay local income taxes (levied, on average, at 31 per cent), and the threshold for the central income tax would rise by two per cent above inflation every year.

The progressive schedule on capital income was also replaced with a 30 per cent proportional tax on dividends, interest income and nominal capital gains. This flattening was intended to reduce the scope of tax avoidance and to minimise incentives to transform high-taxed regular income into low-taxed capital gains.

They moved away from the previous policy of attempting to stimulate business investment through a combination of high statutory rates and generous investment allowances. Reform reduced the statutory rate to 30 per cent, eliminated a surcharge known as profit-sharing tax, and eliminated many allowances. All these rate cuts (and accompanying cushioning expenditure) involved a revenue loss of between six per cent and seven per cent of GDP.

VAT reform was designed to partially fill this gap. Pre-reform, 40 per cent of private consumption was either exempt from VAT or granted lower tax rates. Although the initial intention to levy a uniform VAT on the commercial turnover of all goods and services was abandoned, substantial base broadening meant only cultural activities, social services and rent were now exempt. The report argues that the changes successfully eliminated tax shelters, stimulated household savings, reduced discrepancies in the taxation of investments in different sectors, and decreased the excess tax burden on income from labour. However, the authors argue that the short-term costs were significant and probably contributed to the economic downturn in the early 1990s.

775. Katz, M.M. et al., *Third Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa Tax Reform,* Katz Commission, 1995

Tax Reform for Fairness, Simplicity and Economic Growth. The Treasury Department Report to the President (Office of the Secretary, Department of the Treasury, 1984)

In his State of the Union address in January 1984, President Reagan criticised the US taxation system and called for a programme of fundamental tax reform. The resulting report confirmed Reagan's analysis and proposed sweeping changes to remedy tax complexity, inequity, interference with economic choices and ill-design. From 1954 to 1984, simplicity declined, tax bases disappeared, unexpected economic distortions arose, and taxpayer 'morale' deteriorated to the extent that taxpayers were increasingly willing to resort to tax avoidance strategies.

To address those problems, the report proposed a modified flat income tax, involving large rate reductions, increased personal exemptions and the removal of a number of existing deductions, exclusions and credits. The 14 existing income tax brackets would be replaced with three at 15 per cent, 25 per cent and 35 per cent. An increased tax-free allowance would remove those below the poverty line from taxation, and the overall package would cause an average decrease in marginal tax rates of about 20 per cent. Simplicity would be served by the consolidation of about 65 provisions in the tax code. This reform would reduce the number of taxpayers who itemise their taxes to fewer than 25 per cent.

The report also sees taxation of capital and business income as deeply flawed, lacking internal consistency and ill-suited to a period when inflation was varied and unpredictable. Subsidies to different kinds of businesses (particularly energy production and finance) distorted behaviour, and the tax structure provided opportunities for wealthy individuals to avoid tax. It argues the proposed reforms would rationalise business and capital income to "subject real economic income from all sources to the same tax treatment".[776] It would create a single corporate rate at 33 per cent (2 per cent below the proposed top personal income tax rate); capital gains tax would no longer be levied on fictitious gains caused by inflation, only real gains; and double taxation of business income would be minimised by allowing corporations to deduct a proportion of the dividends paid out from previously-taxed earnings. Finally, the report argues that substantial tax preferences for energy and finance should be abolished.

The Structure and Reform of Direct Taxation. Report of a Committee chaired by Professor J.E. Meade (Institute of Fiscal Studies, 1978)

The Meade committee was tasked by the Institute for Fiscal Studies with considering an ideal tax system, to test the British tax system against that ideal, and to provide recommendations for future reform. It was highly critical of the then tax system, considering it to have no rational base, to have been designed on an ad hoc basis, and to lack stability and coherence. Meade and his committee argued for a long-term piecemeal reform process that they said would command the widest possible political support. They are particularly concerned that a tax structure will not be rejected and replaced after a change of government, and that reform would be enacted

776. *Tax Reform for Fairness, Simplicity and Economic Growth. The Treasury Department Report to the President,* Office of the Secretary Department of the Treasury, 1984, pg. xii

gradually and not through a gigantic upheaval. Linked to this is a concern about economic stagnation and a need to encourage higher productivity. "Uncertainty and lack of confidence in the stability of present arrangements are serious impediments to the national effort to improve our economic performance."[777] Meade also hopes that effective taxation could minimise any conflict between greater economic efficiency and the need to take action to prevent poverty and remove "unacceptable inequalities of opportunity, wealth and privilege".[778]

The Committee lists and discusses what it sees as the characteristics of a good tax system. It should limit the number of anomalous complications and inconsistencies; be stable but flexible; encourage economic efficiency by keeping marginal rates down and tax bases wide; be horizontally equitable and vertically redistributive; and must ensure that it is not so burdensome, by international comparison, as to create outflows of capital and labour. Most importantly, it should be simple, coherent and easy to comply with. A lack of simplicity engenders distrust in the public, and compliance costs can be "markedly regressive".[779]

The committee highlights two sectors of the tax system as particularly muddled – an "unsystematic mixture of elements of tax on income and elements of tax on consumption expenditure",[780] and interplay between the tax system and social security causing excessively high marginal rates of implied tax. The Committee recommends moving towards either a fully income based tax or a fully expenditure based tax for clarity's sake. They prefer the latter because it would tax what people took out of the economic system in high levels of consumption rather than what they put in through savings and enterprise. Alongside this, they favour some form of tax on wealth which discriminates against inheritance. Secondly, the Committee recommends a 'New Beveridge Scheme' which would ensure tax thresholds were increased in line with a minimum acceptable standard of living to keep the poor out of tax, would replace some allowances with specific benefits, and limit means-testing while ensuring that benefits were fully part of the tax base.

Blueprints for Basic Tax Reform (US Treasury, 1977)

In the final years of his Presidency, Gerald Ford asked the US Treasury to deliver a blueprint for fundamental reform of the American tax system. Millions of Americans were unhappy with a tax code they could neither understand nor trust, and reform was needed to return the code to the basic principles of equity, efficiency and simplicity. It argued "patchwork palliatives"[781] had built extreme complexity into the tax code and the result was a plethora of unfair provisions that effectively subsidised certain types of taxpayer or particular interests. Crucially, the tax code did not "reflect any consistent philosophy about the objectives of the system".[782] Therefore, this report proposed two alternative integrated systems, both involving a broader tax base but with much lower and simple rates. The intention was to "wipe the slate clean of personal tax preferences, special deductions and credit […] and impose a single, simple progressive tax on all individuals".[783]

777. *The Structure and Reform of Direct Taxation: Report of a Committee chaired by Professor J.E. Meade,* Institute for Fiscal Studies, 1978, pg. 3
778. *Ibid.* pg. xv
779. *Ibid.* pg. 21
780. *Ibid.* pg. 499–50
781. *Blueprints for Basic Tax Reform*, US Treasury, 1977, pg. 1
782. *Ibid.*
783. *Ibid.* Foreword

The first model is a comprehensive income tax, based on a broad concept of income defined in terms of the uses of an individual's receipts. It would integrate corporate and personal income taxes, tax capital gains at full rates after allowing adjustment for inflation, and remove many tax-exemptions. It would replace the complex rate structure with three brackets from eight per cent to 38 per cent. The second model is a cash flow tax based on consumption. It would also replace the existing rate structure with three brackets (this time from 10 per cent to 40 per cent). Both of these plans generally broaden the tax base by including items excluded under the existing tax law. They also permit a simpler tax code because "elaborate rules are no longer required for defining items of tax preference or for protecting against the abuse of such preferences".[784] Similar levels of revenue could be raised via a substantially lower rate structure. Both plans would "achieve consistency with an ideal base, departing from the ideal only when necessary for administrative feasibility, simplicity, or compelling economic or other policy reasons".[785]

The report concludes by acknowledging that reform of an existing tax system poses a different set of problems from the design of a new system from scratch. Policymakers must deal with transition issues (notably changes to asset values and windfall gains for certain taxpayer) and solutions must be embodied in specific proposals.

784. *Ibid.* pg. 2
785. *Ibid.*

Acknowledgements

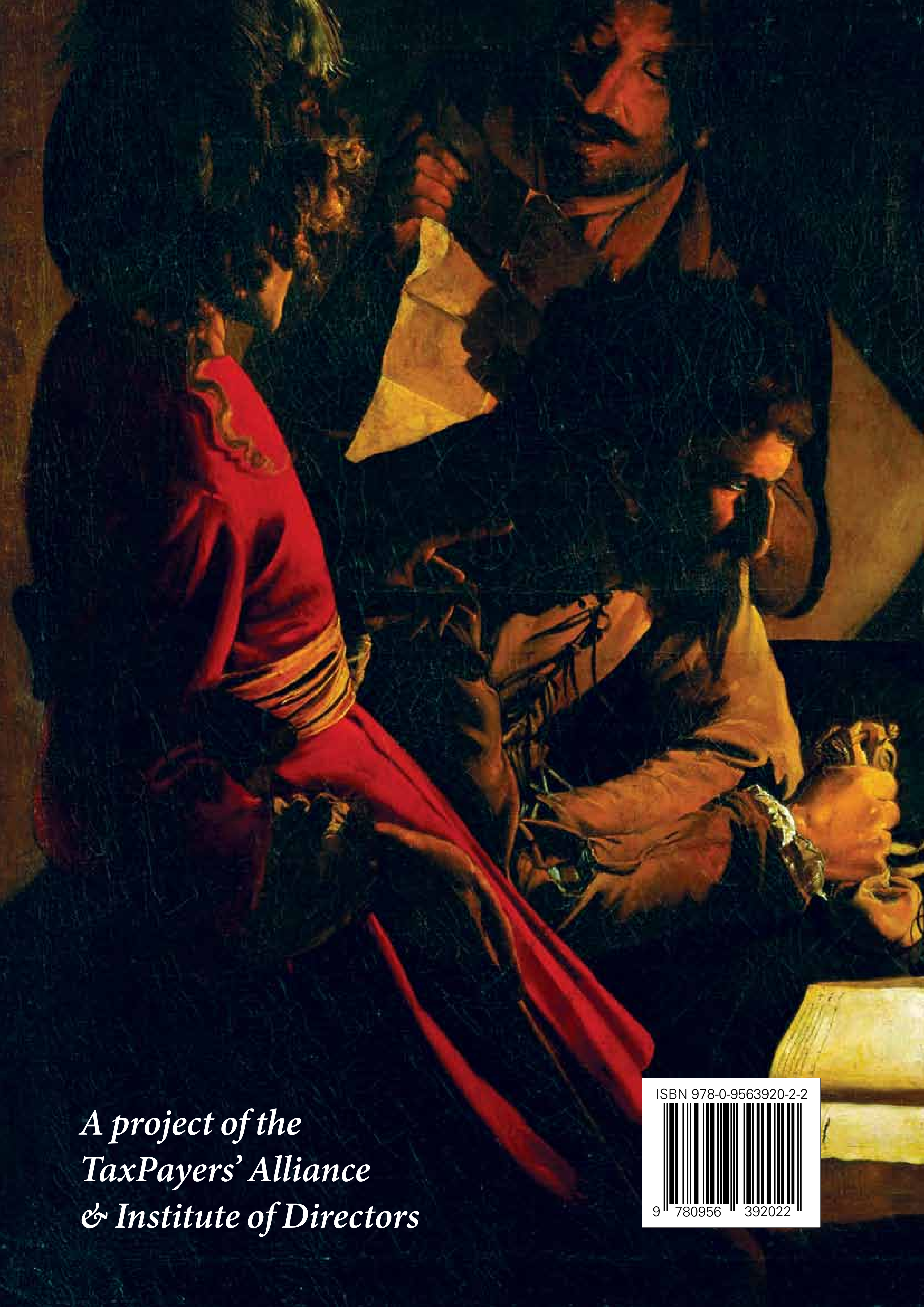
The Commissioners would like to thank the following people for their evidence, advice and oversight which were most helpful in drawing up the conclusion of the 2020 Tax Commission, though their acknowledgement should not be taken as an endorsement of the Commissioners' findings:

Michele Bandini, Patrick Barbour, Yannick Bultingaire, Rupert Darwall, David Hammond, Alexander Jackman, Paul Johnson, Peter Kleeman, Mart Laar, Jon Moynihan, William Norton, Corin Taylor and Peter Vaines.

And the team at the TaxPayers' Alliance:

Emma Bennett, Emma Boon, Chris Daniel, Sandra Fischetti, Emily Hendrix, Maria Fort, Jonathan Isaby, Babatunde Onabajo, Robert Oxley, Sara Rainwater, Lee Rotherham and Joseph Shanahan.

Financial support for the 2020 Tax Commission was provided by the Politics and Economics Research Trust (charity number 1121849). The views expressed in this report are those of the 2020 Tax Commission and not those of the research trust or of its trustees.



A project of the TaxPayers' Alliance & Institute of Directors

ISBN 978-0-9563920-2-2