



AN AGENDA FOR TAX REFORM

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SUMMARY

- A good tax system is one that damages everyone's incentives to work and save as little as possible – the 'Ramsey Principle' – consistently with financing government spending and achieving aims for income distribution.
- This is achieved by taxes that are 'flat' (i.e. the same proportional rate) across people of all incomes (the popularly known 'flat tax'); that are flat across commodities of all sorts ('tax neutrality'); and that are flat across time. This last means that the tax rate is constant over present and future consumption; it implies both that tax should be levied on consumption and that the tax rate should be planned to be constant under forecast conditions ('tax smoothing').
- Taxes can be cut without being balanced by simultaneous cuts in spending because extra work and less avoidance create an offsetting recovery in revenue (the Laffer effects); and because higher growth generates more future revenue. This is an important implication of tax smoothing.
- A UK flat tax on consumption would bring the imputed rent on owner-occupied housing into the tax base and would allow the standard rate of income tax to be cut cautiously to a 15% flat tax rate on consumption, thereafter being cut further in stages as the growth effect rolled in.
- Such tax reform would be popular since there would be no losers, no cutback in public spending programmes and many gainers, not the least of them the UK economy.

CHAPTER ONE

INTRODUCTION

Twenty four years ago Margaret Thatcher inaugurated nearly two decades of reform, designed to restore Britain economically to the low-inflation and dynamic economy it once had been. In 1997, when the New Labour Government obtained power, its leaders proclaimed that it would use the free market to pursue efficiency while also striving for ‘social justice’.

In a number of areas, that has been achieved. In monetary policy, the Bank of England was made independent; in fiscal policy, the Government announced various new rules to buttress fiscal responsibility, though this now looks rather tarnished; in the labour market, the tough approach to benefit eligibility inaugurated by the Conservatives was made bipartisan. Thus some progress has been made.

However, in other crucial areas, no progress has been made; indeed we have slipped back. In no area is this more evident than in taxation and benefits (now renamed ‘tax credits’). Complexity has proliferated, with a stress on special incentives and special penalties; this has created a complex patchwork of high marginal tax rates. This, and how to reform it, is the topic of this paper.

CHAPTER TWO

WHAT IS A GOOD TAX SYSTEM?

THE RAMSEY PRINCIPLE

It is useful to recap on just what, from the viewpoint of economic efficiency, is the best tax system. The key principle is due to Ramsey and is known as the Ramsey Principle of equalising tax across groups, commodities and time (Ramsey was a brilliant student at Cambridge in the 1920s and this comes from an article of his in the *Economic Journal* of 1927).¹

The basic idea is that as the tax rate increases, the extra cost becomes steadily higher (call it the law of increasing dysfunction); the formal reason is that the state is driving a bigger and bigger wedge between what things (eg labour) are worth in the market and the (net-of-tax) return to the people producing them; the latter is the true cost of the effort being expended, the former is the true value to the economy. So as taxes increase and output falls, the loss of that output is more and more damaging because the loss of value to the economy is ever greater while the reduction in effort gained is ever smaller.

On the other hand, where the tax rate falls and output increases, the gain from that higher output gets steadily smaller because the extra value is getting closer and closer to the extra cost. The corollary of this principle is that when the output responsiveness is the same across different markets (a natural benchmark), tax rates should be equalised; because at this point there is no gain from switching the tax burden from one commodity to

¹ See F Ramsey, "A Contribution to the Theory of Taxation", *Economic Journal*, 1927.

another, as the extra gain on the one would be just equal to the extra loss on the other. The three practical implications are that:

- a) the celebrated 'tax neutrality' (across goods and different activities, methods of finance etc) principle of the Lawson years should be reintroduced;
- b) the tax system should move towards a flat rate tax (the same rate across all groups of people regardless of their earnings); and,
- c) the less well-known idea of 'tax-smoothing', which is keeping the tax rate for the economy constant over time, should be the foundation for public borrowing policy.

The concept that should underlie the taxation of commodities and services should be that of taxing consumption, however it is carried out, at a standard percentage rate.

NEUTRALITY ACROSS SECTORS AND ACTIVITIES

Under Nigel Lawson's chancellorship, a determined effort was made to achieve neutrality so that different activities should as far as possible attract the same marginal tax rate. Capital allowances were reduced so that they reflected economic depreciation rates; stamp duty was largely abolished as were preferential rates of tax for privileged activities such as 'development zones'.

Gordon Brown has reversed this thrust in a bout of unprecedented activism. We now have capital allowances back again, to 'encourage investment'. Stamp duty on houses (a tax on mobility) has been raised sharply, with a top rate of 4%. Tax privilege is back for 'derelict zones'. There are special low rates of tax, both income and capital gains, for small and medium-sized enterprises ('SMEs') on the grounds that their activity is particularly fruitful. Saving in various forms has been penalised, notably by the abolition of ACT-relief for pension funds but also by the sharp raising of the level of the old-age benefit threshold (now called a minimum); and by the introduction of pension tax credits for those with pension incomes above this threshold. Previously the philosophy had been to relieve saving of income tax in most approved (long-term) forms, thus moving income tax in the direction of a tax on consumption, again in line with the Ramsey principle – in that future consumption is thereby taxed at the same rate as current consumption.

The aim of reform should be to get rid of special treatment. The concept that should underlie the taxation of commodities and services should be that of taxing consumption, however it is carried out, at a standard percentage rate. In principle, VAT should be extended as far as possible across all categories of spending, so making possible a reduction in the standard rate of VAT. At the same time, income tax should be adjusted onto a consumption tax basis: this would mean that all saving would be deducted from income before it is taxed. This would abolish the mass of saving

exemptions as they would now be redundant. It would also simplify the system. Since these exemptions have much the same value as the total relief of savings via the consumption tax, there is little if any extra cost involved.

The consumption tax base would enable the abolition of capital gains tax, which is most unsatisfactory in principle (because it taxes saving) and also complicated in application. Consumption is then calculated as:

Income (including capital gains) **minus** the difference between end-period and beginning-period asset values.

Since the change in asset values includes capital gains, this tax base amounts to:

Income (excluding capital gains) **minus** any net new asset acquisition.

The simplification, incidentally, of tax returns would be huge: instead of the present mass of detail it would be just income less any net new assets.

One may note in passing that stamp duty, which is a tax on transactions not on any consumption value, should be abolished. The same applies to a number of recently-introduced taxes such as airport tax and insurance tax. Only if such taxes are related directly to charges for services rendered do they have a justification; in this case it would be better for them to be levied explicitly as charges and then passed on to the customer in whatever way the commercial operators feel is best; airport charges, for example, should be levied on airport operators.

Another important point to note is that the consumption tax is levied on all consumption; this includes consumption of all housing which is a long-lived consumer asset. Rented housing is taxed automatically with a consumption tax. However, under a consumption tax, saving to buy a house is untaxed; under an income tax, house purchases are paid for out of taxed income. It follows that the consumption of owner-occupied housing would be taxed under a consumption tax, in the same way that rent is taxed. In switching to a consumption tax this implies that no more tax is paid on owner-occupied housing than it is now; it is merely taxed in a different way.

THE FLAT RATE TAX

The table below shows that the UK tax system (income tax, National Insurance and indirect tax included) produces a top marginal tax rate of about 60%. This is the percentage of the wage paid by an employer taken by the state in NI, indirect tax and income tax.

CALCULATION OF MARGINAL TAX RATES ON £100 GROSS EARNINGS

	Average rate taxpayer	Higher rate taxpayer
Total employer costs (inc. NI)	£109.30	£112.80
Employee gross earnings	£100.00	£100.00
Employee net earnings (after income tax and employee NI)	£68.60	£59.00
Indirect tax (VAT & net excise duties @ 21.8%)	£12.30	£10.60
Cost of goods	£56.30	£48.40
Total tax paid	£53.00	£66.70
Marginal Tax rate	48.5%	57.1%

Notes: Average rate taxpayer is assumed to earn approximately £29,000 and is below the Upper Earnings Limit for National Insurance of £32,760; and is assumed to have a contracted out pension. Vat and net excise duties estimated at 21.8% (adjustment to factor cost/consumption at factor cost). Figures rounded to the nearest 10p.

It is calculated by estimating what percentage of the total wage cost paid by an employer for an employee buys for that employee in terms of actual consumption enjoyed. It turns out that higher-paid employees get approximately £43 worth of goods and services valued at their true cost for an extra £100 paid for their labour by their employer. For the employee on average earnings, the equivalent marginal tax rate is about 48%.

The average tax rate of the economy is 40%. In this, the average yield of income tax is about 20% – this is the result of an average of bands from 10% to 40% with presumably some slippage in the theoretical yield on this taxable income. So a flat rate tax of the same yield, assuming none of the indirect effects on revenue discussed later, would be some 25% against the current mixture. (All figures in this discussion are inevitably approximate given the complexity of the tax system.)

Under the flat rate principle personal allowances are unjustifiable because they imply a rise in the necessary flat rate tax – in effect, personal allowances can be thought of as a zero tax band for people on very low earnings which violates the flat rate optimum. Abolishing personal allowances would increase the tax base by about another fifth, allowing the flat rate to drop to 20% for the same yield.

We will consider later the possible ways in which the flat rate might be introduced in practice; in its basic form it poses a number of practical difficulties. Yet its essential gains can be obtained quite simply. But first we consider the question of benefits (negative tax or tax credits).

THE BENEFIT SYSTEM

Benefits have now largely been renamed as tax credits and are administered by the Inland Revenue and Customs Department. The problem with the current tax credit system is the very high marginal tax rates created by their means-testing – currently the withdrawal rate is 37% which added to other taxes and NI implies a marginal rate of around 70%.

These benefits have various purposes. Family tax credit is intended to increase work income relative to unemployment benefit, so as to make work worthwhile. It is also designed to help poor people with children, in order to reduce the poverty of families. Housing benefit is intended to help poor people pay for housing with rents set by market forces; thus the idea is to shift subsidies from bricks and mortar (council housing), which stops people moving to find jobs, directly to the people intended to be helped. Finally other classes of benefit² are explicitly designed to help with particular situations, such as disability; provided these benefits are dependent on these situations and not on income, they do not create disincentives to acquire income by work.

In themselves, these purposes are worthy. The problem is that, on the one hand, they are expensive in taxes – which drags down the welfare and efficiency of the general taxpayer; and on the other hand, they create serious disincentives (via those high marginal tax rates) to work and retrain for the very people they are helping. Hence it is important to try to find ways of reducing both their tax cost and their disincentives for the recipients.

One way of reducing the tax burden is to lower the generosity of the tax credits; this is entirely reasonable, given that their objective is to relieve poverty. Unemployment income is designed so that its recipients reach socially-acceptable minimum levels of consumption. Therefore by implication this is also the level that tax credits should achieve as a minimum for families with working heads; they are in fact significantly higher, in the order of 10%. The reason that is given for their being higher is that it provides a monetary incentive to work. However, this makes no sense. The premiss of unemployment support is that it is only to be paid to those who cannot yet find a job; after a period of search they are meant to take a job and then this support is withdrawn. This conditionality ('no fifth option' in Labour parlance; in Conservative terms the Job Seeker's Allowance) is now being enforced in a bipartisan manner, as it is generally accepted that people should take available jobs rather than stay on benefits for extended periods. If so the monetary incentive is irrelevant, as once the time is up the unemployment support is withdrawn. Thus we can easily justify this minimum or meanness in the provision of welfare benefits to those in work by the argument that in fact it creates no disincentive to work when benefits are administered toughly so that work must be taken.

² The major class is pensions. See "Agenda for a reforming government" on the author's Cardiff University website (www.cf.ac.uk/carbs/econ/minfordp). Here the focus is only on benefits that primarily affect work incentives.

A further way of reducing the cost to the taxpayer is to means-test the tax credits for people in work more sharply – that is, to withdraw them more quickly as income rises. The age-old problem this causes is that the poor then face a worse poverty trap since the incentive to retrain for better-paid work is apparently very small. But in fact one can argue with some plausibility that it is best to have a short range of income over which the withdrawal rate is very high.³ The idea of this is that while incentives in this range are very poor, the range is nevertheless small enough so that most serious retraining would allow trainees to ‘leap over’ it, in the sense that their income after training would be well above the range and hence the marginal tax rate would be moderate across the leap.

Under these circumstances, the poverty trap would not cause very much damage to retraining plans but would bring the cost of family and related credits down considerably for the taxpayer. The latter cost element in the calculation arises from the shape of the working population distribution: as support is extended up the income range the number of people involved rises disproportionately.

A further principle originally enunciated by Sir Norman Fowler in his review of benefits in the mid-1980s – that the state should only support *families with children* – is now adopted by the main parties. The idea is that single people can help themselves, as can childless couples since both can work. Thus the concept of poverty as the concern of the state essentially relates to families with children. By eliminating a large class of recipients, this again validly avoids both the cost to the taxpayer and the disincentives to those assisted.

With the aid of this analysis, Labour’s latest moves on tax credits can be seen to have been misguided. The withdrawal range for them has been stretched virtually up to average earnings. Also, in order (mistakenly as we have seen) to create an ‘incentive to work’ they have been raised in amount to some 10% or so above unemployment support levels. Our principles suggest that the support should be cut back to the unemployment level and that withdrawal rates should be fast, as they were before 1997.

Housing benefit is in essence, or should be, another Credit. It can be treated similarly. Currently it is paid to benefit recipients in respect of their actual housing bills, hence creating no incentive to economise on housing. It would be better instead to pay them an amount to the value necessary to reach the same level of housing. This should be withdrawn as above, fast. Families will then all shop around for housing just like ordinary unsupported families do today.

³ For some earlier calculations by the author, see, “The Poverty Trap after the Fowler Reforms”, *Improving Incentives for the Low Paid*, edited by Alex Bowen and Ken Mayhew, NEDO, 1991. It is clear that, until the advent of this Government, similar calculations informed Treasury thinking for many years.

'TAX-SMOOTHING'

Tax-smoothing is the principle that the tax rate should be set at the constant level which would pay the government's expected bills into the indefinite future. What would this constant tax rate be? It turns out that it would be a rate sufficient to pay for average government spending as a proportion of GDP and also to keep government debt from rising as a proportion of GDP.⁴ This last implies that taxes must cover debt interest adjusted for inflation and also less an allowance for growth (because growth reduces debt as a proportion of GDP).

The principle of tax-smoothing is that tax rates should be set at the constant level to pay the government's bills into the indefinite future.

To illustrate the idea of tax-smoothing in a practical way, consider what will happen under this formula if there is some unexpected shock – say a recession or a public spending crisis (a war perhaps) – which raises spending or lowers the yield of taxation. Then the implication is that the tax rate should only change by the implied permanent worsening of the finances.

What is this? Suppose taxes fall by £20 billion for a year but are expected to recover completely. Then debt will rise by this amount: interest costs adjusted for growth will rise by £20 billion times the real interest rate minus the growth rate. The following calculation shows that the flat tax rate should be increased so that it yields an additional £0.1 billion.:

Assuming that the real interest rate is 3%, and the growth rate is 2.5%

$$£20 \text{ billion} \times (3\% - 2.5\%) = £20 \text{ billion} \times 0.5\% = £0.1 \text{ billion}$$

Tax smoothing means that government borrowing can increase to take the strain of lower taxes until the benefits of spending reforms work through.

The implication of tax-smoothing is that public debt fluctuations are used to 'smooth tax rates' – and that it should *not* be an objective of policy to pay off debt for its own sake (indeed public debt is necessary for the proper working of the private savings and pension markets.) In practice, one may want to qualify the tax-smoothing principle a bit over the business cycle – for demand or supply reasons – but as a basic benchmark for long periods of time in considering where one should be pushing tax rates, it is highly robust.

Another practical implication of tax-smoothing is that the relevant cost of public spending is the *whole future stream of spending* not just the amount being

⁴ See "Agenda for a reforming government" on the author's Cardiff University website for technical details on this (www.cf.ac.uk/carbs/econ/minfordp).

spent today. Hence for example if reform to public services were instituted with the effect of causing economies over a fairly long period of time, then these economies can be counted today in setting tax rates; of course delayed economies in this do not count as much as immediate economies because one has to pay interest on the debt created by the delay. But they do count to some extent. What this means is that borrowing can rise to take the strain of lower taxes until the benefits of spending reforms work through.

THE 'SCOPE' FOR TAX CUTS: THE LAFFER CURVE AND GROWTH EFFECTS

Another important implication of the tax-smoothing formula is for the extent of tax cuts that can be afforded. Since the formula looks forward to the full path of foreseeable spending and tax revenues, plainly the effects of any policy change on that whole future path is of vital importance to the calculation. It makes no sense to exclude from it anything other than the current situation minus the obvious 'direct' effects of the tax cut, as was Conservative policy in the run-up to the last election.

Since the Reagan and Thatcher periods in the US and the UK, a mass of work has been done on the effects of tax cuts. The consensus has changed within the economics profession: there is now a cautious acceptance that tax cuts have significant effects both on net revenues in the short to medium term and on the growth rate of the economy.

The first of these is the 'Laffer effects' (after Professor Arthur Laffer, their proponent to the Reagan administration, while at Chicago University). These stipulate fairly rapid (i.e. within two to four years) effects on the supply of work, effort and tax avoidance of lower marginal tax rates. These effects create a 'net revenue recovery' or 'back flow' partially offsetting the loss of revenue from cutting tax rates. For example, a study for the UK found that the response to the top tax rate of higher earners' labour supply was approximately 1% for a 1% cut in the top marginal rate.⁵ Using this response, it was possible to replicate the effect on tax revenues of Nigel Lawson's cut in the top rate from 60% to 40%. Further down the income distribution, the proportional response fell: the average response was about half of 1%. That would imply that cutting the top overall marginal tax rate by 10% today would cause a net loss of revenue of only half the 'direct' amount.

The second set of effects, on growth, are potentially more important still. These have come into focus from research in the past decade into 'endogenous growth' (i.e. the study of how government policy on spending and taxation can affect growth). A large number of empirical studies have found an effect of tax rates on growth. Empirical evidence alone might be questioned on the grounds that other mechanisms might have raised growth and reduced taxes. However economic theory too has made progress in

⁵ See P Minford and P Ashton, "The Poverty Trap and the Laffer Curve – what can the GHS tell us?", *Oxford Economic Papers*, 1991.

identifying the causes at work. One is an interaction with the effect of lower tax rates in stimulating labour supply: higher employment promotes ‘learning by doing’ (the more people work, the more they learn). This extra rate of knowledge acquisition raises productivity growth. Another effect is on risk-taking and entrepreneurship: lower taxes mean that individuals and firms will take more risks to get extra income which will mean more innovation and so higher productivity growth at the level of the economy (at this level, individual risks cancel out; rather like competition which causes individuals to lose out to others while benefiting society as a whole).

Empirical studies on the impact of tax cuts have found that the GDP growth rate will rise by one third of the proportional cut in marginal tax rates.

If we turn to the quantities involved, the typical response found in empirical studies is for the growth rate to rise by one third of the proportional cut in marginal tax rates.⁶ For example if the marginal tax rate fell by 10% on average across the economy (from 40% to 36% say) then the growth rate would rise by 3.3% (from 2.5% to 2.58% per annum say). This may not sound much; but of course it is compounded from year to year, steadily raising revenue.

Alternatively, one may look at it from the viewpoint of spending: if government spending programmes are kept the same as before, this higher growth implies that they will fall steadily as a fraction of GDP, thus enabling tax rates to fall. The exact amount can be found from our formula. It turns out that the permissible new tax rate can fall by a substantial fraction.

To illustrate the formula numerically, take the case where the average marginal tax rate is cut by 10% so that the growth rate rises to 2.58% p.a. The average tax rate as a proportion of GDP can now fall by 6% of GDP, which is no less than £60 billion per year. One can think of this as the permissible initial deficit after the tax cut; by implication this will be whittled away by growth until eventually the higher revenues would be sufficient to keep the debt/GDP ratio steady again.

Now of course one would certainly wish to be much more cautious than this. But the point remains that there is substantial scope to run deficits prudently in the context of cuts in marginal tax rates. One of the main worries of those who have discussed a flat tax is that it would require raising taxes on those on lower than average incomes, in order to keep the direct tax yield constant. However, there is no need for this under our perspective here. In effect, all the key benefits of flatness can be introduced simply by cutting the top income tax rate down to the desired flat rate and leaving the lower rates (including the tax credits as reformed above) alone – or even better from a

⁶ For a survey and discussion of these results, see by the author and J Wang “Public Spending and Growth” at www.cf.ac.uk/carbs/econ/minfordp.

political viewpoint, effectively abolishing them by raising the tax threshold. Much of the lost tax revenue would be recouped quickly via the Laffer effect; the rest would be financed by borrowing against the higher growth effects.

The implication of tax smoothing, the Laffer effect and the growth effect is that there is substantial scope for running deficits in the context of cuts in marginal tax rates.

TAXES OTHER THAN INCOME

Suppose one accepts the flat rate consumption tax in principle. What should be done about taxes other than income taxes? National Insurance? VAT, Customs and Excise? Capital Gains tax? Inheritance? Corporation tax? Miscellaneous taxes like stamp duty? Let us consider these in turn.

National Insurance (NI) is not in its entirety a tax but a payment in return for an entitlement, namely the second supplementary pension and insured unemployment benefit. Furthermore one may ‘contract out’ of part of it in respect of this second pension.

It is, nevertheless, in essence a tax since it is a compulsory payment in exchange for general government spending. Notice however that it is close to a flat rate on ‘earned income’. There is a ceiling on the amount of contributions the employee pays but none on what the employer pays. There are thresholds to both. Applying the flat rate principle (but keeping thresholds) means that the employee rate should be uncapped. NI would not be ‘rolled into income/consumption tax’ because it is paid only by the non-retired as a contribution to pensions (which may be contracted out, a principle that should be retained).

VAT, Customs and Excise are all consumption taxes. Excise taxes are large imposts on items in highly ‘inelastic demand’ (i.e. where higher prices cause little reduction in demand); as such they do not violate the Ramsey principle because this refers to items with the same general elasticity of response. In fact it makes sense to levy taxes on inelastic items because they yield extra revenue without much altering people’s spending patterns, which is what causes economic costs. As for VAT, it is not all-inclusive at the same rate which it ought to be to match up to the flat consumption tax principle. It would be best if it could be extended and the rate levelled. However it is not that far from matching up.

Capital gains tax is part of the income tax that would essentially disappear on moving it to a consumption basis. Only if capital gains were partly spent would they be taxed.

Inheritance taxes would go. Only if inherited wealth were spent would it be taxed just like other consumption. The reason is simple: the fact that wealth is inherited makes no difference to the point that taxing it implies overtaxing consumption of it, just as the taxation of income on savings does. Taxing assets on the accident of death is in some ways an even worse tax than taxing the income of savings because it is unpredictable. Uncertainty can be a severe disincentive to investment and enterprise.

Corporation tax was, before the abolition of ACT, a rough approximation to an ‘imputed tax’ on dividends. This meant that when profits were distributed to shareholders any corporation tax paid on them that year was returned to those shareholders. The main exception was foreign shareholders whose treatment varied with double tax agreements. Since the abolition of ACT, corporation tax has become simply a tax on company profits, with foreign companies being able to claim back certain amounts via double tax agreements. Because of these agreements, this tax has become a lawyers’ paradise. However the tax itself is economically damaging because it penalises the return on capital. Because capital is free to flow nowadays across borders without exchange controls this in practice means that it has to recover this cost from consumers and so it is passed on in prices. But the relative cost of capital and labour is distorted by the tax, creating a wasteful incentive for firms to use less capital and more labour. So corporation tax can be thought of as similar to an inefficient sales tax.

Lawyers mesmerised by the sums they get back for companies via double tax agreements from foreign Treasuries argue that corporation tax should be kept in order that the Treasury can obtain corporation revenues from those foreign Treasuries instead of their clients paying. This is a doubtful argument. True; eliminating corporation tax would eliminate these receipts from foreign Treasuries. But it would also stimulate activity by withdrawing a distorting tax. One way forward would be to keep the tax as one paid by corporations and thus eligible for double tax agreements; but to levy it as a value-added tax which would retain its revenue qua consumption levy while eliminating its distortionary impact.

Finally, **miscellaneous taxes** like stamp duty and airline tax should be treated as taxes on transactions. These are in general poor taxes since they do not correspond to consumption values. If they caused no change in behaviour patterns, they could be justified on the same basis as excise duties. If they corresponded to economic costs (as with the environment), that could be another justification. However in the absence of these they should be converted into consumption-based taxes – e.g. to tax housing consumption, the imputed rent value of housing could be incorporated into VAT in place of stamp duty.

What we have seen in this review of the tax system is that existing taxes can be made to conform with the flat rate consumption principle with some modest ‘tweaking’. We have also noted that some could be left alone without much damage to the flat rate principle.

It is nonsense to think that every tax reform must be balanced in its direct effects by other tax changes.

It is nonsense to think about tax reform as if every change must be balanced in its direct tax effects by other changes. This nonsense which has governed recent Conservative thinking might unkindly be termed Micawberist Myopia. It is a needless concession to the enemies of reform because it makes reform almost impossible in practice. A cautious application of the tax-smoothing principle, in conjunction with allowance for Laffer and growth effects, would allow wide-ranging tax reform to be both practicable and responsible.

CHAPTER THREE

PRACTICAL STEPS

The application of the flat rate consumption principle can be achieved by a process of successive approximation. Existing taxes can be tweaked or left alone. The main effort can be directed to reforming income tax. Probably the most important element in the flat rate tax is the shift to a consumption base which includes the elimination of capital gains and inheritance taxes, and the inclusion of imputed consumption of owner-occupied housing. The second most important concerns the abolition of the top rate; this could at once be cut from 40% to 22%. Equally important is a rise in thresholds to cover the existing lower rate band, together with the reform of tax credits; the main impact on the incentives of poor people comes not from taxation but from benefits discussed above.

There will plainly be an immediate loss of revenue from the cut in the top rate from 40% to the standard rate of 22%. According to the standard 2005/6 tax ready reckoner, the cost of this would be £21 billion, about 2% of GDP.⁷ However there would be large offsetting gains in revenue from bringing imputed owner-occupied housing into the tax base. In addition, the Laffer effects discussed earlier are likely to recover much of the lost income tax revenue: top rate taxpayers have the highest elasticity. Furthermore, to calculate the growth effect, this cut in the top marginal tax rate of about a half would reduce the top marginal rate from overall taxation by about a third. Top rate taxpayers contributed 55% of total income tax revenue and 37% of income in 2005/6. This in turn implies that the effect

⁷ See the IFS, *Green Budget*, January 2005.

on the (income-weighted) average marginal tax rate is a cut of about 12%. The permitted fall in revenue due to the growth effect would therefore very easily cover even the direct loss of revenue as discussed earlier.

The sticking point for discussions of tax reform has invariably been: how can we pay for it without upsetting numerous people? However, as this discussion reveals, it turns out to be far less problematic than is usually made out. The following table sets out the key changes and their costs in revenue.

TABLE OF KEY CHANGES IN REVENUE

	£ billion
Switching to a consumption tax base	
Abolition of CGT, IHT, stamp duty	– 15
Tax at 22% on 6% yield from owner-occupied housing (0.22 x 0.06 x £2,500 billion)	+ 33
Reduce income/consumption tax rate to 22%	– 21
Raise income tax threshold to cover 10% band	– 6
Uncap NI employee rate	+ 8
Cuts in tax credits	+ 1
Subtotal	–
Laffer effect	+ 12
Growth effect (equivalent cut in average tax as a percentage of GDP of 6%)	+ 60
Cut in standard (consumption) tax rate (by 7%) to 15%	– 25
Total	+ 47
<i>permitting gradual further reductions in flat tax rate and other taxes over succeeding years</i>	

Source: IFS Green Budget January 2005, ONS statistics, and author calculations

It should be noted that these tax reforms would bring the standard (and now flat) income tax rate down to 15% and falling; and would be extremely popular in all social groups. They would be paid for effectively by the rise in employment rates and in growth. With a 15% flat tax, the overall marginal tax rate would drop to 43%. In the longer term, the additional growth would permit the flat tax to fall to 2%, implying an overall marginal rate of 33%.

In politics there is a well-respected principle: for any reform to succeed, there should as few losers as possible. The overall cut in taxation proposed here implies an absence of any major class of losers – the vast majority of those who lose from paying tax on owner-occupied housing or from the uncapping of the employee NI rate will benefit more from the cuts in tax rates. However inevitably there will be some individuals for whom there is a

serious loss; notably anyone (probably retired) who has a valuable house (bought out of taxed income) but with a small current income. To avoid injustice to these people, an indefinite transitional provision is proposed, whereby anyone who would pay more tax under the new system may opt to be taxed under the old system. Since there will be few such people, and since this option will only be available at the time of the crossover, no explicit provision is made for the small cost involved.⁸

⁸ A precedent lies in the 1998 reform of the housing market when existing tenants were given exemption until they vacated, for their lifetime.

CHAPTER FOUR

CONCLUSIONS

Principles of reform suggest clear paths ahead for tax reform without cutting the planned growth of state spending. Tax can be simplified, made neutral across time and activity, and turned into a flat consumption tax. Benefits can be targeted closely to those in need at much reduced cost to the general taxpayer and so to the workings of the economy. All this can be done in a way that is also highly appealing politically.