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Taxation policy for the long term: the importance of sound tax policy

The immediate outlook for Britain's economy looks increasingly grim and a return to sound Tax policy is now an urgent matter. Slower growth, rising unemployment, resurgent inflation, spiralling public borrowing and sliding house prices are all guaranteed to make life more difficult for ordinary families.

For a long time, benign global economic forces and the positive impact of Margaret Thatcher's labour market and supply side reforms shielded us from the damaging actions of the Government. The economy grew at a decent rate despite Gordon Brown's tax rises, despite his regulations, despite his complex tax laws and despite his meddling.

1. The importance of a competitive tax system

What do I mean by a return to sound tax policy?

Taxation should have one simple overarching purpose – to raise predictable revenues to fund necessary government spending with minimal impact on wealth creation and freedom of choice.

It should promote economic efficiency. Tax should be as low as possible, should not distort business decisions, and should discourage neither economic growth nor individual enterprise and effort. Tax rates should generally travel in one direction – downwards.

It should be fair. The least well-off should pay a smaller proportion of tax, while people in similar circumstances should be treated equally.

It should be simple and transparent. Tax should be clear, easy to understand and apply, easy to calculate and easy to collect.

It should be stable and predictable – changes to tax law should be kept to a minimum and made on the basis of clear policy following effective external consultation and parliamentary scrutiny.

Simple, stable, fair and low – these are the guiding principles for a sound and competitive tax system.

Achieving them demands one essential pre-condition: government spending needs to be controlled.

I shall return to the issue of public spending but first, I want to emphasise the importance of a competitive tax system to a successful economy.

A number of international studies on the relationship between tax and growth of GDP have been published. The OECD has suggested that up to one-third of the growth deceleration in the developed economies between 1965 and 1995 can be explained by higher taxes.

The findings on the negative effects of taxation vary, but a conservative midpoint would be that a 10 per cent increase in taxes as a share of GDP reduces annual GDP growth by 1 per cent. Compounded over time, the effect is significant. An economy growing at 2 per cent per annum would take 35 years to double in size, while an economy averaging 3 per cent growth would take 24 years. High tax burdens make us all poorer.

The evidence is compelling that high taxation has a negative impact on economic growth. This is hardly surprising. Higher taxes make working that extra hour, or investing that extra pound, less profitable and so less attractive. And money transferred from the efficient private sector to the low-productivity public sector means that capital is not deployed as productively.

A Tax reduction programme should then increase economic growth, and through that extra growth, pay for itself, at least in part. The Treasury still bases its forecasts for tax revenue on "static" modelling, which does not take into account the behavioural impact of tax changes. This is an undue constraint on Tax reform. Suppose a government has £10 billion to reduce the main corporation tax rate. On a static basis a 1p reduction in the corporation tax rate costs £2 billion, which means that £10 billion would allow a 5p cut. But if the positive effect on incentives and growth is enough for the tax reduction to pay for itself by a half, then £10 billion would allow a 10p cut in the corporation tax rate

We know from experience that tax reductions can lead to higher tax revenue. The cut in high marginal income tax rates in Britain and the US in the 1980s increased income tax revenue, and increased the share of income taxes paid by the highest earners – a classic case of the Laffer Curve in action.

The 2003 US cuts in income tax, capital gains tax and dividend tax saw revenues consistently higher than forecast, while the economy took off.

US studies have produced a wide range of views on the magnitude of the dynamic effect.

- Lawrence Lindsey (former director of the National Economic Council) and Professor Martin Feldstein found that taxable income increases by up to 2 per cent for every 1 per cent decrease in tax rates;

- Jon Gruber and Emmanual Saez found that a decrease in marginal tax rates of 10 per cent leads to a 4 per cent increase in taxable income;
- Economists at the Federal Reserve Board of Governors and Harvard University found that for middle income families a 1 per cent decrease in tax rates would lead to a 0.75 per cent increase in labour income.

.Gordon Brown's great deception has been to convince people that tax cuts mean cuts to public services. He has placed his opponents in this box for too long. Brown's contention is simply wrong. The last ten years have proved that more spending does not automatically mean better services, while the mounting evidence shows that tax reductions need not lead to a corresponding loss of tax revenue. Those who care about public services and a competitive economy need to challenge Brown – reductions in tax do not mean worse services. A better way is possible.

The Tax Reform Commission proposed that the Treasury appoint an independent panel of economists to build its own dynamic model to estimate the effects of tax changes in the UK. To his great credit George Osborne has committed a future Conservative Government to doing just that. Last year the TaxPayers' Alliance commissioned the Centre for Economics and Business Research to construct one. They found that a phased reduction in the main corporation tax rate to the Irish rate of 12.5 per cent over 9 years would deliver enormous benefits, including a boost to GDP, employment and disposable income of around 9 per cent compared with baseline, and an increase in fixed investment of 60 per cent. Importantly, over time the tax reduction would pay for itself through higher income tax and VAT receipts.

It's not just the level of taxes that matter. Simplicity, stability and fairness are also vital.

A complex tax system increases the cost of doing business. Companies and individuals have to spend proportionately more time understanding the tax consequences of their actions. Resources are diverted away from productive activity to employ tax advisers and compliance officers. The HMRC Measurement Project put the administrative burdens of UK tax regulation to UK businesses at over £5 billion.

A complex tax system damages wealth creation and distorts the economy as companies and individuals are incentivised to structure and carry out transactions to minimise tax liabilities rather than maximise economic benefits.

Complexity begets complexity. As each new piece of legislation is introduced tax advisers seek to exploit loopholes, which are subsequently closed by further legislation, which creates further loopholes. This vicious circle as we have seen can end up with hasty, ill-thought-out retrospective taxation.

Complex tax systems are unfair. Smaller companies and ordinary folk are not able to pay high fees to tax advisers and are less likely to benefit from complex reliefs and exemptions. PricewaterhouseCoopers found that only 11 per cent of businesses took advantage of tax relief schemes such as capital allowances on energy saving technologies and R&D tax credits. Even fewer – just 7 per cent – of the smallest companies took advantage of these reliefs. US research has shown how the compliance burden of federal income taxes is greatest for the poorest taxpayers and the smallest corporations.

Fairness matters. As former Federal Reserve chairman Alan Greenspan argued in his compelling autobiography, being fair to the poor is essential to popular support for a capitalist system. Although Mr Greenspan was talking about income inequality, the argument also applies to how tax systems treat people. There is no reason why a tax system cannot exempt the poorest households from its burdens.

2. The Government's failures

These are not just economic theories – countries with lower and simpler tax systems do better.
Unfortunately, Gordon Brown has failed to understand this. He has managed to turn a leading tax system into a complex and uncompetitive mess.

This Government has been addicted to spending. After two years of following Ken Clark's spending plans 'Prudence' was jilted and public spending quite simply ballooned. On the OECD numbers, spending has increased from 37.5 per cent of GDP in 2000 to around 45 per cent now, an increase unprecedented in peacetime and virtually unsurpassed in the OECD. This spending surge has led Gordon Brown and now Alistair Darling – backed up by the increasingly aggressive tax authorities – to raise tax in ways which are threatening to squeeze the life out of Britain's economy.

Since 1997:

- The tax burden has risen from 39 per cent to over 42 per cent of GDP;
- Pension funds have been hit by the abolition of dividend tax credits;
- The national insurance contributions rate has risen by 1p and the upper earnings limit has been abolished;
- Council tax has doubled;
- The rate of stamp duty has been raised from 1 per cent to a top rate of 4 per cent and thresholds have not kept pace with house-price growth, meaning that millions of first-time buyers now have to pay it.
- The inheritance tax threshold has failed to keep pace with house price growth.

- The failure to increase income tax thresholds in line with average earnings, has increased the number of higher rate taxpayers by 1.5 million. The top rate of tax now hits people on middle incomes.

And the list goes on. Research by the Conservatives has shown that Gordon Brown has levied stealth taxes around 100 times, while the TaxPayers' Alliance has found that Gordon Brown has filched a cumulative £80 billion in the last decade by failing to increase tax thresholds in line with earnings or house prices. Overall, the average household is paying, in real terms, over £6,500 more in tax than it was in 1997.

The Government has also greatly increased the complexity of Britain's tax system:

- Tolley's Yellow Tax Handbook of the British Tax Code was 4,555 pages in 1997. Nine years later, it had doubled to 9,841 pages.
- Over the 2000-05 period the Finance Act averaged 481 pages compared with 313 over the previous five-year period – an increase of over 50 per cent.
- There are now 74 Inspectors' Manuals (some of which are several volumes long) setting out how the Revenue interpret and apply the law for direct taxes alone.
- Even accountants who make their living from navigating the tax system are now raising concerns. The Institute of Chartered Accountants of England and Wales recently stated that:

  "The UK tax system is spiralling out of democratic control ... the complexity of the system has developed in such a way that even highly numerate taxpayers are struggling to understand the tax implications of their actions."

These tax rises come at a time when other developed economies have been improving their tax systems and reducing their overall tax burdens. The evidence, once again, is stark:

- In 1996 Britain's tax burden was around the OECD average of 39 per cent of GDP. Now it is 4 percentage points higher than the developed country average;
- In 2000 there were only 2 OECD countries with lower top marginal income tax rates than the UK. Now there are 7;
- In 2000 there were 20 OECD countries with higher corporation tax rates than the UK. Now there are only 10, while the average EU corporation tax rate is far lower than the UK. The reduction in the main corporation tax rate to 28 per cent in April will not be sufficient to alter this pattern.
- Britain now has the dubious honour of having the longest tax code in the world, longer even that India's 9,000 pages.
- The UK economy has been falling down the international competitiveness league tables. In the Institute of Management and Development's World Competitiveness Yearbook, Britain has fallen from 9th in 1997 to 20th last year.

The survey of businesses that we conducted at the Tax Reform Commission was revealing. We found that firms were well aware that the tax system was heading in the wrong direction:

- 60 per cent said that they were spending more on tax planning and advice, compared with only 3 per cent spending less;
- 78 per cent said that the tax system had got more complex in the last five years compared with 2 per cent who said it was less complex;
- 19 per cent said that the complexity of the UK tax system had forced them to consider transferring operations overseas;
- And 66 per cent agreed that the tax system was having a negative impact on the UK's international competitiveness, while only 10 per cent disagreed.

The Government's tax regime has been unfair to families. Incomes after tax and housing costs for average earning households are actually falling, while Gordon Brown's complex and intrusive tax credits system means that less well-off households are being hit by 70 per cent marginal tax rates, and withdrawal rates of up to 80 or 90 per cent when the loss of other benefits are taken into account. Is it any surprise that so many Britons of working age are on welfare when the incentives to work are so poor? It is entirely rational for people to simply stay at home. This state of affairs needs to change. It is wrong that the less well-off are paying higher tax rates than the rich, wrong that the Government is giving tax credits with one hand and taking away tax with the other, and wrong that families have been forced to return overpayments through no fault of their own.

There are unfortunately too many examples of the Government's neglect of sound tax policy, too many embarrassing reversals, too many unintended consequences. A zero per cent starting rate of corporation tax sounded great until Gordon Brown realised that most of the new incorporations were solely for tax purposes. Then he came back at small businesses with a vengeance, abolishing the zero per cent rate and increasing the small companies' rate from 19 per cent to 22 per cent, a punishing rise, and one not offset by reductions or simplifications elsewhere.

But there are few tax changes that have been so damaging to business confidence and the Government's credibility than the changes to capital gains tax and taxation of non-doms proposed in the Pre-Budget Report:

Firstly, capital gains tax. An 18 per cent rate on all gains might on the surface seem like a good simplification. But to business owners planning to sell-up when they retire it means an 80 per cent tax rise. The indexation allowance that applied to gains made before 1998 was abolished, a particularly cruel impost of retrospective taxation.

There was no proper consultation before this change was announced, and it introduced a damaging level of uncertainty for businesses, who thought they were living under the taper relief regime, which Gordon Brown introduced, only to wake up and find their plans ruined.

It was very encouraging to see business groups like the IoD so loud in their opposition to these ill-thought-out changes, which amounted to a tax rise of almost £1 billion at the start of a downturn.

Then we had the changes to non-dom taxation. People flocked to London because of the low-tax, deregulated regime established in the eighties. The biggest boost to the City of London in recent years has been the Sarbanes-Oxley regulations in the US. Non-doms are the most internationally mobile group of people and if we have an uncompetitive tax regime they will leave, taking their business with them.

But if the UK tax system risks driving non-doms away, it surely must be uncompetitive for wealth creating and creative Britons as well. Just last week a report was published by the OECD which found that Britain is experiencing the worst "brain-drain" of any country, losing one in ten of its most skilled citizens. In a world in which capital and labour are increasingly mobile, the long-term answer is to have a competitive tax system with low rates for everybody, rather than special deals for a few.

The Government's non-dom tax plan was a mess, proposed in panic over a possible election, introduced with no consultation, and threatening heavy-handed retrospective intrusion into the affairs of non-doms. The Society of Trust and Estate Practitioners predicted that the exodus would cost Alistair Darling up to £2 billion of tax revenue overall. Even Gordon Brown's new flexible friend Lord Jones, the former CBI Director General and now a Government Minister, said that the changes would make it harder to sell Britain as an attractive location.

3. Tax **reform abroad**

We can look to other countries that have made successful tax reforms in recent years and learn from their example. In most cases, spending restraint has been a key part of that success.

In Australia, the conservative government of John Howard carried out major reform of the tax system in his 12 years in office. He cut income tax rates, raised thresholds, abolished stamp duty and simplified business taxes.

The results have been dramatic, and delivered falling tax rates, increased revenue, increased growth, increased government spending, budget surpluses and the elimination of government debt. Australia is now a creditor nation for the first time, unemployment is half the level of a decade ago, and GDP growth has been much stronger than in the UK.

Tax reduction and spending restraint were a key part of Ireland's economic transformation over the past two decades. In 1987, the IMF was threatening to intervene in the Irish economy. Now Ireland is one of the richest per capita countries in the world. It has reversed its long history of net emigration, as people and companies return to its shores.

The process began by drastic spending reductions in the late 1980s to bring the budget under control. This was followed by major tax cuts, including the reduction in the standard corporation tax to 12.5 per cent over ten years and the halving of the capital gains tax rate.

It was not EU money that created the Celtic tiger – one only has to look at the failure of spending to revive the East German economy to see that the Irish miracle was homegrown.

4. What needs to be done

Turning around the British ship of state cannot be done overnight. But here are a number of key proposals that will help to heal our broken tax system and make it more competitive, fairer and simpler.

We need to make a start by following the old adage – do no harm. With a global credit crisis and a slowing economy in Britain, the very worst thing to do is raise taxes on capital investments and internationally mobile people.

There are important tax simplifications that can and should be made. It was encouraging to see George Osborne in a speech to Policy Exchange ten days ago support a number of the Tax Reform Commission recommendations in this area. But more needs to be done.

The corporate tax base should be broadened and tax rates reduced by replacing the complex schedular system with one based on accounting profit. The indexation allowance should be abolished. Full pooling of losses should be permitted. R& D tax credits and film tax credits should be abolished. Over time, the basic income tax rate and corporation tax rate should be aligned.

There is no case for such differing sets of rules for income tax and national insurance contributions. There are a great number of complicated tax-free employee benefits that can and should be scrapped, including the foreign service allowance and relief for professional subscriptions. This would help fund reductions in income tax rates.

Capital taxes are also in need of reform. Capital gains tax is unnecessarily complicated while inheritance tax is now hitting ordinary families to a greater extent than the super-rich, who can afford expensive lawyers and accountants to avoid it. The Tax Reform Commission proposed a short-term capital gains tax, which would replace both the current capital gains tax and inheritance tax and simplify the whole system of capital taxes. Under the proposal, chargeable gains would be reduced by 10 per cent for every year that the asset had been held, meaning that gains on assets held for ten years or more would be completely tax-free. This would mean that the business-owner who sells up before retiring would pay no capital gains tax, instead of 10 per cent now and 18 per cent under Mr Darling's plans. It would also mean that the main family home would be exempt from inheritance tax altogether, as well as any other assets held for ten years or more.

The current Conservative Party proposal to raise the inheritance tax threshold to £1 million would take ordinary families out of inheritance tax, and is therefore very welcome. There is however an opportunity to go further and create a fairer, simpler system of capital taxation.

Some taxes should be abolished altogether as they destroy more revenue than they raise. Stamp duties which are levied at a rate of 0.5 per cent on the purchase price of shares in UK incorporated companies are an example.   It is a complex tax (parts of the legislation date back to early last century) and it raises around £4 billion a year

It is not charged on overseas sales of securities issued by companies incorporated overseas or on sales of debt.   As other transaction costs fall, so stamp duty has grown as a proportion of total costs. Investors have therefore had an increasing financial incentive to engage in transactions which do not attract the tax. This has contributed to the growth in off-market trading activities such as contracts for difference.

Analysis has shown that stamp duty depresses share prices by up to 10 per cent. One study suggested that if stamp duty were abolished the increase in the market capitalisation of the FTSE All Share could be in the region of £150 billion. An IFS study also concluded that stamp duty depresses share prices, particularly for firms with more frequently traded shares, and that "these effects are real and measurable".

Other countries have scrapped Stamp duty to good effect. Getting rid of it would provide a competitive boost to the City of London, attract capital from abroad and, in these uncertain times, help to revive the stock market.

The Tax Reform Commission also proposed to reduce the burden of income tax on ordinary people, by reducing the basic rate of income tax to 20 per cent and raising the tax-free personal allowance. Gordon Brown reduced the basic rate in last year's Budget, but it was a great shame that he increased the tax burden on the least well-off by increasing the starting rate of income tax to 20 per cent and not raising the threshold.

We must make the tax system fairer. It cannot be beyond us to break free of the tax-credits stranglehold, reducing families' dependence on the state and reducing the amount of tax they have to pay at the same time. Let's raise the personal allowance, take the poorest out of tax, and give families their dignity and independence back. Let's end the trauma of an aggressive Revenue and Customs demanding overpaid tax credits to be returned, when it was the incompetence of the Department that caused the overpayment in the first place.

And we must end damaging uncertainty for businesses by, among other things, reforming the way changes are made to tax law. The Tax Reform Commission made a number of proposals in this area. To allow time for proper consultation and scrutiny to take place, all changes to tax law with any technical content to be included in the annual Finance Act should be proposed no later than the preceding Pre-Budget Report, while a Joint Parliamentary Select Committee on Taxation should be set up to provide further scrutiny.

A new Office of Tax Simplification should be set up. Similar to the National Audit Office, which provides independent scrutiny of departmental spending, the new Office of Tax Simplification would provide an authoritative, independent voice on tax law. It would have two primary functions – to review current tax law and make proposals for its simplification and to examine proposed tax legislation to determine whether it is consistent with sound taxation principles.

It is hard to imagine that, with these proposed changes to strengthen the way tax law is made, the Chancellor's disastrous capital gains tax and non-dom plans would have seen the light of day.

The former chancellor Lord Howe of Aberavon has been asked by George Osborne to make recommendations on how to achieve practical and substantial reform in this area. No one is better qualified to do this.

Public opinion is moving quickly and people are in no mood for wasteful public spending and high taxes. A recent YouGov poll found that 64 per cent believe that the Government spends too much and taxes are too high, while a majority believe that the Government wastes at least £20 in every £100 that it spends. Ignoring this growing group of hard-working people who have been let down seems politically foolish.

Revenue-neutral tax changes will never be politically successful because the losers make more noise than the winners. There were winners to Darling's capital gains tax changes, but we have not heard much from them. Simplification has to be accompanied by a reduction in the overall burden of tax . A cynical public are still feeling conned by Gordon Brown's revenue-neutral simplification measures in the Budget of March 2007.

The inheritance tax plans announced to such great effect by George Osborne last October created far more winners than losers. But most revenue-neutral changes will not be nearly as populist. Imagine the reaction to a proposal to abolish inheritance tax for nearly all households but pay for it by raising fuel duty – it would not go down so well, to say the least! The Conservative Party should be wary of raising green taxes too far.

Matching Labour's plans to increase spending by 2.1 per cent a year in real terms for the next three years was a mistake, but one which the Conservative Party is unlikely to have to implement as the Prime Minister will almost certainly go to the wire before calling a General Election. Far more important is whether any subsequent pledges to match the Government's spending plans are made – if they are, they tie the Party into spending promises that could mean higher taxes or higher borrowing in a downturn. It is not enough to pledge that things will improve over the course of an economic cycle. If the next economic cycle lasts ten years like the last one, that is far too long to wait for the tax competitiveness that Britain's economy so urgently needs. The Institute of Directors has in previous Budget submissions called for total public spending to be increased by 1.5 per cent a year in real terms. That would seem like a much more sensible target to aim for. It would be sufficient to allow all the Tax Reform Commission proposals to be implemented over a parliament, which on a static basis would have reduced tax revenue by £21 billion.

Conclusion

When the Tax Reform Commission report was published, Ed Balls, then Economic Secretary to the Treasury, said that “the scale of the tax cuts is huge … the hole in the public finances that this would create is dangerous for the economy”. But £25 billion has just been given to Northern Rock ; more incidentally as Lord Bilimoria pointed out in the Lords last Thursday than any Government has given to prop up any institution anywhere ever. And even without the Northern Rock fiasco, the Government will have borrowed £40 billion in this financial year alone. In 2003 Gordon Brown planned public sector debt to reach £472 billion next week. It has already reached £541 billion an overspend of 15% or £69 billion.

Ed Balls is quite simply wrong – the price of not reforming our tax system is too great. Britain’s economy cannot continue to perform under the increasing burden of a higher, more complex, more uncertain and more unfair tax system. Political will and courage are now needed to grasp the nettle of reform.