# Bold, liberal tax reforms for a stronger economy and fairer society

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We hear a lot about how government should spend (or not spend) our money, but far less about how that revenue could best be raised. Yet the design of the tax system – which collects over a third of GDP – shapes our economy and society. The UK's taxes are in need of reform over the next decade and liberals – through our philosophy, policies and political influence – are best placed to deliver them.

This paper examines six of the most important challenges: simplifying income taxes; taxing investment returns intelligently; fixing corporate tax biases; reforming inheritance tax; taxing real estate; and making consumption taxes fair.

The overarching theme is delivering a stronger economy *and* a fairer society. The proposals outlined in this paper can deliver both: a tax system for 2025 that is simpler, more efficient and pro-growth, but also more progressive, empowering and fair.

## Income

Income tax gets the lion's share of political tax discussion – dominated this parliament by increases in the income tax allowance and arguments over the top rate of tax.[1] Yet income tax makes up only a quarter of tax revenue, and less than 17% of taxes paid by the poorer half of society.[2] So while these changes in income tax are easy for everyone to understand, we should not overlook more fundamental and durable tax reforms.

One of the biggest reforms needed is the merging of National Insurance and income tax. Despite its

1 The highest marginal rate of income tax is actually the 60% rate between £100,000 and £120,000 (in 2014-15), caused by the withdrawal of the Personal Allowance (with National Insurance on top of this). This should be the focus of those who think rates of 45% or 50% are too high.

2 The effects of taxes and benefits on household income, 2012/13', Office for National Statistics.

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name, National Insurance does not meaningfully differ from other taxes. Employees pay not one but three forms of income tax: income tax itself, a parallel 'earnings tax' (employee National Insurance) and a 'salary tax' that reduces pay (employer National Insurance).

The result is a complex and opaque system that is far less progressive than we are led to believe and that taxes wages more heavily than income flowing from wealth. In 2009 for example, Labour's headline income tax rates were 20% and 40%, but after fully accounting for National Insurance we find these rates were effectively 39% and 48% for employees.

A liberal tax system should not be so deceptive. Maintaining these additional and unnecessary forms of income tax makes for confusion and bad policy, and obstructs other goals such as the fair taxation of capital.

## Capital

When it comes to taxing wealth – or rather the returns from wealth – liberals must balance two goals that at first seem mutually exclusive. On the one hand, a stronger economy requires investment in productivity and innovation, and concern beyond short-term consumption. This leads some to suggest that we should not tax the returns on savings and investment at all. But we also want a fairer society in which wealth, luck and rent-seeking are not favoured over hard work and enterprise, and in which there are no easy ways to avoid tax.

Fortunately, a system that is fair yet pro-growth is possible. To avoid discouraging saving, we should not tax the 'normal' rate of return on investment (using a market benchmark such as low-risk government bond yields). This is, in a way, an extension of the intuitive suggestion that only above-inflation gains should be taxed.[3] It is not right, for example, that many have recently been taxed on bank savings that have lost value after inflation. But to ensure a fair society, above this new 'rate of return allowance' (which would likely be 2-5% a year) the returns on wealth should be treated by the taxman like any other income.[4] Crucially, this means applying not just our current income tax rates but the National Insurance we currently reserve for earnings.

These tax rates and rate of return allowance should apply equally to all forms of investment (the pension tax system may be a special case and needs its own wholesale review). If we do have distortions, they should certainly not be in favour of the property market, as no level of incentive or investment will create new land. One step in levelling the playing field and boosting jobs and innovation would be taxing capital gains from property and commodity speculation more heavily than British companies to account for the corporation tax the latter have already paid.[5]

## Business

As well as reforming the taxes that investors pay, we must look at those paid by businesses.[6] Here again there are perverse distortions created by the tax system. Chief among these is the well-known but yet to be tackled bias towards debt. Companies can (rightly) offset debt interest against taxable profits, but cannot offset the interest cost of attracting investment or reusing profits. Favouring debt over equity in this way is a poor basis for shared and stable prosperity, and the taxation of all equity financing means some investment never goes ahead. An intelligent, liberal response would contrast both with (some on) the Right's zero-sum global game of tax cuts and (some on) the Left's vacuous bashing of corporations.

The best solution would be to match the allowance for debt financing with another for equity.[7] In the short term one way to fund this might be to simultaneously reduce the generosity of the debt relief. We should also seek to abolish stamp duty on shares, which is an extra tax on equity and pensions.

## Inheritance

Inheritance tax is one of the least bad options for funding public services, in terms of both fairness and the economy. The important question is not whether

3 The work of Thomas Piketty similarly suggests that rates of return become more worrying if they are greater than the growth of the economy or earnings.

4 Though we are usually unsure who ultimately pays these taxes. Lower wages and higher prices may be the result.

5 Dividend taxes already account for corporation tax, but capital gains tax does not.

6 Though noting that we're usually unsure who ultimately pays these taxes. Lower wages and higher prices may be the result.

7 In fact mirroring the 'normal' rate of return allowance proposed on the investor side.

or not we ***want*** to tax the inheritance of wealth – even though it limits social mobility and perpetuates inequality. The real choice is whether we tax inherited income or raise that money by taxing hard work.

Currently, one can inherit £650,000 from one's parents without paying a penny of tax. It would take over 30 years of full-time work for the median-earning employee (let alone those on lower incomes) to take home the same amount after tax. Only 5% of estates pay any inheritance tax at all.

Some steps can be taken to tighten the existing system, which offers a plethora of loopholes to the super rich. But bolder reform might, as many have suggested, shift inheritance tax from the deceased to the inheritors (as a bonus eliminating the objection that inheritance tax is a form of 'double taxation').

Specifically, I suggest no tax would need to be paid immediately by the grieving and preoccupied. Instead, any inherited financial assets would remain in special bequest accounts, with the freedom to move money between such accounts and to one's pension fund.[8] The recipient would only be taxed – at their regular income tax and National Insurance rates – on money withdrawn from the account, which could be spread out across their life.[9] Cash from inherited property sold within a few years would also go into such an account, with separate rules for retained property and businesses.

Unearned income would be treated just like earned income, the dead would pay nothing, no payment would be needed up front, and receipts would by default go into savings and pensions.

## Real estate

Along with other reforms needed to ease our housing market crisis, property taxes can do much to deliver both a stronger economy and a fairer society. Property wealth stems largely from natural or policy driven scarcity, excessive loans, inheritance and the value of public and community investment. Taxing this wealth can boost opportunity for families and businesses through lower taxes elsewhere and lower property prices. It is often overlooked that cutting property taxes may simply lead to yet higher (and more volatile) house prices and rents.[10] Despite the consensus that taxes on immovable property are the least economically damaging[11], our tax system favours housing over nearly all else, and our existing property taxes – council tax, stamp duty and business rates – are deeply flawed.

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Replacing business rates with a tax on the rental value of the land alone would be a strong first step, in line with over a century of liberal tradition. Taxing business property discourages its development and use: "it would be better to tax the value of the land excluding the value of any buildings on it, which would have no such effects".[12]

Council tax too is in terrible need of reform. For one, relative council tax valuations will be a quarter of a century out of date in 2016.[13] We must find a way to move to regular revaluation. Its structure is also regressive, being in part a continuation of the poll tax. The Liberal Democrats and Labour have proposed reducing the unfairness at the very top of the market (homes worth over £2 million) with additional council tax bands or a 'mansion tax'. But this is far too timid. Homes of £320,000 and of £2 million should not attract the same tax. And we must tackle unfairness at the bottom of the scale too. For example, in the North East over half of homes are lumped together in Band A; while it seems that even with the proposed mansion taxes the poorest households will stay pay the most tax relative to their property values.

The aim should be to move to a tax proportional to value.[14] This could be a single rate (such as 1% of value per year) or a progressive series of rates, banded or not, and likely with some local flexibility. Such a change "would bring about a considerably more progressive distribution of tax burden".[15]

An improved annual tax could also be increased

8 The same system could equally include any large gifts from the living.

9 This is a technically a form of 'expenditure tax', as proposed by John Kay and Mervyn King, among others, and ultimately equivalent to the normal rate of return allowance above.

10 See for example L Rosenthal, 'House Prices and Local Taxes in the UK', Fiscal Studies vol. 20, no. 1, 1999, on the scrapping of rates; S Adam & H Miller, 'IFS Green Budget 2014', Ch. 11, on business rates; and I Davidoff & A Leigh, 'How Do Stamp Duties Affect the Housing Market?', IZA DP No. 7463, 2013.

11 OECD, 'Tax Policy Reform and Economic Growth', 2010.

12 'IFS Green Budget 2014', ibid.

13 For new homes, estimates are made of what they would have been worth in 1991, had they existed.

14 Or technically to the imputed rental income – which is in turn proportional to value.

15 JRF, 'After the Council Tax: impacts of property tax reform on people, places and house prices'

to replace the revenue from stamp duty land tax. This up-front and unpopular levy is, despite improvement in 2014, "one of the… most damaging of all taxes"[16] and discourages families from moving to their preferred homes.[17]

## Consumption

Property taxes form part of a broader dilemma. Liberals want a progressive tax system – typified by income tax – but also want to reduce taxes on jobs, tax immovable property and environmental harms, and maintain a broad tax base.

Consumption taxes make up the majority of low and middle income families' tax bills,[18] and while certain reforms to council tax and others would help, ultimately we must retain them. If anything, taxes on land, greenhouse gases and other environmental harms should be increased. Trying to do away with such taxes is not the right approach, and the same applies to the lower or zero rates of VAT that exist for food, energy and many other goods.[19]

But how can we make these taxes progressive and extend the concept of taking the poorest 'out of tax'? The best approach would be instead to give every family or individual a universal tax rebate – a fixed payment of a few thousand pounds – to make up for the VAT, council tax, business taxes and others that unavoidably increase the cost of a basic standard of living.[20]

Of course, this is much the same as welfare. But labelling a large chunk of welfare as a tax 'prebate' would by itself make such help more acceptable, both for recipients and for those who currently attack it.[21] Making the rebate universal would be an even bigger step, and would remove the damaging withdrawal of means-tested benefits.[22] This universal tax prebate would in fact be similar to a 'citizen's income', but with greater political appeal than "people being paid for doing nothing".[23] This approach in essence means, for example, making energy use untaxed up to a point (based on family size), but without reducing financial incentives to use less energy. This is the liberal, fair and economically sound approach.

## Summary

Merging National Insurance with income tax, applying these rates to 'supernormal' returns and inheritance, removing biases against investment and those in favour of property and debt, making property taxation more progressive and pro-growth and exploring ways to make consumption taxes fairer. No matter how much revenue you think the tax system should raise overall, these changes would make it fairer and more pro-enterprise. It is a strong and recognisably liberal tax agenda.

16 P Johnson, 'Tax without design', IFS, May 2014.

17 C Hilber & T Lyytikäinen, 'Housing Transfer Taxes and Household Mobility: Distortion on the Housing or Labour Market?', 2013.

18 'The effects of taxes and benefits on household income', ibid.

19 Government-approved food only. Cakes: yes, biscuits: no; cooling pasties: yes, hot pasties: no…

20 The US FairTax campaign calls for a federal consumption tax with such a 'prebate'.

21 There is a technical but important, longstanding question of what counts as negative taxation and what counts as public spending.

22 Or rather disperse, in effect using taxation instead as the withdrawal mechanism. Allowing people to choose the frequency of their tax prebate (with interest) might additionally be one way of facilitating saving.

23 As Green Party proposals were described. There is nonetheless also a strong case for "compensation in part, for the loss of [one's] natural inheritance, by the introduction of the system of landed property" (Paine, 1797); and for redistribution if technological advances largely remove the need for market-based human labour.

**This pamphlet is part of a series of papers addressing contemporary issues in public policy from a liberal perspective. Marking the 10th anniversary of the publication of the Orange Book, a selection of these papers will be published collectively in a forthcoming special edition publication, The Challenges Facing Contemporary Liberalism: 2015 -2025.**