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Library Note

Debate on 28th January: the Case For a Fairer and More Progressive Tax System

This Library Note aims to provide background reading for the debate to be held on Thursday 28th January:

“To call attention to the case for a fairer and more progressive tax system”

This Note examines the differing perspectives recently put forward by interest groups and policy think-tanks on whether reforms should be introduced aimed at providing for a fairer and more progressive system of taxation in the UK.

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1. Introduction

How far should a system of taxation seek to be 'fair' or progressive? How far should taxation seek to redistribute wealth and to address inequality? What defines a 'good' taxation system, and against what criteria should this be measured? These questions have been and continue to be the focus of much contention and debate. In 1776 Adam Smith wrote in *An Inquiry into the Nature and Causes of the Wealth of Nations* that a 'good' taxation system can be defined by whether it delivers four key principles: "equity, certainty, convenience and efficiency", criteria which are often still employed to analyse modern taxation systems and reforms today.¹ Yet if such criteria are taken as a valid measure of 'good' taxation, considerable debate remains regarding how far the UK taxation system conforms to these principles. Arguably, nowhere is this debate more fierce than regarding the principle of 'equity' or 'fairness', and the distinction drawn between 'regressive' and 'progressive' taxation.

At the simplest level, this distinction (and between progressive, regressive, and 'proportional' taxes) can be drawn as follows:

A proportional tax is one that imposes the same relative burden on all taxpayers—i.e., where tax liability and income grow in equal proportion. A progressive tax is characterised by a more than proportional rise in the tax liability relative to the increase in income, and a regressive tax is characterized by a less than proportional rise in the relative burden. Thus, progressive taxes are seen as reducing inequalities in income distribution, whereas regressive taxes can have the effect of increasing these inequalities.²

Different perspectives exist however regarding how far it is desirable for a system of taxation to follow and embody the principles of proportional and progressive taxation, and how tax reform in the UK should proceed in the future. A number of these perspectives are explored in the substantive element of this paper below. However, before examining these arguments it is useful first to frame this debate in the context of the current UK taxation system, including the ways in which it has evolved and changed in recent times during both Labour and Conservative administrations, and the current economic climate.

2. The UK taxation system—history and evolution

As part of the soon to be published *Mirrlees review: reforming the tax system for the 21st Century*, Stuart Adam, James Browne and Christopher Heady at the Institute of Fiscal Studies have conducted an in-depth review of the UK taxation system, and how it has evolved and changed in the past 30 years.

As part of this review, they examine how reforms in the UK taxation system compare with those which have taken place within other comparable economies. They conclude that many of the key developments which have taken place at a domestic level have been in line with those seen internationally, including: an increased share of revenue from VAT;

¹ Kirkby, J and Griffiths, I, *What's wrong with 50p?: unfair, complex, uncertain, inefficient and damaging* (2009), p 2: http://www.cps.org.uk/cps_catalog/50p.pdf.

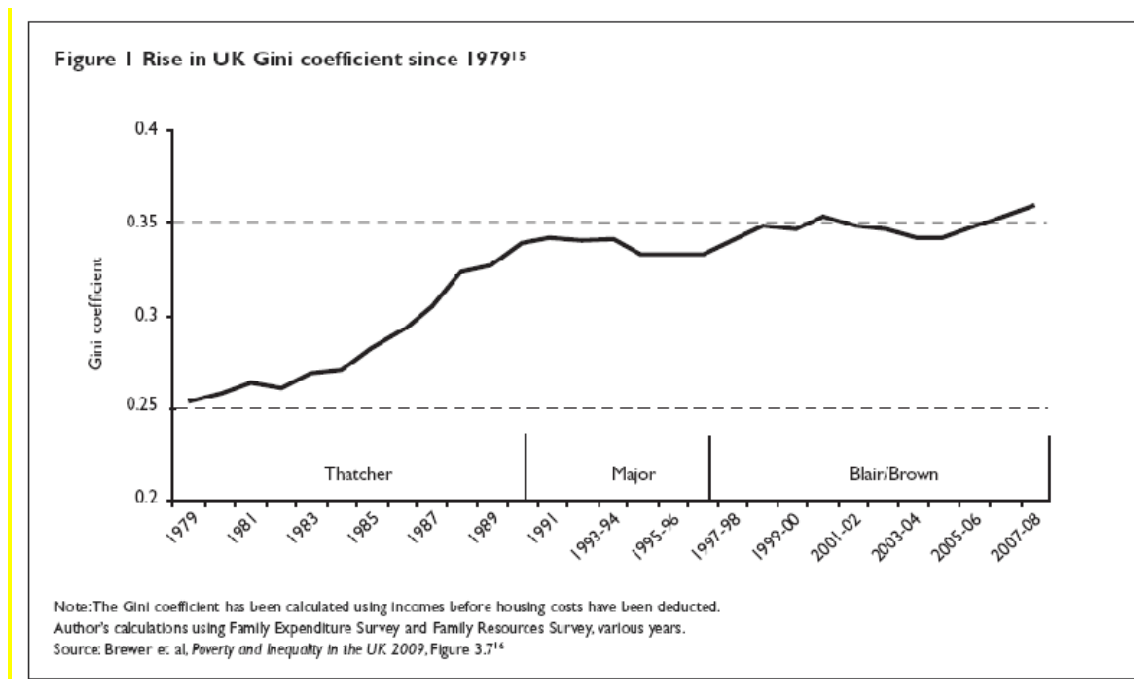
² Encyclopaedia Britannica: <http://www.britannica.com/EBchecked/topic/584578/taxation/72006/Proportional-progressive-and-regressive-taxes>.

cuts in the basic and higher rates of income tax; movement towards taxing the incomes of members of couples independently; the introduction of tax credits for low-income workers; cuts in the statutory rates of corporation tax and a broadening of the tax base by reducing the value of allowances for capital investment; the reformation of shareholder taxation to give less credit for corporation tax already paid on profits; and the introduction of environmental taxes.

Conversely, however, Adam et al argue that some reforms and characteristics of the UK tax system have been unusual or unique. These include that an unusually small share of UK tax revenue is derived from social security (national insurance) contributions, and an unusually large share comes from recurrent taxes on buildings (council tax and business rates). Adam et al also point out that the UK applies a zero rate of VAT to many more goods than most other countries and that it is unusual in having abolished tax relief for mortgage interest. They add that the UK taxation system is also “exceptionally centralised”, with only 5% of revenues raised locally, and has become more so over time, “notably with the move of business rates from local to central control”.³

Adam et al suggest that the combined result of these reforms is a taxation system which does “redistribute significantly from rich to poor”.⁴ However, they also suggest that, while “income inequality is clearly lower after taxes and benefits than before”, there has also been an “exceptionally large rise in income inequality in the UK [since 1978]”.⁵

Measured according to the Gini coefficient, a standardised and much utilised measure of inequality, the illustration below, taken from a report by the left of centre think-tank Compass, *In place of cuts: tax reform to build a fairer society*, shows how income inequality has apparently grown over time:



³ Adams et al, *Taxation in the UK*, The Institute of Fiscal Studies (2009), p 2: <http://www.ifs.org.uk/mirrleesReview>.

⁴ *ibid*, p 2.

⁵ *ibid*, pp 2, 32. The inequality referred to is calculated according to the Gini coefficient for different types and measures of income, from the fiscal years 1978–79 to 2006–07.

This apparent rise in inequality is also borne out in the recent *Wealth and Assets Survey* published by the Office for National Statistics (ONS) in December 2009, which gathered information on wealth in Great Britain by surveying over 30,000 households between July 2006 and June 2008. One of the key conclusions of the survey revealed:

The least wealthy half of households owned a total of 9% of total wealth in Great Britain, with the wealthiest 10% of households owning 44%. By comparison, the least wealthy 10% of households had a negative total net wealth of £500 million, meaning their liabilities outweighed their assets. This is made up of negative net financial wealth (loans, overdrafts, credit cards etc) and negative net property wealth (negative equity).⁶

Adams et al contend that it is hard to state definitively whether tax and benefit reforms which have taken place since 1978 have contributed to, or counteracted, the increase in income inequality discussed above. This is in part, they suggest, because it is difficult to determine what is meant by 'reform', adding that the tax and benefit system in 2008 (the most recent year examined as part of the study) does more to reduce inequality than if the system employed in 1978 had remained in place, with tax thresholds and benefit rates increased in line with inflation. However, it equally "does less to reduce inequality than if rates and thresholds of the 1978 system had kept pace with GDP per capita".⁷

Examining the actions taken by successive Conservative and Labour Governments during this period, Adam et al believe that changes to the taxation system enacted by Labour Governments "have clearly been more progressive than the Conservatives".⁸ They argue that reforms by Labour since 1997 have had a similar effect as increasing benefit rates in line with GDP, while reforms by Conservative Governments since 1978 were "roughly equivalent to increasing them in line with inflation".⁹ Conversely, however, Adam et al point out that reforms under Conservative Governments since 1978 have done more to strengthen financial incentives than those under Labour. They suggest that Conservative tax and benefit reforms "unambiguously strengthened average incentives for people to work" and for those in work to increase their earnings. In contrast, reforms since 1997 "have had much less impact on incentives to be in work—on average they are only slightly stronger than they would have been if Labour had increased the benefit rates they inherited in line with inflation—and Labour's reforms have weakened average incentives for those in work to increase their earnings".¹⁰

This historical context is arguably an important element of evaluating any future reform to the UK taxation system, particularly any move towards a more 'progressive' system. However, as Adam et al also note, the effects and amount of redistribution that any given tax and benefit system achieves is dependent upon the economy to which it is applied, and commentators from the Institute of Fiscal Studies note that recent changes to the UK economy have been profound:

The economic and financial crisis that has unfolded over the last two years has caused a dramatic deterioration in the UK's public finances, with public sector borrowing set to peak this year at a level not seen since the Second World War

⁶ House of Commons Library, *Economic Indicators January 2010* (6th January 2010), RP 10/01.

⁷ Adams et al, *Taxation in the UK*, The Institute of Fiscal Studies (2009), p 2.

⁸ *ibid*, p 2.

⁹ *ibid*, p 2.

¹⁰ *ibid*, p 2.

and public sector indebtedness set to climb to levels not seen since the late 1960s.¹¹

These new economic circumstances have driven much of the debate on taxation and public spending outlined below.

3. Perspectives on reform

3.1 Compass, *In place of cuts: tax reform to build a fairer society*

Authored by George Irvin et al, *In place of cuts*, published by Compass in 2009, makes the case for “urgently needed tax reform” as the basis for a “sound, sustainable and prosperous future”. Such reform would both avoid the need for deep cuts in public spending and the risk of further recession and stagflation. The authors add that “Britain does not lack the fiscal means to reduce the deficit and/or to provide decent incomes for its poorer citizens, while investing in modernising and greening its infrastructure”. Tax reform, the report suggests, is a key mechanism through which this can be achieved.

Among the report’s key conclusions is a challenge to what its authors call the ‘Dutch auction’ currently taking place across the three main political parties about the need for cuts in public spending. The report argues that not only is cutting spending during a recession a bad idea, but that any ‘hole’ in public finances can be “financed through tax reform which makes the current system fairer”.¹² Further, the report maintains that not only is the current UK tax system regressive, with taxes “falling more heavily on the very poor than the very rich [and] so contributing to growing income inequality”,¹³ but any cuts in public spending would equally have ‘disproportionately negative’ consequences for poor and middle income households.

In order to explain these assertions the report draws upon a number of sources. Referring to the rise in the UK Gini coefficient highlighted above, the report suggests that by 2008 Britain had “the most unequal tax structure and income distribution of any of the large EU economies”.¹⁴ However, the report’s authors contend that “nevertheless, debt-fuelled consumption continued to rise, placing investment and economic growth at the mercy of a bubble”. The report argues that the way to address such inequalities and vulnerabilities, particularly when viewed in a historical context, is clear:

Redressing the economic and political balance in labour’s favour must be central to any strategy of economic recovery. Redistribution, in part by means of radical fiscal reform, is not an ‘optional extra’. Redistribution lies at the heart of creating a high-wage, low-debt economy; creating a ‘sustainable’ growth path requires not merely a greener Britain but a more egalitarian Britain.¹⁵

The report also sets out several reasons why cutting back on public spending in particular during a recession “won’t work”. Firstly, Irvin et al suggest that as a result of

¹¹ Chote, R, Crawford, R, Emmerson, C, and Tetlow G, *Britain’s fiscal squeeze: the choices ahead*, The Institute for Fiscal Studies (September 2009).

¹² George Irvin, David Bryne, Richard Murphy, Howard Reed and Sally Ruane, *In place of cuts*, Compass (2009), p 9:

<http://clients.squareeye.com/uploads/compass/documents/Compass%20in%20place%20of%20cuts%20WEB.pdf>.

¹³ *ibid*, p 9.

¹⁴ *ibid*, p 9.

¹⁵ *ibid*, p 9.

the 'paradox of thrift', as defined by John Maynard Keynes, the more a country tries to save, the more income and investment fall, and the less is available to save—thus ensuring that as national income falls, so does tax revenue¹⁶. Secondly, the report argues that the combination of financial meltdown and recession is potentially “deadly”, because it will necessitate a shift across the private sector from spending to saving, and from profit maximisation to debt minimisation. In such circumstances, the report argues, only the public sector can boost aggregate demand. Finally, the report suggests that there is a very real possibility that the UK could be poised for a ‘double dip’ recession. However, even if the UK does emerge from recession in the near future it could be some years before healthy growth resumes. Attempting major public spending cuts under current conditions “could well turn the recession into a decade of stagflation as experienced by Japan”. For this reason, as Britain emerges from recession “fundamental tax reform will be needed if public finances are to be put on an even keel”.¹⁷

Turning to what shape such tax reform should take, the report first expands upon what it defines as “the regressive nature” of personal taxation in the UK. The UK tax system, the authors suggest, currently contributes to the widening of the gap between rich and poor, meaning that when direct and indirect taxation are considered together it is clear that “the poorest 10% of UK households pays a higher proportion of its income in tax than the richest 10%”.¹⁸ To illustrate this conclusion, the report highlights the “injustice” of the Marginal Tax Rate (MRT), where the combination of National Insurance and basic tax rate at 20p means that the MRT for a large majority of workers, including many on or below the poverty line, is effectively 31%.¹⁹ Irvine et al add that the top tenth of households have seen much greater increases in their post-tax incomes over the past decade than other households due to the comparatively low rates of tax they pay. They therefore conclude that the “time to address this imbalance is long overdue”.²⁰

The report proposes a number of reforms which the authors believe could both make the taxation system more fair and equitable, but also encourage growth and aid economic recovery. Such reforms would entail:

A radical readjustment of the tax structure in the UK so that the lower income households pay less tax in total and the very highest income households pay more. The proper form of the overall household tax take—the amount taken from each household in all taxes, direct and indirect—should be one which is essentially progressive. That is to say, the higher the gross household income, the higher should be the total rate of tax paid. The total rate of tax includes direct taxes (such as Income Tax, National Insurance and Council Tax) and indirect taxes (such as VAT and excise duties).²¹

The report proposes that key elements in collecting more taxes from those households with the highest incomes would include an extension of the standard rate of National Insurance through the full range of earned incomes, the removal of the capping level on council tax valuation bands, and the introduction of higher Income Tax bands. The report notes that raising tax rates would be a major incentive towards tax avoidance and/or evasion, which it identifies as a key problem in the current tax regime, and so “vigorous action on avoidance and evasion” would also be a necessary part of this

¹⁶ *ibid*, p 11.

¹⁷ *ibid*, p 11.

¹⁸ *ibid*, p 10.

¹⁹ *ibid*, p 12.

²⁰ *ibid*, p 13.

²¹ *ibid*, p 17.

reform. In addition, in order to assist low income households, the report proposes that the thresholds for National Insurance and Income Tax should be raised, and calls for the full remission of Council Tax. The report also suggests that indirect taxes such as VAT are a key element of the regressive nature of the current taxation system, and should be examined.

The report also makes a number of specific recommendations for how a fairer tax system could be implemented. These include a new 50% tax band for incomes over £100,000 and removing the upper limit on employee National Insurance Contributions (NICs) and making NICs payable on investment income. However, these reforms combined with tougher action on tax avoidance, the introduction of a financial transactions tax, and identified cuts in certain areas of public spending such as the ID cards scheme and the upgrading of the Trident Missile Defence system would, the report argues, result in a fairer taxation system as well as contributing to sustained economic recovery and strong public services.

In summing up these changes the report states:

For some years, the UK has been burdened with an inequitable, lopsided and dysfunctional tax system. With a more radical approach to putting fairness centre stage, proposals can be devised which, once in place, would be administratively much simpler than current tax credit arrangements, would cost far less to administer, and would involve redistribution from the highest incomes to the lowest. The proposed revisions are radical but they would result, first, in the overwhelming majority of people paying either the same or less tax and having more to spend in relation to gross income and, second, in an increased resource for government to fund job-creating public and environmental programmes.²²

3.2 IPPR, *The road to progressive taxation*

Writing in *Thinking for tomorrow*, the journal published by the left of centre think-tank the Institute for Public Policy Research, Richard Murphy proposes that the time is right to move towards a reformed system of progressive taxation in the UK.

Murphy suggests that the modern UK taxation system is now of such nuance and complexity that the principles put forward by Adam Smith (discussed above) are no longer entirely adequate to define good taxation, and must be updated. In their place Murphy puts forward his own system, where a 'good' taxation system should embody ten attributes, with "one over-riding characteristic to which they all contribute". Those criteria dictate that such a system is:

- Comprehensive—in other words, broad-based;
- Complete—with as few loop holes as possible;
- Comprehensible—as certain as possible;
- Compassionate—it takes into account the capacity to pay;
- Compact—it is written as straightforwardly as possible;
- Compliant with human rights—in a way that discriminating in favour of 'non-doms' is not;
- Compensatory—it is perceived as fair;
- Competitive—it does not alienate an activity the community would encourage;
- Complementary to social objectives—taxing cigarettes for instance;

²² *ibid*, p 11.

- Computable—the liability can be calculated with reasonable accuracy.

All of which facilitate the chance that it will be:

- Competently managed.²³

Murphy argues that the above objectives cannot be fulfilled without progressive taxation. Within this assertion Murphy also rejects the notion that progressive taxation merely means that the proportion of income paid in tax increases as income rises. He proposes that to define progressive taxation in this way would be to ignore the numerous ways in which income is disguised and tax avoided in the UK tax system. Instead, Murphy argues that progressive taxation is not just about setting tax rates—it is about the “design of a whole taxation system and its relationship with the taxation systems of other countries”.²⁴

Defining progressive taxation in this way presents particular problems for the UK, Murphy argues, principally because in recent times “changes to our tax system have been piecemeal at best and lacking any coherent strategy”. Murphy suggests that the result is a taxation system “where vested interest has too much significance” and change is only assessed on the basis of the advantage that it brings to taxpayers, “with none being expected to lose”.²⁵ According to Murphy this has created “voluminous legislation, complexity and the opportunity for abuse”, but without delivering a system of taxation which conforms to the qualities noted above.

Murphy believes that in this context only reform which takes a principles-based approach can be fully justified. Progressive taxation, he argues, has to be seen as a tax system in which the intent is to charge an increasing rate of tax as economic well-being increases, requiring a broad assessment of progressiveness and a comprehensive tax base that captures all those factors which might contribute to perceptions of well-being. Drawing the net of taxation as widely as possible ensures that the first principle of ‘completeness’ highlighted above is met, whereas if a significant source of well-being is omitted then the system in turn “cannot be wholly progressive”.

Equally, Murphy thinks that “completeness is simply the inverse of comprehensiveness”, suggesting that:

If all income streams are included as contributing to well-being but some are subject to significant deductions and reliefs while others are not, progressiveness is reduced. It is quite clearly the case that if reliefs are available against another then the system will not produce horizontal equity.²⁶

Murphy proposes that taking this argument “just a step further” results in the theory of ‘marginal utility’, which says that as income rises the additional value which that person

²³ Richard Murphy, *Thinking for tomorrow*, IPPR (2009), p 212:
<http://www.ippr.org/publicationsandreports/publication.asp?id=703>.

²⁴ *ibid*, p 213.

²⁵ *ibid*, p 213.

²⁶ *ibid*, p 213.

attributes to each extra pound they earn decreases. In other words:

If you earn £10,000 a year, a pay rise of £1,000 increases your income by 10 per cent and has a potentially huge impact on your well-being. To a person earning £100,000 an additional £1,000 may not make much difference.²⁷

Murphy contends that this principle has considerable implications for the concept of fairness (or justice) in relation to taxation, arguing:

In economic terms it can be argued that justice is created if the marginal loss of well-being to each taxpayer as a result of the tax payment they make is equalised. Equity is created when this principle is applied across all taxes, and not just to any one tax in isolation. In that case it is obvious that it is essential that the opportunity that each person has to describe their income in differing ways to manipulate the tax they pay be minimised, or else injustice results... Increasing tax rates themselves are not enough: if progressive taxation is to be created the marginal utility lost by the taxpayers as their income rises has to increase. The system is neither compassionate nor compensatory to the poorest in the community if that is not the case.²⁸

Murphy claims that the current distribution of tax burden in the UK is incompatible with the definition of progressive taxation offered above. Drawing upon statistics presented by Compass in 2008,²⁹ Murphy argues that for example, though it might appear (according to those figures) that those in the lowest income bracket may pay no income tax at all, this group actually has the highest effective tax rates. Murphy suggests that four taxes ensure that this is the case: VAT, council tax, tobacco duties and alcohol duties. Key among the problems with these taxes is that council tax takes far too little consideration of the capacity to pay, while taxes on alcohol and tobacco might compliment social objectives but “their impact is massively skewed within society”.³⁰

Moving on to reforms which he believes would result in a more progressive system of taxation, Murphy firstly suggests that it is “absurd” that at present the existing national insurance system guarantees that taxation rates on income derived from labour are always higher than those derived from capital, “whether that be interest, dividends, rents or capital gains”.³¹ This “not only destroys horizontal equity but taxing less the income of those with savings inevitably contributes to a lack of ‘progressivity’ in the tax system and increases the gap between rich and poor as a result”.³² Murphy believes that the best method to address this issue is arguably through a new class of national insurance, paid at the same rate as that paid by employees, on all investment income of more than £6,000 a year (which should mean that the tax will only be charged on savings of more than £100,000), and leaving pensioners exempt from this charge.

Action must also be taken on the issue of tax avoidance, Murphy argues, though the charge suggested above would tackle what he defines as “one of the big issues in tax avoidance at this time”—the use of private limited companies to shift income between partners in a family unit to reduce tax rates. Murphy also advocates a minimum rate of tax for those earning over £100,000 a year, describing forthcoming reforms which will

²⁷ *ibid*, p 213.

²⁸ *ibid*, p 213.

²⁹ Ruane S and Byrne D, *The UK tax burden: can Labour be called the ‘party of fairness’?* Compass (2008).

³⁰ Richard Murphy, *Thinking for tomorrow*, IPPR (2009), p 212.

³¹ *ibid*, p 214.

³² *ibid*, p 214.

mean that from April 2010 those earning more than £100,000 will have the value of their personal allowance restricted as a “first step”. Bolder reform is needed, Murphy argues, which covers all allowances and reliefs on a progressive basis, so that above a certain level tax is paid on all income at the highest rate of marginal income tax. This would guarantee a more progressive income tax system because:

It is apparent that the low effective rate of tax paid by the UK’s highest earners is generated, at least in part, by the very high level of allowances and reliefs they claim.³³

Murphy also puts forward a number of reforms to other areas of taxation, which for reasons of brevity are not included here, but which can be found in full in *The road to progressive taxation*. In concluding, Murphy summarises his perspective on the future of progressive taxation as follows:

A rallying of progressive taxation... need[s] to be full-blooded, justified and delivered if progressive politicians are to provide the solutions needed as we enter a major economic crisis... [such] reform could affirm tax as central to that near-forgotten social contract that binds the electorate together with those they elect and which therefore underpins the whole philosophy and process of democratic government.³⁴

3.3 Centre for Policy Studies, *Go for growth: cut taxes now to cut debt* and *What’s wrong with 50p?: unfair, complex, uncertain, inefficient and damaging*

The Centre for Policy Studies, a right of centre think-tank, has published a series of ‘Pointmaker’ discussion papers which examine a variety of policy issues including taxation. *Go for growth*, written by Lord Forsyth of Drumlean and Corin Taylor, and a complementary paper *What’s wrong with 50p?*, written by Jill Kirkby and Iain Griffiths, examine how changes to the taxation system could assist in overcoming the UK budget deficit and stimulate the growth of the UK economy. Both papers emphasise the critical importance of these twin goals and suggest that in order to achieve them considerable tax reform, as well as a reduction in public spending, should be an immediate priority.

To support and explain this perspective, in *Go for growth*, Forsyth and Taylor point to a number of factors, including falling economic growth, record government borrowing, taxpayer support of the banking industry, the numbers of companies and individuals moving overseas, and the fact that “public expenditure is now close to half of national income while tax revenue barely exceeds a third”, as signs of an unbalanced and unsustainable economic model. They argue that a “rebalancing” is needed towards exports and productive investment, while reducing consumption and borrowing. The deficit must also be reduced to avoid a “vicious cycle” of higher gilt yields and inexorably rising debt servicing costs. In order to achieve these goals they suggest that reform is needed, the key goal of which should be economic growth and providing circumstances in which the “small and medium businesses that are vital to our country’s future” are nurtured. They add that the way to best provide for these conditions, and to enact these reforms, is through “carefully targeted tax cuts”.³⁵

³³ *ibid*, p 215.

³⁴ *ibid*, p 216.

³⁵ Lord Forsyth of Drumlean and Corin Taylor, *Go for growth: cut taxes now to cut debt* (2009), p 1: http://www.cps.org.uk/cps_catalog/go%20for%20growth%20-%20cut%20taxes%20now%20to%20cut%20debt.pdf.

Forsyth and Taylor argue that the UK no longer has an internationally competitive tax system. They give the example of rates of corporation tax, which they suggest are far less competitive than they were in the 1990s:

In 1996, the UK's corporation tax rate was joint fifth lowest in the OECD. Now it is the 17th lowest, and is the eighth highest in the EU27.³⁶

Combined with this uncompetitive tax system, Forsyth and Taylor highlight that the UK also has the challenge of reducing the largest deficit in its history, referring to estimates from the Treasury, the OECD, the IMF and the European Commission which suggest that net borrowing for example is expected to peak at between 12.4% and 14% of GDP—around £175 billion to £200 billion.³⁷

They argue that there is a “wealth of evidence” to suggest that an uncompetitive tax system and high public spending are incompatible with economic growth and deficit reduction. They assert instead that higher taxes actually reduce economic growth, highlighting the results of a survey of OECD countries from 1980-2000, which suggested that:

A one percentage point increase in the tax/GDP ratio reduces output per capita by 0.3%, or 0.6% to 0.7% if investment is taken into account.³⁸

Forsyth and Taylor also maintain that lower government spending, especially government consumption spending, increases economic growth. Referring to studies by the European Central Bank of EU15 and OECD countries from 1970 to 2004, they highlight that a one percentage point increase in the spending/GDP ratio reduced output by 0.12 percentage points for OECD countries, and 0.13 percentage points for EU countries.³⁹ Finally, Forsyth and Taylor contend that fiscal consolidations that are principally comprised of lower spending are more durable than those largely comprised of higher taxes. They point to a Policy Exchange paper surveying 12 episodes of fiscal consolidation internationally and in the UK, which found:

Provided that spending cuts dominate over tax rises, [fiscal] tightening appears to be more likely to promote recovery than impede it... successful consolidations have typically placed around 80% of the burden on spending cuts; 20% tax rises.⁴⁰

However, cutting spending may not be enough to stimulate growth. They suggest that, in order to be effective, spending restraint must be combined with serious tax reform, and present four key targeted taxation reforms “which would stimulate growth... and should be implemented in full and without delay”.⁴¹ The first of these reforms is the reduction of the main rate of corporation tax from 25% to 20%. Forsyth and Taylor believe that this

³⁶ *ibid*, p 4. Research cited KPMG, *Corporate and indirect tax Rate survey 2009*.

³⁷ *ibid*, p 4. Figures drawn from HM Treasury, *Budget 2009* (April 2009), Tables C4 and C5; European Commission, *Public finances in EMU 2009*, Table V.27/1; International Monetary Fund, *United Kingdom: 2009 Article IV consultation—staff report* (July 2009), Table 1; OECD, *Economic survey of the United Kingdom 2009* (29th June 2009).

³⁸ Further details can be found in: Tax Reform Commission, *Tax matters: reforming the tax system* (October 2006), table 2.1.

³⁹ Lord Forsyth of Drumlean and Corin Taylor, *Go for growth: cut taxes now to cut debt* (2009); OECD, *Economic survey of the United Kingdom 2009* (29th June 2009).

⁴⁰ A Lilico et al, *Controlling spending and government deficits: lessons from history and international experience*, Policy Exchange (November 2009).

⁴¹ Lord Forsyth of Drumlean and Corin Taylor, *Go for growth: cut taxes now to cut debt* (2009), p 10.

would make the UK once again a “world leader on corporation tax”.⁴² Further, the main rate and small companies’ rate would be aligned with the basic rate of income tax, providing greater simplification. Secondly, Forsyth and Taylor recommend the abolition of the forthcoming 50% rate for earnings above £150,000 and abolishing the phase-out of the personal allowance for earnings above £100,000. This idea is explored more fully below, but Forsyth and Taylor argue that the 50% rate, due to come into effect in April 2010, is unlikely to raise extra revenue, but will cause “considerable economic damage as increasing numbers of people choose to leave the UK”. They add that the planned phase-out of the personal allowance would add unnecessary complexity and distortion to the income tax system. The third reform that Forsyth and Taylor advocate is an increase in capital gains tax rates to 20% and 40%, while applying a “ten-year taper” so that no capital gains tax would be payable on longer-term gains, thus encouraging longer-term investment rather than short-term speculation. Finally, Forsyth and Taylor recommend the abolition of stamp duty on share transactions, which could increase share prices and cut the cost of capital to UK companies.

The authors maintain that these reforms would have a “disproportionately strong impact on boosting the UK’s tax competitiveness, on encouraging longer-term business investment, on supporting savings, and ultimately on increasing the trend rate of growth”. Such action is necessary for the domestic economy to rebalance, not least because the UK “cannot afford to take resources out of the productive part of the economy any more”.⁴³

In *What’s wrong with 50p?* Jill Kirkby and Iain Griffiths present a number of complementary arguments to those outlined above by Forsyth and Taylor. However, they go further in examining the UK taxation system against the principles outlined by Adam Smith for good taxation and the need for deficit reduction and economic growth, with particular regard to the introduction of the forthcoming 50p income tax rate.

Kirkby and Griffiths argue that the proposed new 50p income tax rate meets none of the criteria outlined by Adam Smith for good taxation. With regard to the principle of fairness, Kirkby and Griffiths state:

Advocates of a flat tax argue that everyone should hand over the same proportion of income in tax, since the wealthy will provide a larger share of total revenue. Progressives say that fairness requires a stronger element of redistribution so that the better off relinquish a larger proportion of income on the grounds that they can afford to do so. [The 50p tax proposal] fails on both counts.⁴⁴

They add:

The richest 1% of people in the UK already provide 24% of all government revenue from income taxation. Indeed, the richest 10% of the population account for over half of government revenue. The existing 40% regime is already highly redistributive.⁴⁵

Kirkby and Griffiths also suggest that according to the idea of horizontal equity, all people in the same circumstances should face the same tax rate. However, they argue that as the incentive to avoid taxation increases (through the introduction of a higher rate) the

⁴² *ibid*, p 5.

⁴³ *ibid*, p 7.

⁴⁴ Kirkby, J and Griffiths, I, *What’s wrong with 50p?: unfair, complex, uncertain, inefficient and damaging* (2009), p 2.

⁴⁵ *ibid*, p 2.

capacity of different individuals will inevitably vary. They suggest that as tax avoidance becomes more prevalent, so in turn will disparity between individuals on high incomes inevitably increase, as those highest earners with the most creative advisors will be able to protect a larger proportion of their earnings from taxation.

Kirkby and Griffiths add that the 50p income tax rate, and the current UK taxation system as a whole, also fail to meet the principle of being administratively simple. They highlight that once the 50p rate is introduced there will be 16 different personal tax rates in the UK (including rates levied on trusts and dividend income) and a top marginal rate of more than 60%. They suggest that such complexity causes errors, and the introduction of a new tax rate for high earners will raise the cost of administration and compliance still further.

Equally, Kirkby and Griffiths argue that the new 50p tax rate also fails to meet the principle of 'certainty', chiefly as a result of the complexities in the taxation system and the potential for unintended consequences, particularly with regard to marginal rates. Nor does it meet the criteria for 'efficiency', because those on higher incomes may seek to reduce their participation in the labour market as a result of this taxation, and that this in turn could have a "particularly damaging effect" on the rest of the economy, as this group includes entrepreneurs who deliver "multiple spill over benefits" to the economy and growth.

Kirkby and Griffiths also suggest that the 50p tax rate will fail to raise the revenue expected and will be damaging to competitiveness, particularly as the richest and most mobile members of the British population have greater incentives to move abroad. They conclude:

The new 50p tax rate fails all the tests for effective income taxation. By portraying it as a measure to reduce government debt, the Chancellor is painting the illusion that the government's profligacy will be paid for only by the richest members of society. But even on the Chancellor's own numbers it will be make a tiny inroad into the mounting debt, so that further tax increases, or major spending cuts, or both, will be required. The long term damage to the economy will be significant as business and individuals move abroad, while the benefit in reduced debt will be minimal. The removal of this top rate is essential to making the British economy competitive again.⁴⁶

3.4 The Taxpayers' Alliance, *A taxpayers' guide to the party political responses to the fiscal crisis*

In *A taxpayer's guide* Matthew Sinclair from The Taxpayers' Alliance examines a number of taxation and public spending issues which have arisen as a result of the financial crisis, and makes a number of recommendations regarding the future of the taxation system.

Sinclair turns first, like the studies highlighted above, to the proposals to introduce a 50p tax rate on income over £150,000, and other proposals to restrict the personal allowance for those with incomes over £100,000 and to restrict tax relief on pensions for those with incomes over £150,000. Sinclair acknowledges that these measures are designed to increase revenue while making the tax system more progressive. However, he suggests that the introduction of the new 50p rate may actually serve to reduce total revenue

⁴⁶ *ibid*, p 8.

generated by taxation. To underpin this assertion, Sinclair highlights the way in which the estimations of the revenue that this tax would generate were created:

The likely behavioural effect of the 50p rate is based upon evidence from the last significant changes in top marginal rates in the 1980s, and that mobility for high earners is likely to have increased since then meaning that the behavioural response and revenue loss from the 50p rate may well [be] larger. That would imply a reduction in revenue if this tax is introduced that is much higher than the IFS expect. The Centre for Economics and Business Research has suggested that the 50p rate will lose the Government £800 million a year, mean 140,000 lost jobs over time and lead to 25,000 high earners leaving the country.⁴⁷

Sinclair suggests that the effects of restricting high earners' use of the personal allowance and pension relief are likely to be more complex:

Restricting use of pension relief will make avoidance harder and therefore may reduce the behavioural response but, when combined with the other changes pushing up taxes on high earners, it seems possible that the main change would be increased emigration as the avoidance strategy of last resort.⁴⁸

Sinclair is also critical of any proposals to increase National Insurance Contributions:

An increase in employees' national insurance would effectively operate as an increase in income tax. By contrast, an increase in employers' national insurance would effectively operate as a tax on employment. As it would increase the cost of taking on workers such a measure would reduce the demand for labour. That would mean workers would either need to accept lower wages than without the new tax or face greater chances of unemployment.⁴⁹

He adds:

As of November 2009, nearly 2.5 million Britons are unemployed, or 7.8 per cent of the workforce. Young people, who are likely to be the worst affected by any rise in national insurance as they tend to be lower paid and therefore more easily pushed into unemployment, are facing even higher unemployment rates. Nearly a fifth of those aged 18–24 are unemployed.⁵⁰

On the subject of VAT and indirect taxes, Sinclair asserts that any plans to raise the level of VAT would be ill-advised. He notes that "the most regressive taxes are indirect taxes", pointing out that the poorest fifth of the population pay 27.9% of their gross income in

⁴⁷ The Taxpayers' Alliance, *A taxpayers' guide to the party political responses to the fiscal crisis* (2009), p 12: <http://www.taxpayersalliance.com/research/2009/12/new-indepth-briefing-paper-a-taxpayers-guide-to-the-political-parties-responses-to-the-fiscal-crisis.html>. Research cited McWilliams, D, *Government will lose £800 million from tax hikes on the rich*, Centre for Economics and Business Research (22nd April 2009).

⁴⁸ *ibid*, p 12.

⁴⁹ *ibid*, p 19.

⁵⁰ *ibid*, p 24. Figures drawn from ONS, *Labour market statistics—November 2009* (11th November 2009): <http://www.statistics.gov.uk/pdfdir/lmsuk1109.pdf>.

taxes, while the richest fifth pay 10%. Sinclair suggests that any increase in those taxes would only have regressive effects:

VAT is heavily regressive [and] increasing tax on the poorest would increase poverty and benefit dependency. That may [in turn] reduce the revenue gain from increasing VAT and endanger efforts to tackle long term social problems.⁵¹

Finally, Sinclair examines proposals for a tax on the value of properties, or so-called 'mansion tax', which again he argues could have negative consequences:

The problem with this policy is similar to that with council tax... people with high value properties do not necessarily have high incomes. Many elderly people, having paid off their mortgage, live in houses they have paid for over a lifetime on a relatively low pension income.⁵²

He also predicts that any such property taxation system would be complicated to administer and generate relatively little revenue as a result.

⁵¹ *ibid*, p 27.

⁵² *ibid*, p 31.

