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FAIRER TAX FOR A BETTER ECONOMY

ESSAY

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BOLD IDEAS
for CHANGE

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EXECUTIVE SUMMARY

Comprehensive tax reform

Lacking any underlying rationale and subverted by habitual expediency and vested interests, the UK tax regime is demonstrably unfit for purpose. Comprehensive reform is urgently needed.

To start, not enough tax is being raised to meet the outgoings. Precipitate public sector cuts have stalled the economy yet failed to close the gap, blindsiding the interdependence of the private and public sectors.

But this merely throws into stark relief deeper weaknesses in the tax system and economy against a backdrop of profound economic challenges and marked dysfunctional inequalities. At their epicentre is the need to improve economic performance while paying for the necessary public investment and services. But any improvements soon run up against the buffers of the present tax system. Here unfairness and inequity intersect with often economically disproportionate, detrimental or inconsistent impositions.

Conversely, a better, more rational tax system could yet square the circle of improved economic performance, greater fairness and raising enough tax.

Overtaxing work

The UK tax regime's first critical fault line is the overtaxing of work. Accounting for 45 per cent of all tax receipts, productive labour is heavily and disproportionately taxed.

- Only work is liable to National Insurance, while other types of earnings often have preferential tax rates as well. This is then reinforced by earned income having the most restrictive deductions, allowances and opportunities for avoidance, as well as bearing nearly all the progressive tax burden of the tax regime as whole. Together, work is taxed at least 50 per cent more than – if not more than double – all other types of earnings or gains.
- High work taxes are at a high economic price, including:
  - Imposing most heavily at the economy's most critical juncture.
  - Heavy, regressive impositions on labour costs, reducing output, employment, investment and growth.
  - Significant and increasing competitive disadvantage: once tax rates, absolute pay/tax costs and productivity are factored in, the UK has among the highest, least sustainable labour tax costs in the world.
  - Constraining and disincentivising incremental economic activity, for both employers and employees, with progressive income taxes highly regressive in terms of these costs and disincentives.
  - Extensive economic imbalances and distortions. Critically, they weigh heavily against work and all activities with a work component while favouring rent-seeking and purely financial over substantively productive activities.
- Significantly reducing taxes on work is the best and now only way of making a meaningful difference to economic performance, encouraging growth and greater fairness. The problem is how to pay for it.

Undertaxing wealth

The second critical fault line in the UK's tax regime is unfairness and the failures of progressive taxation in the face of marked detrimental inequalities.

- Personal Income Tax is responsible for nearly all progressive tax, yet ends up, firstly, being borne overwhelmingly by work income alone and, secondly, concentrating progression between the bottom and middle of the income spectrum (let alone the wealth spectrum). As incomes increase, progression is then further flattened by the increasing benefit of preferential tax rates, allowances, deductions and avoidance opportunities.
- Returns from wealth are all favourably taxed compared to earned income. They escape National Insurance, often have preferential tax rates, benefit from more generous deductions and allowances, and are extensively mitigated and avoided. They make up 17 per cent of UK personal incomes yet just 6 per cent of tax collected from such incomes.
- Wealth itself is all but untaxed. Inheritance Tax and Capital Gains Tax bite on wealth only tangentially, are subject to wholesale avoidance, exemptions – and even then are favourably treated. They raise only 1.2 per cent of taxes, an imposition on the country's net wealth of less than 0.1 per cent.
- The UK has among the most pronounced and economically dysfunctional wealth inequalities in the developed world. The deeply ingrained effects range from weaker output, demand and investment through the bias for rent-seeking over substantively productive activities to socio-economic closure and degradation.
- Taxing wealth is potentially economically preferable to the alternatives, particularly taxing work; and it would be fairer and tackle inequalities more directly. It also provides the only means available for raising significant amounts of new tax. The question becomes how to tax wealth.
- The case for a wealth tax goes beyond a 'bolt on' to the existing tax regime. The UK's fiscal, economic and inequality problems, the inherent dynamics of such taxes, experience from other countries, and the need to leverage wider tax reform and offer a clear quid pro quo all pull in the same direction: towards wealth tax as a substantive, well-grounded tax in its own right.

Culpable company taxes

The tax regime's third critical fault line is the way companies are taxed.

- Company earnings are particularly favourably taxed, with low rates, generous allowances and deductions, no progressive tax and extensive legitimated avoidance. Amounting to only 2.5 per cent of GDP, UK corporation tax makes one of the lowest contributions among developed economies. Companies in Britain receive far greater benefits – being, in effect, heavily subsidised – from the public purse.
- Corporation Tax (mainly for larger companies only) has now been cut repeatedly; yet, as before, this won't deliver hoped-for improvements in output, growth or competitiveness. Equally, such tax cuts are a poor fiscal and economic investment, with better returns to be had from using the resources in other ways.
- Across the regime, then, all the advantage is given to back-end profit taxes while all the loading is put on front-end tax costs, particularly labour taxes. Yet, given the prevailing application and rates of these taxes in the UK, it is labour taxes that have the greater negative economic and competitive impact and which, conversely, if mitigated would most enhance economic performance.
- UK company taxes reinforce rather than redress the economy's shortcomings and imbalances. They are highly regressive in practice; favour rent-seeking and financial activities; bias against the substantively productive; favour market power; fail to support innovation; and disadvantage UK domestic businesses.

- Meanwhile, the tax system and economy are being cannibalised by avoidance and an 'offshore' financial realm within. This dangerous extra-jurisdictional dimension is coring out the tax revenues and warping the economy's essential structure by giving some – particularly multinational and larger companies – unfair tax, market and competitive advantages.

Tax for today's Britain

Reform is desperately needed. Given the problems and demands, this reform needs to be far-reaching, comprehensive and multidimensional, leveraging one problem and solution against another.

In the reforms proposed in this paper, better and fairer taxes most enhance economic performance, while improved performance and fairer taxes pay for necessary investment in the public sector – each the prerequisite for and complement to the other. The key axes of these reforms are to shift some of the tax burden from work to wealth in tandem with restructuring company taxes.

Equitable earnings taxes: Taxes on work would be significantly reduced, while the treatment of different types of earnings would be brought together into a common unitary tax regime.

- National Insurance would be abolished, mitigating 60 per cent of £104 billion presently paid by employers and employees.
- Inclusive 'Earnings Tax' would be set at a standard rate of 27.5 per cent over an increased tax-free allowance of £13,250 a year (being 50 per cent of average pay). Higher rates of 35 and 40 percent would apply to annual earnings over, respectively, £50,000 and £75,000.
- All non-work earnings would be brought into line with and under the same unitary Earnings Tax. This includes capital gains coming under the same personal allowance, tax rates and earnings calculations as all other earnings.

Refocused company taxes: In exchange for significantly reduced work taxes and greater support for productive activities, companies would pay more in general Corporation Tax.

- The main rate of Corporation Tax would return to 27.5 per cent, subject to a 15 per cent small company and start-up rate.
- The effective rate of tax would be increased by curtailing general deductions, allowances, tax breaks and so on, while vigorously closing off legitimated avoidance and the parallel 'offshore realm within'.
- Conversely, there would be more targeted tax (as well as more direct support) for substantively productive activities, particularly through deeper capital, R&D and investment allowances.
- A new wealth tax component to corporation tax would be introduced, based on 'net retained capital'.
- The present taxes on financial transactions would be reformed and broadened into a general financial transactions tax.

Taxing wealth: Closing the circle both fiscally and progressively, a general wealth tax would be introduced.

- The new tax would be levied on all holders of wealth, including both individual and corporate entities, with total net wealth over £150,000 at a progressive rate of 0.5–1.5 per cent per annum.
- Inheritance tax would be overhauled to dovetail with this new tax, capturing significantly more wealth than at present but taxing it at initially lower, then progressive rates.

Better tax: These multidimensional reforms would confound the country's otherwise conflicting intractable challenges.

- Economic performance is likely to be significantly enhanced by the sharp reduction in labour tax costs, lower income taxes and promotion of substantively productive activities. Conversely, the effects of the negative impositions are limited and acceptable. Overall, the economic benefits more than offset the negatives.
- The reforms put the public finances on a sounder footing. The various tax measures are broadly fiscally neutral at the outset and then, with the improved economic performance, help close the fiscal gap and pay for much-needed public investment.
- The new taxes are fairer, more equitable and more effectively address entrenched inequalities – as well as resulting in numerically more winners than losers. Conversely, the minority of losers – specifically, the interests of wealth – are worse off but are offered offsetting benefits and quid pro quos.

Political opportunity: Lastly, tax reform is a considerable political opportunity. Here it brings together potentially broad political appeal with a clear credible strategy for simultaneously boosting the economy, addressing the fiscal deficit and promoting fairness and equality.

1. COMPREHENSIVE TAX REFORM

> **‘Isn’t it appropriate that the month of the tax begins with April Fool’s Day and ends with cries of “May Day”?’**
> Rob Knauerhase

Ubiquitous and more than a third of GDP, tax – how it is raised and spent – is central to Britain’s ability to meet its profound economic, fiscal and social challenges. Yet the UK tax regime is demonstrably unfit for purpose.

Most immediately, the tax system is simply not raising enough in tax to meet outgoings from the public purse given the economy’s performance, with the country borrowing the shortfall. But this merely throws into stark relief deeper weaknesses in the tax system and economy against a backdrop of profound economic challenges and marked dysfunctional inequalities.

1.1 Taxation by expediencies

Lacking any underlying rationale and a baroque, long since subverted complexity of piecemeal measures bolted together, the UK tax system can legitimately be characterised as an economically detrimental and socially pernicious exercise in iterative fiscal expediency. Here often economically disproportionate impositions, inequitable inconsistencies and detrimental biases intersect with the reality of a tax system that is neither fair nor seen as fair.

This is in the defining context of a stalled economy and deep economic challenges. At the epicentre is the need to improve economic performance while still paying for necessary public investment and services, all at a time when the public finances are in a parlous state, with an ongoing deficit and mounting (albeit sustainable) national debt.

1.2 Shooting both feet

The Coalition government has tried and failed to close the deficit by unprecedented cuts in public expenditure while the economy was already in recession. Meanwhile, increasing taxes on the majority to fund tax cuts for companies and the well-off has failed to deliver the hoped-for private sector resurgence. The economy is now stuck on a treadmill of weak demand and low confidence, flatlining growth, perilously low investment and further spending cuts that again fail to close the gap.

Eviscerating the public sector simply chops the ground out from under the economy, undermining demand and growth while eroding underlying capabilities and the enabling economic springboard, leaving the private sector with even fewer reasons to expand and invest. Beyond the need for immediate demand stimulus, such policies are driven by a deeply mistaken ideologically denial of the economic part government and the public sector do and need to play in a modern economy, particular one in the UK’s circumstances.

1.3 The enabled economy

In a developed economy the public and private are inextricably intertwined, both integral and far more mutually supporting than competing. The question is how they can best work together, not one being at the price of the other.

The public sector, hence tax, provides the all-important physical, economic, institutional and social infrastructure – the enabling springboard – for all economic activities. It plays a critical role in leading out and underwriting large-scale, strategic and sophisticated scientific, technical and commercial capabilities. And its demand and employment are indispensable parts of overall demand and employment.

The UK is facing an ongoing erosion of its economic strengths. Numerous others are relentlessly improving their capabilities and productivity from a lower cost base. We have already lost much of our former manufacturing and mercantile activities and we are now losing mid-level technical and service activities. Meanwhile, other advanced economies are doing more to sustain their comparative advantages through new technology, better skills, new ways of adding value and superior deployment. This is against a backdrop of serious structural economic weaknesses and imbalances, from an over-reliance on property and financial activities to deep detrimental inequalities.

Growth and economic performance in a developed economy are driven by known factors: capital investment, R&D, innovation, new technology deployment, human capital, economic and physical infrastructure, the availability of finance, and the openness and flexibility of markets. And the UK stands out in having for many years underinvested in them all, particularly compared to our competitors. Underinvestment in these essential economic underpinnings – not excessive public expenditure or excessive taxation – is the single most important cause of the country's economic problems. Even sustaining our remaining strengths – let alone re-energising the economy – means investing significantly more in our capabilities and ourselves.

And – despite the oft-repeated 'freemarket' prescriptions – this requires public sector investment, enablement and economic leadership. Much of what needs doing, from education to infrastructure, is something business never could or would be expected to pay for.

Equally, there is no reason to now expect a spontaneous resurgence in the private sector or for it to do now what it has failed to do in the past – in far better circumstances – despite 30 years of repeated neoconservative tax breaks and 'incentives'. Nor is there any reason why market and national economic interests should now necessarily align – at least unprompted – given the UK's less-than-favourable mix of costs and productivity, short-term investment horizons, structural problems, aging infrastructure and general economic malaise.

Conversely, the evidence is clear that public and private investment is overwhelmingly mutually reinforcing – not competing – and together most enhance productive capabilities and economic growth. Equally, the economy is wanting in leadership, planning and support. Again the evidence is clear that those pursuing more proactive, strategic economic leadership do better than those who leave it entirely to the 'market'.

1.4 The growth and tax paradox

Growth and economic resurgence are essential prerequisites for addressing both the deficit and wider challenges; without them the public finances remain trapped on a downward spiral of outgoings exceeding taxes, repeated cuts notwithstanding (which, with the cupboard already stripped bare, now means raising more in tax just to close the deficit). And without them there isn't the headroom to do what needs doing, whether that means investing more, reducing taxes, or addressing pressing social priorities.

But if trying to balance the books by substantially cutting the public sector is self-defeating, and if trying to encourage growth through tax breaks for companies and the well-off won't deliver either, their reverse is no better. Increasing taxes without otherwise improving economic performance – simply to bankroll a public sector quickly rendered unsustainable and underperforming – is equally self-defeating, soon choking off the very growth and economic resurgence that it is intended to encourage.

1.5 Hurting not helping

Trying to meet any of these challenges – whether improving economic performance, escaping the deficit impasses, raising enough to pay for the necessary public sector, or addressing Britain's deep structural imbalances and inequalities – soon, however, comes up against the buffers of the present tax system; which all too often end up compounding rather than redressing the problems. The tax system's shortcomings then trace back along critical fault lines:

- Work – productive labour – is overtaxed, despite being the economy's most vital juncture and coming at a high price.
- Conversely, wealth – both its returns and wealth itself – is disproportionately undertaxed; indeed, it has all the advantages, despite Britain's marked economically dysfunctional inequalities.
- Meanwhile, companies are not paying their way, yet their taxation ends up reinforcing rather than redressing the economy's weaknesses, while the entire system is being distorted and undermined by wholesale legitimated avoidance and a parallel 'offshore' economy within.

1.6 Multidimensional tax reform

Far-reaching tax reform is therefore sorely needed. Given the conflicting demands and challenges at hand, this needs to be comprehensive and multidimensional. A matrix of interrelated reforms is needed that simultaneously enhance economic performance while more fairly and less detrimentally raising sufficient revenue to pay for the necessary public sector.

Challenging as this may be, a rational, fairer tax system suited to today's Britain could profoundly shift the economy's tax/growth dynamics and performance. With sufficiently comprehensive reform, the UK could yet square the circle of improved economic performance, greater fairness and raising enough tax.

This paper first considers the critical fault lines of the present tax regime in more detail and puts forward an outline framework for a comprehensive new tax settlement.

2. OVERTAXING WORK

The UK tax regime's first critical fault line is the overtaxing of work. Accounting for 45 per cent of overall tax revenues, work – productive labour and earned income – is taxed heavily and disproportionately, imposing most on this particular vital facet of economic activity.

2.1 The national insurance penalty

Once a genuine insurance, National Insurance is now merely a regressive tax applying specifically and only to employment: it is a de facto tax penalty on work relative to other types of earnings. Following the two-percentage-point increase in 2010/11, the standard rate is now at an all-time high of 25.8 per cent of gross salary.

The £104 billion collected in 2012/13 alone accounts for a fifth of all tax receipts – two and half times as much as Corporation Tax and more than all VAT. The just-announced discount of the first £2,000 of a company's National Insurance from 2014/15 , while welcome to small businesses (see section 4.4), will only mitigate slightly over 1 per cent of this imposition on work – it is more significant for recognising the problem rather than makes any real difference.

2.2 Least favourable taxation

Of all the various types of earnings, earned income is least favourably treated for tax purposes. Other earnings not only escape National Insurance but often benefit from preferential tax rates as well. Together employment earnings are taxed at over twice the standard rate of all other types of earnings and even at higher rates are taxed 50–100 per cent more.

Table 2.1
Tax on earnings – total tax imposition by type of earnings, 2013/14

	Earnings tax rate	National insurance rate[1]	Total tax imposition	Imposition as % of employment imposition[2]
Standard rate (£9,250–£41,450)				
Employment	20%	25.8%	45.8%	100%
Self-employment	20%	9%	29%	63%
Unearned income[3]	20%	0%	20%	44%
Dividends	10%	0%	10%	22%
Capital gains: non-business assets[4]	18%	0%	18%	39%
Capital gains: business assets and shares[4]	10%	0%	10%	22%
Company profits: small company[5]	20%	0%	20%	44%
Higher rate (£41,451–£150,000)				
Employment	40%	15.8%	55.8%	100%
Self-employment	40%	2%	42%	75%
Unearned income[3]	40%	0%	40%	72%
Dividends	32.5%	0%	32.5%	58%
Capital gains: non-business assets[4]	28%	0%	28%	50%
Capital gains: business assets and shares[4]	10%	0%	10%	18%
Company profits: small company[5]	20%	0%	20%	36%
Additional top rate (over £150,001)				
Employment	45%	15.8%	60.8%	100%
Self-employment	45%	2%	47%	77%
Unearned income[3]	45%	0%	45%	74%
Dividends	37.5%	0%	37.5%	62%
Capital gains: non-business assets[4]	28%	0%	28%	46%
Capital gains: business assets and shares[4]	10%	0%	10%	16%
Company profits: to main rate[5]	20–23%	0%	20–23%	33–38%

Notes:
1. Employee and employer contributions: total imposition on earnings.
2. Tax rate as percentage of employment tax rate.
3. General unearned: rent, interest and similar; rate is 10 per cent if annual income is less than £10,815.
4. Has separate allowance of £10,600 a year.
5. Rate is 20 per cent on profits up to £300,000 a year; marginal relief to main rate at £1.5m. Main rate is 23 per cent in 2013/14, then 21 per cent in 2014/15, then a maximum 35 per cent of employment.

Higher rates of tax are then reinforced by deductions and allowances going from highly restricted to more lenient across the spectrum from work income through unearned income to company earnings and capital gains. Equally, earned income can't make use of the extensive legitimated means of mitigating and avoiding tax available to other types of earnings, particularly for the better-off (see section 3.2).

As a result, taxes on work end up accounting for 94 per cent of all taxes on personal incomes and 75 per cent of taxes on earnings of all types (including company earnings and so on). Whether measured by relative levels of earnings imposition or respective contribution to GDP, work ends up carrying at least twice the proportionate tax burden of any other type of earnings or facet of economic activity.

The disproportionate taxing of work then intersects with the effects of progressive taxation. Given the tax system's singular reliance on personal Income Tax for its progressive dimension (see section 3.1) and that this comes so predominantly from employment taxes, work and those who work end up carrying the progressive burden just as overwhelmingly and disproportionately as they do the overall burden. Conversely, from the work perspective – whether that of employer or employee – progressive income taxes are simply a regressive increase in the tax imposition, increasing the costs and disincentives of work, employment and adding to labour value.

2.3 Hitting hardest where it hurts most

Taxing work imposes on the economy's most critical juncture, hitting hardest where it hurts most. Work – including high levels of employment across the economy – is the bedrock of the economy. It is the largest contributor to economic activities and incomes, the principal generator of everything from demand to tax and the vital economic and social purpose of it all. Whatever the justifications or necessities, imposing heavy, disproportionate taxes on this essential dimension of the economy, where they have the deepest effects, is bought at a high economic price. Given the country's profound economic challenges, it is also where Britain is now most vulnerable.

2.4 Ratcheting up the cost of labour

Work taxes add significantly to the cost of labour, businesses' largest cost, reducing overall employment, output and demand (subject to how the taxes are then spent).

Table 2.2
Incremental labour costs from net pay to gross direct labour cost

Proportion of average full-time pay	Incremental labour cost
50%	27%
100%	45%
200%	63%
300%	73%

Here it is the total imposition on the work – the difference between what employers pay out and what employees receive – that ultimately counts in economic terms, not who the taxes are nominally collected from. The average British worker costs nearly half as much again as their net cost; this increasing regressively as higher-rate taxes kick in, reaching an incremental cost of over 100 per cent for the highest paid.

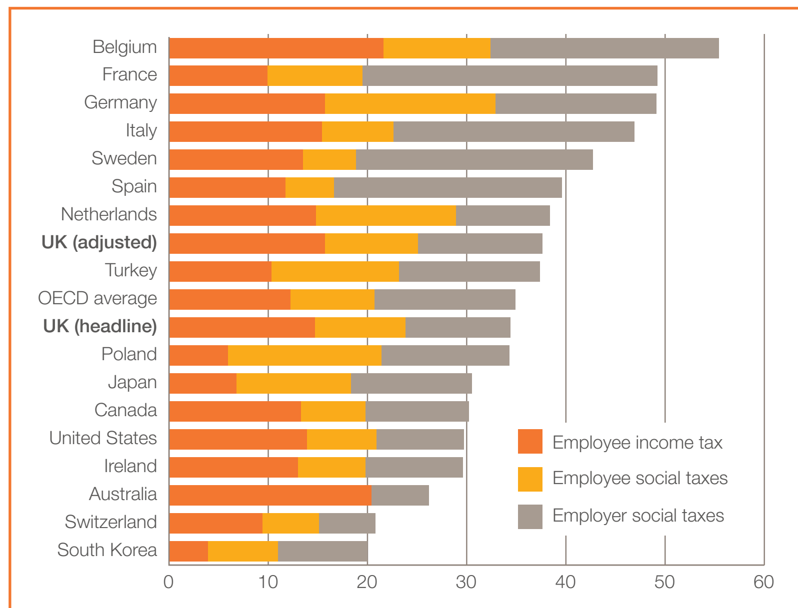
2.5 High anticompetitive taxes

The UK's high work taxes put it at a significant and increasing competitive disadvantage. At first sight, our headline employment tax rates don't compare unfavourably with other developed countries: they are in line with the OECD average, with the UK sitting two-

thirds of the way down the ranking of OECD countries (20th of 34). Things are not, however, all that they seem.

As a preliminary, the headline rates need to be adjusted slightly to allow for technical differences in the application of these taxes, which nudges Britain up the rankings. More importantly, this excludes nearly all the newly developed and rapidly developing economies, with their generally significantly lower labour tax rates (subject to these tending to increase as an economy develops). On a worldwide basis, the UK's labour tax rates are in the highest 10 per cent.

Figure 2.1
Total labour taxes, OECD countries, 2011 (total labour taxes as % of labour cost of average worker)

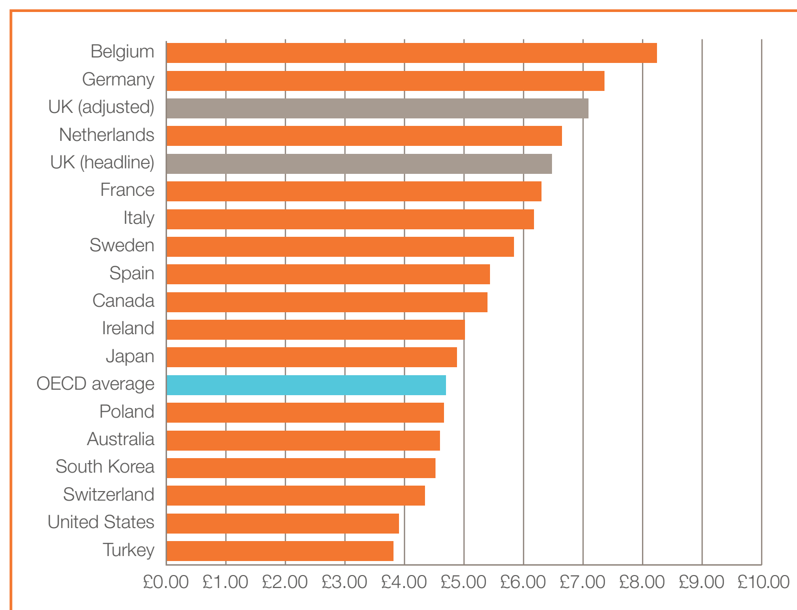


Tax rates then apply in terms of absolute monetary levels of pay and labour cost. In conjunction with the UK's high levels of pay in international terms, it has some of highest monetary labour tax costs, pushing it nearer to the top of the rankings.

Allowance also needs to be made for differences in productivity – the value of output produced for that tax cost. The United States and much of Europe are able to produce an average of 20–30 per cent more value per hour. The UK's relative position is also deteriorating as time passes, with Britain continuing to underinvest compared to its peers in nearly every factor known to contribute to economic growth. Having at least started to narrow the gap slightly in the 1990s (albeit off the back of unsustainable financial services 'growth'), the productivity gap between the UK and other developed countries is back to where it was a decade ago – and is now widening once again. At the same time, many emerging economies are rapidly increasing their productivity, closing the gap or even moving ahead in an increasing range of sectors and capabilities.

Once tax rates, absolute pay/tax costs and productivity are factored in, the UK has among the highest, least sustainable labour tax costs in the world. The total labour tax imposition of the average worker producing the same output value is half as much again as the OECD average – £3,000 a year more per worker.

Figure 2.2
Labour taxes per equivalent output (monetary taxes per average worker standard hour output)



If differences in the competitive exposure and productivity of the UK's most important sectors and how this intersects with UK pay distribution and pay inequalities are also factored in, the uncompetitiveness of its labour taxes is yet more marked.

The UK's work taxes therefore leave it increasingly competitively vulnerable. It is caught between those countries with similar tax rates and costs but higher productivity, which are pulling further ahead, and those with similar (or more quickly improving productivity) but which benefit from lower tax rates and absolute labour/tax costs. Short of a sharp decline in real rates of pay and/or a stepped increase in productivity, the competitive unsustainability of this tax imposition can only get worse.

2.6 Disincentives and incremental activity

High earnings taxes are also a regressive constraint on and disincentive to incremental economic activity.

Crucially, the effects straddle the employment relationship. Both sides act on the basis that they are the ones paying for the taxes, where neither is entirely mistaken in as much as these ultimately attach to the work itself, both as a cost and reward (see section 4.4). For employers, the greater the incremental cost of labour, the more it reduces marginal sales, production and investment. For employees, the more that is deducted from gross pay, the more it curtails the work undertaken and reduces earnings, hence consumption and overall demand.

The progressive dimension of employment taxes is then highly regressive in terms of disincentives and incremental economic activity. As rule of thumb, taxes increase in their impact by a factor of their level; with the relatively high rates for employment (compared with other types of earnings; see section 2.2) and the higher-rate taxes within this doing much more damage proportionately. High earnings taxes, particularly higher-rate employment taxes, also provide an increasing incentive for mitigation, avoidance, flight and evasion. Yet in order to raise the necessary tax revenues, this feeds back into a still-greater imposition – creating further disincentives for those economic activities (primarily employment) still fully caught in the tax net.

Critically, at prevailing tax rates, it is Britain's labour taxes – not its taxes on company profits – that have the greater suppressive, disincentive economic impact (see section 4.4) and which, conversely, if mitigated would most enhance economic performance.

2.7 Economic distortions and imbalances

Last but not least, taxing work heavily and disproportionately compared to other types earnings or dimensions of economic activity causes and reinforces far reaching imbalances and distortions in the economy, particularly when compounded by the present systemic tax mitigation and avoidance (see section 4.6).

- Overtaxing work disfigures the labour-cost-benefit-investment equation of transactions.
- Not only is work disincentivised and reduced directly but the economy generally is weighted against work and all activities – public or private – with a work component.
- Conversely, it biases the economy in favour of unearned income, rent-seeking and capital gains, particularly in preference to investment in more substantively productive activities.
- It creates unjustified inconsistencies between the winners and the losers, giving some an unfair and/or competitive advantage while leaving others at a disadvantage.

2.8 All very well, but…!

There is, therefore, a pressing need for Britain to reduce the punitive tax treatment of labour and cut its work taxes. Improving economic performance, encouraging growth and employment, fairness and consistency of treatment here all pull in the same direction. Significantly reducing taxes on work is the best way – and in the present circumstances, the only way – of achieving any of these aims by themselves, let alone all at the same time, at least with enough scale and impact to make a meaningful difference.

All very well – but reducing work taxes would need to be paid for, at a time when the public finances are already under serious pressure. Even if the government's failed attempts to reduce the immediate deficit this way hadn't already stripped the cupboard bare, trying to fund a significant remission of work taxes by cutting public expenditure would be both fiscally self-defeating and economically self-destructive. Indeed, as discussed in the first chapter, given the UK's challenges and circumstances it needs to be going in precisely the opposite direction: it needs to be sustaining, if not actually reinforcing, its investment through and in the public sector.

Conversely, there isn't realistically enough fiscal headroom to meaningfully reduce work taxes by simply increasing other existing taxes under the present tax system. The increases needed would again become self-defeating long before they generated enough replacement tax revenues. This necessarily means raising substantial tax revenue from somewhere else – even if we didn't already need to raise more tax revenues anyway.

3. UNDERTAXING WEALTH

The tax regime's second critical fault line is its unfairness and the failures of progressive taxation in the face of marked economically and socially detrimental inequalities. When it comes to either 'broader shoulders bearing heavier loads' or equalising life's chances, inequalities are being reinforced not redressed by the tax system, with wealth having all the advantages.

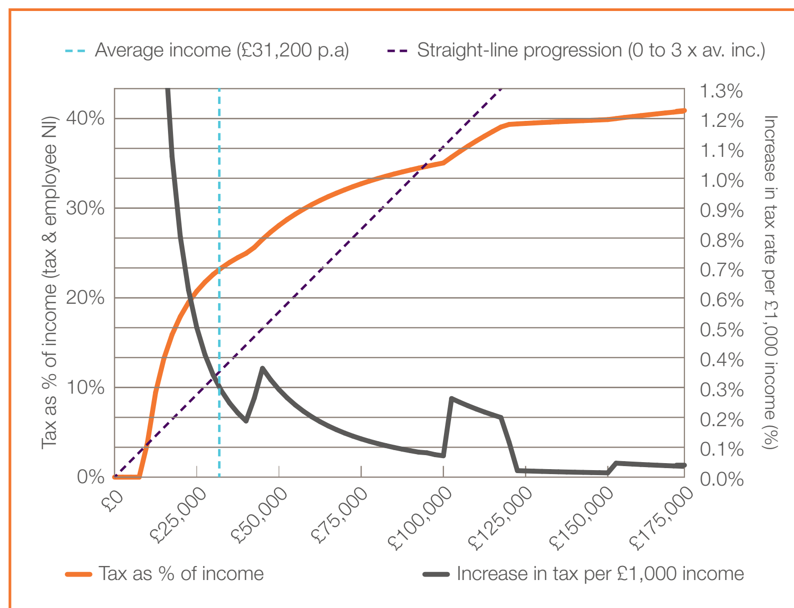
3.1 The progressive squeeze on earned incomes

The problems start with personal Income Tax alone being responsible for virtually all the progressive aspects of the tax regime as a whole. Meanwhile this singular reliance on one dimension of gain and wealth for all progressive tax has itself long since been warped and blunted as either an effective or fair means of taxing progressively.

First, personal income taxes end up being borne overwhelmingly and disproportionately by earned income, with work/employment accounting for 94 per cent of the taxes collected. As such, progressive Income Tax has all its detrimental regressive effects on working and employment (as discussed in chapter 2) but is demonstrably not capturing other types of earnings and economic activities on an equivalent progressive basis.

At the same time, Income Tax rates, bands and thresholds, particularly for earned incomes, concentrate its progression in the bottom half of the income spectrum, before it flattens off for those with higher incomes.

Figure 3.1
Tax progression on earned income, 2013/14 (at left/orange: tax as % of income; at right/grey: increase in tax rate per £1,000 income)



Notes:

- Progression is concentrated at the bottom of the income range. For instance, a step up in annual income from £15,000 to £20,000 produces an increase in tax rate 25 times greater than a leap in income from £150,000 to £200,000. Similarly, the average income pays almost 60 per cent of the rate of tax paid by incomes five times greater.
- There is a squeeze in the middle-income range, as the 40 per cent tax kicks in at £41,450 (roughly a third above average income).
- The bump at £100,000 reflects the removal of the personal allowance (£1 lost for each £2 of income).
- The top 45 per cent rate starts at £150,000. Crucially, reducing or increasing this rate by 5 per cent has little impact on the progression overall (as distinct from the cost/benefit for individual taxpayers, the cost/gain to the public purse, or their regressive costs or disincentives).

Like Labour before it, the Coalition government has exacerbated both the disproportionate taxing of work and the pushing of progression down the income spectrum. Top-rate Income Tax has been cut from 50 per cent to 45 per cent. Yet National Insurance has been increased across the board and higher-rate tax thresholds continue to be eroded. These have now been cut by a quarter in real terms since 2010/11, bringing millions more into higher-rate tax and sharpening the progressive squeeze in the middle, notwithstanding increases in the personal allowance.

Finally, as one goes up the income scale the underlying progression is further flattened and distorted by the increasing benefit of allowances and deductions, the increasing proportion of earnings that benefit from more favourable rates and treatment for non-work income (see below) and increasing use of mitigation and avoidance.

3.2 Undertaxing wealth's earnings

The flipside of both overtaxing work and the regime's progressive failures is the undertaxing of wealth.

Earnings from wealth – interest, rent, dividends, company profits and capital gains – are favourably taxed compared to work. They escape National Insurance and are often taxed at lower rates as well (see section 2.2). Together, returns from wealth are – at most – taxed at only one to two-thirds of the rate for the same earned income. Meanwhile, deductions and allowances become increasingly more permissive as one traverses the spectrum from earned income through unearned income to company earnings and gains. And, unlike earned income, the returns from wealth can often benefit from extensive, legitimated means of tax mitigation and avoidance available to the better-off.

The overall tax benefits and discrepancies are difficult to pin down but substantial. Income from wealth is 17 per cent of pro forma UK personal incomes, yet accounts for only 6 per cent of collected personal income taxes; or just 1.9 per cent of overall tax receipts, compared to 45 per cent from earned income (see figure 3.2 over).

But even this is limited to personal declared incomes and so excludes the substantial returns from wealth that are sheltered in companies, trusts and the parallel 'offshore' system (see section 4.6). Conservative estimates of the earnings generated from UK private wealth, even at today's preferential tax rates, suggest personal income taxes from the returns of wealth would otherwise be two to three times the £10 billion currently collected.

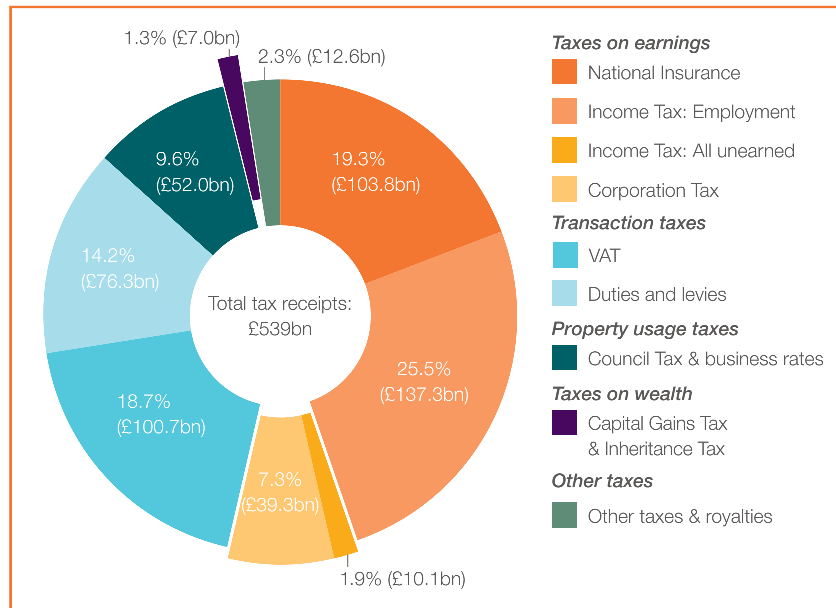
3.3 Wealth itself untaxed

And, most important of all, wealth itself is all but untaxed.

Even if its returns were taxed the same as earned income, this still would not recognise wealth's unique regenerative capacity to provide recurring control and returns from its ownership alone. Inequalities and their consequences are first about wealth, with personal income just the handmaiden.

Insofar as wealth is taxed, the taxes that there are – Capital Gains Tax and Inheritance Tax – bite on wealth only tangentially. Raising just 1.3 per cent of overall taxes, they are equivalent to an annual imposition of less than 0.1 per cent on the UK's £7.7 trillion net wealth.

Figure 3.2
UK tax receipts by type, 2012/13



Capital Gains Tax is paid only on a 'gain' and only when this is realised, shading off into the equivalent of earnings as a benefit from wealth – while the capital itself is untaxed. Gains are then favourably taxed, including: a separate £10,600 annual tax free allowance; permissive deductions, allowances and relief schemes; and, critically, tax rates only 20–50 per cent of those for earned income (see section 2.2).

These advantages are highly regressive, with the wealthiest 10 per cent benefiting by £23 for each £1 of benefit to all those in the least wealthy half of the population. Nevertheless, tax on capital gains is often mitigated or avoided, particularly by those with substantial wealth. In 2012/13 it raised just £3.9 billion. Advantageous tax treatment and ready avoidance in turn reinforce the bias towards rent-seeking activities and asset speculation over productive activities.

While Inheritance Tax attaches to wealth itself, it only applies on death, not to lifetime use and benefits. Nominally paid on 40 per cent of the net value of an estate over £325,000, it is subject to wholesale exemptions and overwhelmingly avoided by the genuinely wealthy. It is paid by only 20,000 people a year (from a mortality rate of 575,000) and raises just £3.1 billion a year. Yet the demographic figures suggest £75–80 billion a year in wealth is passing between generations, with £45–50 billion from those with net wealth above the IHT threshold.

3.4 Britain's wealth inequalities

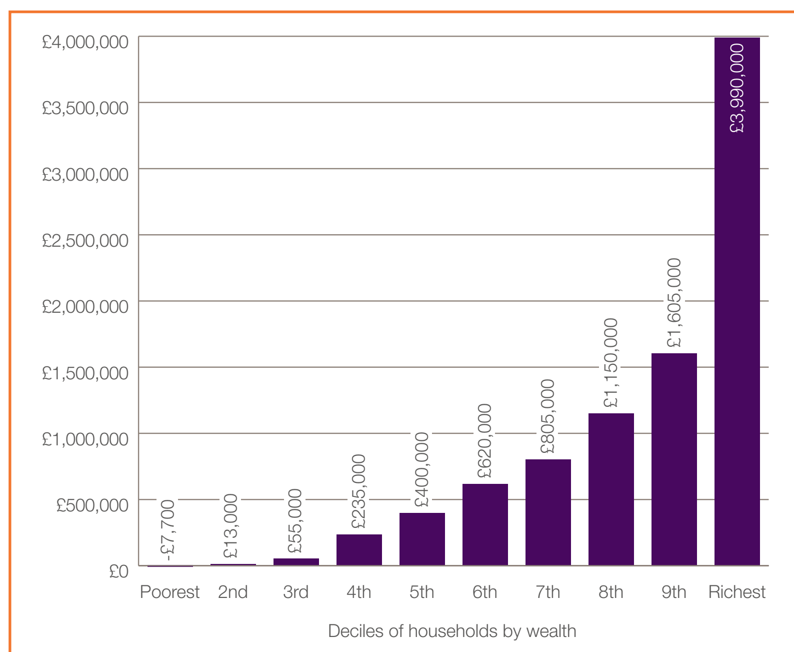
Britain's income and wealth inequalities are among the most marked in the developed world. The wealthiest 10 per cent own more than the rest of the population combined; conversely, the least wealthy half own only just over one-20th of all the wealth. Two-thirds of people have net wealth of less than £100,000, and a quarter of the population (24 per cent) have minimal or negative wealth. Among advanced economies, only the US has a more unequal wealth distribution, and the contrast between the UK and much of Europe is particularly pronounced.

Table 3.1
Wealth distribution, 2010
(% of adult population)

Top 1%	22%
Top 5%	42%
Top 10%	56%
Top 25%	78%
Bottom 50%	6%

The pro forma declared personal wealth of the wealthiest 10 per cent is more than 25 times greater than the average wealth; for the wealthiest 2 per cent, this factor is more than 125 times. But by excluding wealth sheltered in companies and trusts and offshore, among others, these are marked underestimates. Again, only the US among developed economies has larger differences in relative levels of wealth.

Figure 3.3
Average levels of net personal wealth, UK, 2006–08 (net of liabilities)



Notes:
Includes: property wealth, financial wealth, physical wealth, pension wealth. Excludes: business wealth (all types of businesses owned and wealth owned by businesses), trust wealth, undeclared and offshore wealth – these forms of wealth add an increasingly large amount as wealth increases (as much again at the top of the spectrum).
Since 2008, these figures have increased materially but increases have been greater at the top than the bottom of the wealth spectrum.

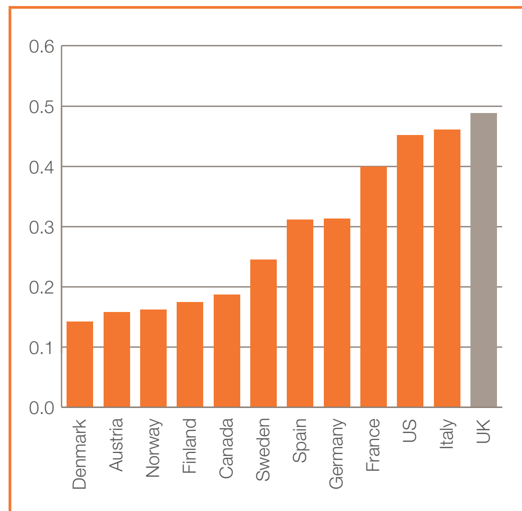
Moreover, inequalities are increasing, with wealth steadily concentrating and transferred upwards. Admittedly, inequalities have increased across developed economies generally – but this has been more pronounced in the UK (and the US), and from a more unequal starting point. Between 1995 and 2010, the wealthiest top quarter's share of total wealth increased by between six and seven percentage points and the top 1 per cent's by nearly four points – representing an increase in their share of overall wealth by a fifth in just a decade and a half. Conversely, the least wealthy half of the population's share of wealth fell from just under 9 per cent to 6 per cent – a fall of a third. And all the indications are that since 2010 this trend has only accelerated.

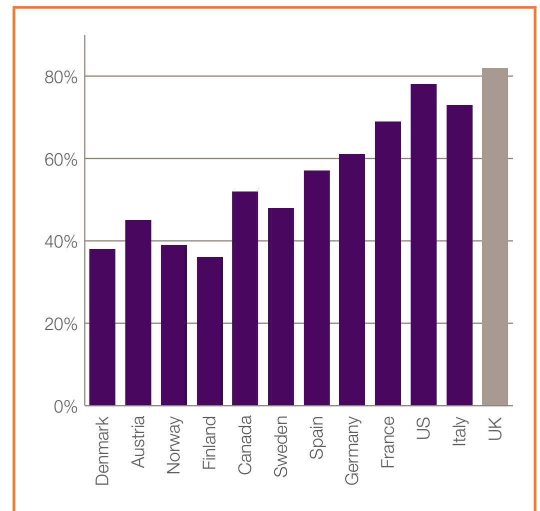
Self-evidently the tax regime's progressive aspects are not reducing wealth inequalities; in fact, it is debatable if they are even slowing the rate of increase.

Marked and increasing inequalities intersect with declining socio-economic mobility and the resurgence in the determining role played by inheritance. Wealth and its advantages increasingly stay close to home and among their own, then passing down to the next generation.

Figure 3.4 (left)
Replication of income across generations (1 = perfect replication, 0 = no replication)

Figure 3.5 (right)
Persistence of wealth between generations (100% = complete continuity, 0% = no continuity)





Notes:
OECD 2007 (D'Addio); income elasticity/inelasticity marks 'the extent to which a son's earnings level replicates the father's. The higher the value, the greater is the persistence of earnings across generations, thus the lower is the intergenerational earnings mobility. This approach is supported by a meta-analysis of the available data and methodological rigour. It, however, looks to only income and doesn't weight or differentiate between levels of income (that is, measures only identicality across all incomes); and to this extent under represents the advantages brought by higher incomes'.

Notes:
National data 2005–09; the extent wealth relative to the median wealth persists over generations. The higher the value, the greater is the persistence/endurance of wealth across generations, albeit that any kind of inheritance will inherently give rise to a degree of intergenerational wealth persistence. Conversely, by taking into account the level of wealth – the greater mobility of lower levels of wealth being of lesser significance than the relative immobility of higher levels of wealth – it gives a clearer picture of the persistence of wealth itself, subject to small margin of error to allow for inconsistencies of national data and analysis. Similar results are obtained from analysis of the extent ongoing capital accumulation accrues to existing capital, rather than as new capital (a phenomenon known as 'capital condensation').

3.5 The economic price of inequalities

Pronounced inequalities of income and wealth – and their tax treatment – are morally objectionable, unfair, divisive and politically corrosive. But there is still a widespread belief that this is the inevitable, even necessary price of encouraging growth and enterprise. It is therefore important to stress that the UK's inequalities are as economically dysfunctional as they are socially pernicious.

The price of inequalities includes:

- weaker demand, output and consumption
- poorer use and deployment of capital
- imbalances of market and economic power and favouring of incumbent wealth
- the seeking and taking of excessive returns
- underinvestment, particularly in longer-term productive capabilities
- biasing towards rent-seeking over substantively productive activities

- propensities for financial and asset speculation, which in turn causes systemic economic volatility
- detrimental downward pressure – a 'race to the bottom' – on labour costs (and rights)
- weaker innovation and new capital formation
- underinvestment in and underutilisation of human capital (inequality in direct conflict with both equality of opportunity and making the most of available human resources)
- economic (and social) closure and foreclosure by existing wealth and a tightening grip on the economic, institutional and political levers of power
- deteriorating economic infrastructure and increasing socio-economic dysfunction and alienation.

As inequalities increase and wealth overwhelmingly accrues most to those that already have it, Britain is caught in a self-reinforcing dynamic of advantage and deprivation. Unless met head-on, the economic and social price of inequality can only grow ever steeper.

3.6 Taxing wealth more

Given the UK's detrimental inequalities and the equally marked undertaxing of wealth and its returns, there are good prima facia reasons for taxing wealth more. And, given its potential advantages in terms of wider economic and taxation challenges, increasingly it is remiss not to.

Critically, taxing wealth more (but not excessively), is economically preferable to the alternatives, particularly taxing work. It would:

- impose less – and less directly – on ongoing economic activities and transactions
- drag less on demand, output, employment, consumption and growth
- redress the bias towards rent-seeking over substantively productive activities, particularly employment
- bite on economically dysfunctional wealth inequalities
- discourage less productive wealth accumulation or usage.

Taxing wealth also has the potential to address the UK's deep inequalities and their consequences more directly and effectively, making up for the progressive shortcomings of Income Tax on its own.

Meanwhile, the country needs to escape its fiscal Catch-22: improving economic performance while still paying for the necessary public sector when there is already a large deficit and on-going shortfall between taxes and spending (see chapter 1). This means finding meaningful amounts of additional tax but in less economically detrimental ways than from existing taxes – and taxing wealth is the only real candidate.

On the downside, taxing wealth can create disincentives or distortions in investment and wealth accumulation as well as bring attendant risks of diversion and flight. The balance of advantages and disadvantages then turns on how wealth is taxed.

3.7 How – and how not – to tax wealth

'Taxing wealth' covers a spectrum from taxes on specific kinds of wealth, particularly property, through narrow wealth taxes on high personal wealth only, to broader general taxes on all wealth ownership.

Increasing existing taxes

First, however, it needs explaining why increasing existing taxes that impinge on wealth is a necessary starting point but insufficient on its own.

There is a strong case for increasing taxes on the returns from wealth, if only to remove the unfairness, distortions and avoidance of the present system. Tax for earned and unearned personal income could be taxed on a par; taxes on company earnings might be increased (see chapter 4); the advantages enjoyed by capital gains could be curtailed.

But this would only redress existing disparities in the treatment of earnings. It doesn't tax wealth itself, with personal income remaining the proxy for the real nexus of inequality. Pragmatically there is also a playoff between the amounts raised and tax increases being undermined by reduced economic activity, disincentives, avoidance and flight. Given realistic limits, the tax raised might be useful (see section 5.5) but only enough to close part of the fiscal gap.

Merely trying to sharpen income tax progression is equally problematic. Under the existing tax regime, this increases the burden on employment far more than it bites on the returns of wealth or underlying inequalities, and merely intensifies the regressive effects on labour and costs (see section 2.6). This would still be the case – just less so – even if earned income and income from wealth were taxed on the same basis. Meanwhile it again still treats income as the singular proxy for all inequalities. And, again, it soon runs into the tension between the amounts raised and strangling the golden goose it is trying to tax. Here, despite the progressive shortfalls, the top 25 per cent of earners already account for 74 per cent of all income tax collected – and the top 10 per cent some 47 per cent – and have seen the heaviest increases since 2008/09.

Similarly, there is a strong case for reforming Inheritance Tax. But this is distinct from taxing wealth's lifetime benefits, advantages and inequalities.

Property and land taxes

Despite vocal advocates and their use in several countries as municipal tax, a British property or land tax has serious drawbacks on closer consideration.

Such taxes are limited to single class of assets – albeit an important one. Economically and fiscally arbitrary, they pass over all other wealth while creating inconsistency driven distortions and avoidance. The UK already has high taxes on property usage and transactions. And we have highly skewed land and property ownership, polarised between all-but-monopolistic landed interests held at repressed values and the vast majority buying or renting toeholds of urban property at high, inflated, increasingly unaffordable prices. The danger is the tax hitting lifetime acquired owner-occupied urban property more than the deeper inequalities in property ownership or wealth. All this then curtail the amounts of tax that can be raised.

Conversely, property can't go anywhere or readily disguise itself. If all that's wanted is a modest tax to raise limited supplementary revenue to the existing unreformed tax regime, then a property or land tax might be (or at least seem) straightforward and less readily avoided. Here, a land rather than property tax – say, based on owned acreage according to land type – would be preferable, given the UK's highly distorted property market. By attaching more to the pure 'rent' ownership component of property, it would have limited impact on incentives or the housing market, while going more to the real nexus of property inequalities.

Failing that, rather than fiddling around with a necessarily limited additional property tax, one might as well simply extend the existing Council Tax bands, removing the present cap for more valuable properties. Nevertheless, if real reform is in order then looking to a property tax at all remains ill-advised.

Wealth tax precedents

Switzerland, France, the Netherlands and Norway have narrow personal wealth taxes of variously 0.75–1.8 per cent a year on net wealth over a tax-free threshold. Germany, Spain and Sweden had similar taxes which have subsequently been revoked (in all cases, by governments on the political right).

Entirely of one type, all are limited to private personal wealth – excluding companies, trusts and so on – and narrowly applied, usually with high starting thresholds. All are on top of already-high complex employment taxes yet have extensive exemptions and deductions, particularly for business and investment wealth. As a result, the costs and complexities of the tax weigh heavily against the necessarily limited amounts of tax collected.

There are fewer contemporary precedents for broader, more general taxes on wealth or for using such a tax to reduce other taxes. These significantly change the dynamic and interplay of advantages and disadvantages. Switzerland and Chile provide encouraging indications, successfully using taxes on, respectively, wealth and property to help keep down earnings taxes. In the past, broad general wealth taxes also characterised many economically successful civilizations, from the Roman empire to imperial China.

3.8 The better wealth tax

There are object lessons in these precedents and the inherent dynamics of such taxes – essentially, 'the bolder the better'. The narrower the tax and greater its restrictive complexity, the more the detriments and distortions weigh against any advantages while limiting the amounts raised. Conversely, the broader the tax – the less it differentiates between ownership and assets and the more it mitigates other taxes – then the better the potential balance of advantages over disadvantages. In particular:

- **Breadth of ownership:** the tax best embraces all owners of wealth. This keeps down the tax's level relative to amounts raised; minimises disparity of treatment induced distortions and avoidance; and increases its fairness and legitimacy.

  The crunch is that this really needs to include corporate bodies (companies, trusts and so on) as well as personal wealth. As repositories of considerable wealth, their omission is economically and fiscally inequitable, and soon leads to their wholesale use to shelter wealth, thereby irredeemably undermining the tax and the amounts it can raise. Including corporate bodies, however, brings with it problems of how to assess corporate 'wealth', as company accounting practices intersect with drawing a double-counting 'ownership' line.

- **All wealth:** the tax best includes all types of wealth without differentiation. Again, this broadens the tax base yet is most economically and fiscally neutral, reducing distortions and avoidance.

- **Threshold, rates and progression:** a lower starting threshold broadens out the tax base, helping keep down rates while adding a degree of legitimacy. Conversely, the more the tax extends down the wealth spectrum or is insufficiently progressive the less it bites on inequalities, becoming just another inequitable imposition. Given

its marked inequalities, the UK might benefit most from a moderately high starting threshold combined with reasonably sharply progressive rates.

- **Benefits versus imposition:** the more the tax brings countervailing advantages, whether by mitigating other taxes or as a catalyst for other changes, the greater its potential benefits and acceptability. Conversely, the more it is just extra to pay and merely another complexity, the more onerous and less beneficial it will be. The quid pro quo can make all the difference to both introducing the tax politically and its ongoing legitimacy, particularly when it comes to avoidance or flight by those who have to pay it.

The greater benefit therefore lies in taking the bull by the horns and looking beyond a modest supplementary tax to a broader substantive tax on wealth in its own right, one that raises meaningful sums and can leverage wider tax changes (see section 5.4). The options for reform then depend on how far the country and its leaders are willing to go in shifting the tax loading from earnings to wealth generally.

4. CULPABLE COMPANY TAXES

The tax regime's third critical fault line is the way companies are taxed in Britain, where the contribution companies do or don't make intersects with the way these taxes are structured.

4.1 Not paying their way

Comparatively little tax is collected from company earnings – that is, profits and capital gains. Raising £39 billion in 2013/14 (or £34.5 billion excluding North Sea revenues), Corporation Tax contributes only 7 per cent of overall tax receipts. Representing just 2.5 per cent of GDP, this is among the lowest company tax contributions for a developed economy.

Where once company and personal earnings were taxed on the same basis, the passing of time has seen company earnings increasingly favourably treated. This has included increasingly permissive allowances and deductions, significantly lower tax rates and absence of any progressive higher rate tax. As a result, company earnings are today highly and disproportionately favoured compared to every other type of earnings or dimension of economic activity.

Successive governments had reduced the main Corporation Tax rate to 33 per cent by 1997 and then 28 per cent by 2008. The Coalition government is now reducing it year-on-year to 20 per cent by 2015/16, a cumulative tax cut of £6 billion a year for larger companies (but larger companies only – see section 4.4). The amount of Corporation Tax collected will now fall for the next five years even with the hoped for recovery.

On the basis of the headline Corporation Tax rates, the tax on company profits is only 33–38 per cent of the imposition on work earnings (see section 2.2). But the comparative tax rate is, in practice, significantly lower still. Company earnings are liable to tax only after generous deductions, allowances, specific tax breaks and relief schemes. Meanwhile, many companies, particularly the larger ones, avail themselves of extensive legitimated tax avoidance, on a scale that undermines and distorts the entire tax regime (see section 4.6). The result is an average effective tax rate of just 11–12 per cent on business profits actually made by companies operating or based in the UK, albeit with considerable variations between companies.

Companies overall receive far greater direct benefit from the £600 billion a year in public expenditure than they pay for and are, de facto, heavily subsidised at a systemic level. Even including other taxes paid by companies (see section 4.4), the cost-benefit account remains heavily overdrawn – and this is before getting into the indirect benefits all businesses accrue from the collectively provided enabling economic springboard (see chapter 1).

This favourable tax treatment and de facto subsidy is usually justified (if it's acknowledged at all) by the critical role companies' play in driving output, employment and growth. But this still depends on how effectively the way we're going about it really is: even if we want to support and encourage business, is this the best way of doing it? Nor does it necessarily follow that the relationship is not nevertheless too one-sided or that companies might not now pick up a bit more of the tab.

4.2 Failure to deliver

Successive cuts in Corporation Tax since the 1990s have failed to deliver their supposed economic benefits; and the present cuts will prove just as disappointing. The neoconservative 'free market' theory is that cutting taxes on company profits is the best way to encourage enterprise, growth, employment and investment – but this is not how it works in the real world.

The empirical evidence is clear that the UK's recent reductions in Corporation Tax have had negligible effect, whether on output or growth (to date or prospective), while making little difference to weak, deteriorating investment. Over a longer timeframe, reducing company taxes has brought little of the hoped-for benefits, accompanied by lower levels of growth, employment and investment than in comparable periods characterised instead by higher company taxes and more complementary private–public investment. Equally, each successive recent economic cycle has seen weaker UK growth, economic performance and investment in direct correlation to the pursuit of 'free market' policies.

The wider international and historical evidence bears this out. Just as importantly, to the extent that reducing corporation tax does bring any benefits, this is far from fiscally cost-effective. Much of the effect is simply dissipated and any gains are bought at a high price in taxes foregone. Indeed, the US Congress Budget Office recently concluded that such cuts are not only the least effective but also the least fiscally efficient ways of stimulating the economy (albeit the US one).

The underlying economics is also deeply flawed. It overstates (by an order of magnitude) the influence of changes or difference in corporation tax on production, employment and – particularly – investment. They are a small part of overall costs and do not (unlike labour taxes) impact on viability and profitability per se, merely the after-the-event tax on these profits. Equally, investment is overwhelmingly driven by other factors, with the general (market and sentiment driven) cost of capital framing an equation of markets, capabilities and costs. All of which is before taking into account the effects of funding such tax cuts, including how this affects businesses or offsets any benefits, whether directly or through the effects on overall demand and confidence.

Reducing taxes on company profits will not prove an effective means of encouraging the enterprise and growth this country needs, particularly in view of their already-low levels. Conversely, increasing these taxes, at least within limits, will have equally marginal negative effects. Even if we want to favour business, such cuts are a poor fiscal and economic investment. There are better ways of supporting companies and productive activities, whether through better focused tax concessions or increased direct public investment in business (see section 4.4). Meanwhile, the favourable treatment of companies compared to other types of endeavour causes its own differential-driven avoidance and reinforces wider economic distortions and imbalances.

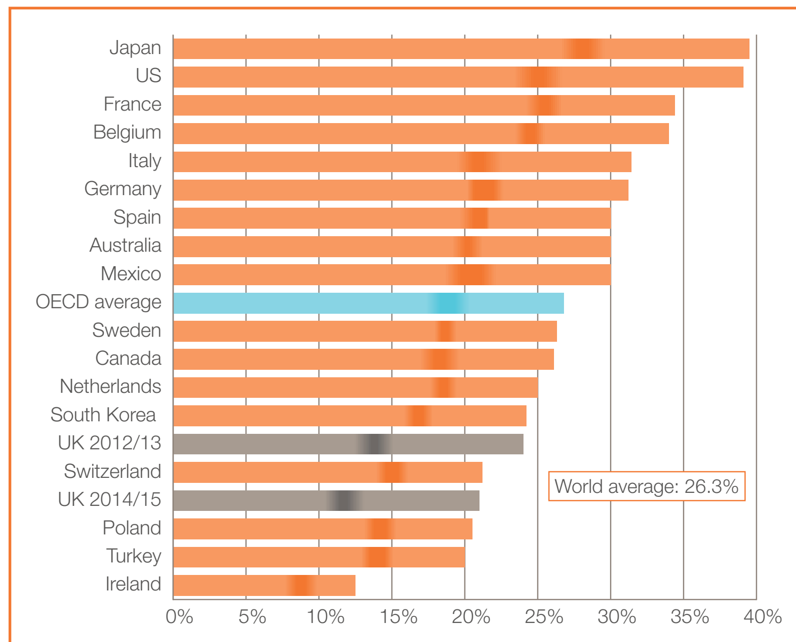
4.3 The competitiveness chimera

The advantages of or need to cut company taxes to boost competitiveness is also a chimera. Since the 1980s, while countries have lowered their tax rates on a tit-for-tat basis, the UK has consistently been towards the bottom end of the range of taxes on company profits (among all countries, not just developed economies). The most recent reductions in UK Corporation Tax make, at best, only marginal comparative difference.

The UK's comparative position is more favourable still when one considers the underlying, effective rate of tax. And this is without allowing for the UK's highly permissive approach to avoidance by international companies and capital. Recognising that there are substantial differences in effective rates for those who do and don't benefit (see section 4.6), competitively the UK already has some of the lowest 'actually paid' company taxes[1] – to little effect.

1 These are the 'effective economic rates of tax' – that is, effective rates of tax on actual profits earned in the economy, before taxable profits have been reduced by permitted avoidance (see also note 3).

Figure 4.1
Tax on company profits, OECD countries, 2012/13 (main corporation tax rate with distribution of 'actually paid' tax as shaded peaks, as % of taxable profits)



Note:
The distribution of 'actually paid' taxes represents an approximation of the tax rate paid on substantive profits before the actions of accountants and/or the use of legitimated measures that reduce the amount of nominal 'taxable profits'.[2]

The whole line of reasoning mistakes, or at least massively overrates the influence of company tax rates on competition. The rates of tax on profits – let alone marginal changes in already low taxes – are a small component in even the immediate cost equation for a business. This is then part of a far wider interaction of markets, capabilities and overall costs in which price competitiveness is only one facet of a company's viability, comparative advantages and profitability.

Taken together, competitiveness, incremental economic activity and incentives are surprisingly insensitive ('inelastic') to changes in levels of Corporation Tax within a range of 20–30 per cent, although they start to be more heavily affected beyond this range. It is far more about the ability to sustain and evolve competitive business capabilities and advantages, which brings us back to the lack of correlation between low company taxes and economic performance and the UK's underinvestment in the key drivers of long-term growth (see chapter 1).

4.4 Other taxes: costs versus profits

Companies, of course, also pay other taxes, such as VAT, employment taxes and various duties. It does not, however, follow that this redresses the balance for companies paying low taxes on their earnings.

Other people and activities usually pay these taxes as well (with companies again often treated preferentially), evening out the comparative scales. Equally, companies are often just the collection agency for taxes that are actually paid by the consumer or

2 Net company trading profits in the UK (before tax and exceptional charges), plus realised capital gains in the period, less average standard capital allowances (after offset to and depreciation based on average capital asset composition). As such, this excludes (a) special allowances/schemes/deductions, and (b) avoidance (albeit that it probably still lets much transfer pricing through the net).

user of a product or service; they only pay these taxes themselves on their own direct consumption. These are subsets of taxes that attach to the thing or transaction itself – they're built into the cost, for whomever or however they're used. Crucially, then, this is distinct from the tax payable on any profit a company makes after such costs: Corporation Tax is what a company pays on its own earnings after all costs, including any tax already wrapped up in these costs.

When it comes to labour taxes, a company technically pays only the employer's National Insurance contributions, and then 'collects' its employees' Income Tax and National Insurance contributions. From the employer's perspective, however, the job exists because of them and it is the total cost of labour – including all taxes – that has to be absorbed in the price of goods and services. Conversely, from the employee's perspective, all the tax comes off the back of their work and earnings. But, as discussed in section 2.6, this is precisely the problem with taxing work: attached to work itself, both as cost and reward, it straddles the employment relationship, inhibiting both sides.

Irrespective of who bears what burden, the incremental cost to companies of labour taxes still necessarily affects profits. This begs the question of why the tax regime should be so generous with its favours for business in terms of back-end profits while overloading front-end tax costs. By prevailing policy thinking, the priorities are this way around because it is the best way to create jobs and boost growth. But this is perverse.

The cost of front-end labour taxes impacts more heavily and more directly on the viability and competitiveness of a business (at least for those with labour costs, which as a generalisation biases towards more productive activities) and feeds through more directly into incomes, employment and demand. By contrast, channelling tax advantages through back-end profits and capital gains tries to leverage back from the far end of the business chain to the front. Meanwhile, any effect is necessarily dissipated through the generality of companies and activities, not to mention leakage as some of the benefits disappear 'offshore'. The US, Australia and Japan, for instance, prefer a mix of lower labour taxes but higher company taxes than the UK.

In the UK, under prevailing tax rates, disparities of treatment and respective levels of imposition, it is unambiguously labour taxes rather than taxes on company profits that are having the greater negative economic and competitive impact and, conversely, would if mitigated, most enhance economic performance. Indeed, it would be a positive economic bargain to reduce labour taxes at the price of increasing taxes on company profits.

Similarly, the economic benefits of well designed targeted tax concessions, tax-funded direct business investment and provision of low-cost, long-term finance are all generally significantly greater than from the same investment in general company tax concessions, particularly across the board cuts in Corporation Tax.

4.5 Company tax distortions and dysfunctions

Meanwhile the way UK company taxes work has considerable wider shortcomings.

Regressiveness

Corporation Tax is highly regressive in practice, rather than progressive to offset the advantages of size and market power. The top 100 UK companies pay an average effective rate of less than 5 per cent – and many pay nothing at all. On the other hand, the top 5,000 pay an average of about 11 per cent; your run-of-the-mill profitable SME pays about 17 per cent.

While the government has been reducing the main Corporation Tax rate for larger companies, the 20 per cent small company rate and the marginal relief on profits up to £1.5 million have been frozen and are to be abolished entirely from 2014/15. The difference between the nominal tax rates of the smallest and largest companies has now fallen from 10 percentage points (then a third of the main rate) to, shortly, zero. There is now nothing to offset the greater benefits larger companies derive from deductions, allowances, special schemes and, above all, avoidance. Nor is there anything to encourage new or innovative small or medium-sized businesses, precisely those for whom such incentives make the most meaningful difference.

The new £2,000 allowance for employer's National Insurance provides some small consolation for the smallest companies; but this is swamped by the effects of overtaxing work and the wider regressiveness of company taxes generally.

Bias towards rent-seeking and finance

At a systemic level the favourable treatment of companies and tax concessions are general, hence indiscriminate, and favour profits over costs, merely compounding wider propensities in the economy. Similarly, the system's bias against productive activities (as discussed below) makes rent-seeking and financial activities easier and more profitable by comparison.

Specific provisions then reinforce these systemic leanings. Rents and financial returns and expenses (such as interest) are often more favourably treated than substantive goods and services. There is a raft of tax breaks and subventions that benefit the finance sector (albeit these have other aims in mind: from underwriting business lending and now mortgages, through pension relief and ISAs, to investment relief to quantitative easing – not to mention the massive bailout of the banks). On top of this, again, sits the favourable tax treatment of property, support for large landed interests, and concessions and tax-breaks for developers.

Bias against the substantively productive

Conversely, the tax system works against those who generate value or output from more than existing ownership alone.

Again this starts with impositions being general and penalising costs over profits, hence indiscriminate and reinforcing wider business propensities. And is in part the reverse face of the advantages of rent-seeking and finance making productive activities less attractive. These are then reinforced by 'hot' money swirling back and forth from the offshore realm into the domestic economy (see section 4.6), with its predilections for short-term and speculative over more productive investment.

But the crunch is the heavy taxing of work. In general, substantively productive activities have more work in the costs and investment mix (indeed, providing work is prima facie affirmation of an activity being substantively productive). And, conversely, the costs of labour are generally the single largest cost and investment for substantively productive activities. Loading tax onto work simply creates a bias against activities using or investing in labour and people.

Some compensation is provided by a range of permissive capital, R&D and investment allowances – subject to recent reductions in the first and extensions of the latter. Sensible as these may be, such measures are filtered through and dissipated by the regime's general weaknesses. Given the UK's demonstrable shortfall in investment in its productive capabilities, these measures are clearly insufficient to swim against the tide of high labour taxes and wider systemic biases.

Market power over innovation
The tax system ends up reinforcing market power and, conversely, militates against innovation. The combination of effectively regressive company taxes, greater benefits from allowances and so on, and the permissive licence given to 'offshore' trepidations heavily favours larger, established incumbent companies, particularly multi-nationals.

The pattern of market power in the UK already leans heavily towards return-seeking from existing markets over the evolution of new capabilities, products and markets. This is then compounded by a tax system that (all rhetoric aside) weighs against innovation and enterprise. All the biases against the substantively productive and in favour of the rent seeking and market incumbents are at their most acute when it comes to breaking new ground, particularly the adverse effects of high labour taxes. Yet the tax system offers little meaningful positive support for new or innovative businesses. There are, for instance, no specific start-up provisions (whether for labour or company taxes) and now no progressive dimension to company taxes whatsoever.

Friendly fire
Finally, the tax system is biased against domestic UK businesses, particularly those trying to play with a straight bat. Heavy labour tax costs necessarily weigh against those businesses that employ people in the UK. And, critically, the combination of market power and the free reign of the 'offshore' realm within the domestic economy gives all the advantages to multinational companies, 'offshore' entities and those showing the least commitment to the country.

4.6 Avoidance, and the cannibalism within

Again and again with UK tax system one comes up against the 'offshore' dimension. For most people this conjures up money salted away in accounts abroad or clever international schemes to dodge a bit of tax. But it is much bigger, more insidious and more damaging than is generally understood.

Nurtured in our midst there is an entire parallel, extra-jurisdictional realm of finance that's free to trample over the 'official' tax system and economy. Through a network of company and trust shelters, offshore ownership, transfer pricing, secrecy jurisdictions and international banks, vast sums of money freely move around within the economy in an alternative dimension that works by different rules.

The damage starts with legitimating wholesale tax avoidance by British companies and nationals, on a scale that cores out the UK tax base, particularly the taxes from companies. One can only guess at the numbers.

HM Revenue and Customs puts the 'tax gap' at £40 billion a year across all taxes (including £7 billion in Corporation Tax and £15 billion in VAT). However, as this is just the shortfall against known activities under existing tax provisions, this leaves out 'legitimate' tax avoidance at one end and hidden activities and wealth at the other.

The tax lost through overt avoidance is estimated at £8–15 billion a year in company taxes and £8–10 billion in personal taxes. This then shades off into legitimated 'mitigation' of at least twice as much again. The hidden economy – secret, grey and black – is yet more impenetrable. It is thought to be equivalent to 9–11 per cent of GDP, the taxes on which would be £45–60 billion a year. Similarly, the best guess would be that £125–150 billion is held in offshore bank accounts and hidden liquid assets from an overall total of four to five times as much generally tucked away in the 'offshore' realm by British companies and citizens.

Recovering even some of this would go a long way to solving the fiscal problems. Meanwhile the lost tax revenue has to be made up from other sources: it takes the equivalent of the income taxes from 2 million average households to replace each £10 billion lost through avoidance.

Meanwhile, 'offshore' is given unrestrained licence to operate businesses and own assets in the 'official' economy on preferential terms, even to 'virtualise' itself from within. A company can be 'offshore' simply by having its registered office and board meetings abroad (even nominally), and a bank or trading desk here can simply be designated as 'in' another country. Or those with the means can readily claim to live or 'belong to' somewhere else, while in essence their lives, businesses or wealth are in or from the UK.

The larger, multinational and 'offshore' companies that most benefit gain significant market, competitive and financial advantages. Given the breadth and depth of the inroads, the effect on tax, markets and the economy is far from marginal or peripheral – rather, they feed down the entire tax and value chain. Tentacles extend deep into the economy. The string of foreign takeovers of major British companies has in large part been driven by 'offshore' giving buyers an otherwise illegitimate advantage in acquiring and operating businesses. In nearly every case the takeover is immediately followed by 'moving' the business out of onshore tax jurisdiction into the 'offshore' realm. Similarly, the real key to the success of private equity firms is the same trick of moving acquired companies 'offshore' at the expense of UK tax revenues.

And it's corrosive. Given the advantages, others come under relentless pressure to follow suit. Facing the threat of even more revenues disappearing down the rabbit-hole, the official tax regime comes under pressure to reduce its taxes. This begets a downward spiral of culpable amorality to companies and the better-off not paying their full taxes, while demanding yet more tax cuts. This is now profoundly undermining the legitimacy of the tax regime, fuelling resentment and divisions over who is paying and who is benefiting. Meanwhile, commitment to the country and national economy are eroded by all the advantages going to those who demonstrate it least.

But there is a final, important wrinkle. Britain isn't merely complicit in all this: through the City of London and a network of British dependent territories, it is the world's biggest player. UK banks, markets and professional firms aid and abet not just our own but also everyone else's tax-dodging, illicit money and hidden wealth. But this Faustian pact isn't worth the cost to our collective interests: the gain for a few bought at too high a price to our economy and taxes. Curtailing such activities is not, however, without hypocrisy. We nevertheless need to stop it happening here even if some of our businesses were or are up to no good elsewhere.

The chancellor has recently introduced a raft of new anti-avoidance provisions. These are the first serious attempts to go beyond simply closing off obvious loopholes, raising an extra £1 billion or more a year (across all taxes). On the other hand, they still only scratch the surface: two-thirds of the extra tax comes from just two of these new measures. Meanwhile, the entire system of differential tax rates, sheltering of profits, offshore ownership, residency statuses, secret ownership, transfer pricing and the rest has been surreptitiously reaffirmed and continues unabated.

4.7 Taxing financial transactions

Symptomatic of the tax regime's rent-seeking and financial bias is the favourable treatment of financial transactions. These are often exempt from the kind of taxes that apply to nearly every other type of transaction (for instance, they are not generally subject to VAT). And the taxes that do bite on financial transactions – Stamp Duty and Stamp Duty Reserve Tax – are narrowly conceived and biased against productive investment and towards speculation. While tax applies to financial instruments that vest substantive value (such as shares), it doesn't apply the likes of derivatives or contracts for difference to the same extent: literally, the more speculative the activity the less tax that applies.

This simply compounds the financial system's worst propensities, fuelling systemic volatility. Conversely, the City's PR exaggerates the adverse and competitive effects of encroaching on the favourable tax treatment of financial transactions, particularly in view of the wider international moves towards increasing such taxes.

5. A NEW TAX SETTLEMENT FOR TODAY'S BRITAIN

5.1 Comprehensive multidimensional reform

The British tax system badly needs reform. Given its shortcomings, these reforms need to be far-reaching and, given the intersecting and conflicting imperatives, comprehensive and multidimensional.

At the epicentre is the need to improve economic performance while still paying for necessary public services, in the face of ongoing shortfalls between taxes and expenditure. With government austerity policies failing, it is already the case that more needs be raised in tax. Britain's circumstances and profound economic challenges dictate not just sustaining public investment but also looking to invest more – and more effectively – in our own economic future.

Mutually reinforcing and deep-rooted along critical fault lines, the tax regime's shortcomings exact a high and detrimental price, often exacerbating rather than redressing wider economic, inequality and fiscal problems.

Through their respective ideological lenses, the political left and right see only the aspects of the problems that speak to their interests, all but denying the others. Yet the failures of the tax regime itself doom their present policies to fail.

Britain needs a new tax settlement which enhances the economy, changing the tax–performance dynamics, while more fairly and equitably raising sufficient tax to properly sustain public expenditure and investment, each the prerequisite for and complement to the other. And these changes need the scale and impact to make a meaningful difference.

Sufficiently comprehensive multidimensional reforms, however, might yet enable Britain to square this circle. This report concludes by putting forward a framework of reforms that would make this possible. Using the present regime's critical fault lines as the axes for reform, it plays the needs, constraints and opportunities of one against the other. Here, economic performance is improved by greater fairness and equity, and improved economic performance better sustains the public sector. Equally, companies contribute more, but by and through greater emphasis on productive, performance-enhancing activities.

5.2 Enhancement through equity: earnings taxes

The first axis of the proposed comprehensive reforms is to relieve the overtaxing of work while bringing treatment of different types of earnings together into a common unitary tax regime. Economic performance is to be enhanced through greater equity, fairness and consistency.

Reduce work taxes and abolish National Insurance

The first step is to abolish National Insurance for both employers and employees, cancelling most of it and merging the rest into a new all-inclusive Earnings Tax.

Pivotal, reducing work taxes mitigates the impositions, costs and disincentives at the most critical juncture of business and the economy while going to the heart of present tax inequalities and dysfunctions. All those who work for a living and employ others benefit. It encourages employment and investment in activities involving employment. And it's the best – probably only – means with the breadth and depth of impact to now meaningfully affect the UK's economic dynamics.

National Insurance is the obvious line of attack for reducing work taxes. Bought at a high economic price, it's an increasingly anomalous penalty on employment over other types of

earnings. The benefits of its abolition feed through to both employers and employees, with its regressive effects and redundant dual administration falling away in the process.

For employees, National Insurance disappears entirely, significantly increasing take-home pay, while the remainder is merged into the inclusive Earnings Tax. For employers, while National Insurance disappears as separate tax and they see 60 per cent of its present cost remitted, they retain a reduced obligation but now fully integrated with PAYE. This is here set at 6.75 per cent on pay over £10,400 in 2013/14 (compared with the 13.8 per cent over £7,630 currently).

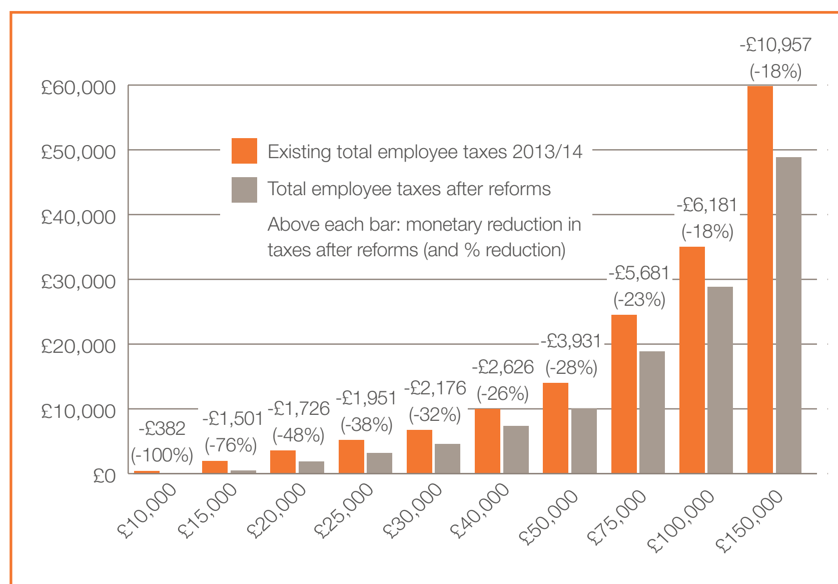
Unitary Earnings Tax

Employees now pay an all-inclusive Earnings Tax on income over a significantly increased tax-free personal allowance, with this in turn setting the benchmark for taxing all types of earnings. Specifically:

- a personal allowance and age-related allowance of £13,250 in 2013/14
- standard rate tax of 27.5 per cent (in place of the present 32 per cent for tax and employee national insurance combined)
- higher rate tax of 35 per cent on total annual earnings above £50,000 and 40 per cent above £75,000.

Deliberately pegged to 50 per cent of average pay, the increased allowance gives all taxpayers greater bedrock of entirely untaxed income. It removes many with low incomes from the tax net altogether – and in passing replaces some circular aspects of tax credits (while retaining them otherwise). Now unitary, all earnings come under the one single allowance, specifically including capital gains, which lose their separate allowance.

Figure 5.1
Change in personal taxes before and after reforms, by annual employment income bands



The 27.5 per cent standard unitary tax rate best balances between remitting existing taxes, optimising the economic incentives and raising enough money. The progressive rates and thresholds, however, intersect with whether and how wealth is taxed (see section 5.4).

Without any tax on wealth, fairness, inequalities and need to raise more tax would dictate sharpening yet flattening progression: taking top rates higher but reaching them more gradually. But this would merely compound the regressive impact on work and all its consequences for costs and disincentives, while wealth and its entrenched inequalities remain relatively unaffected. It therefore makes sense not only to move some of the tax load onto wealth but also some of the progression, relieving the regressive imposition on work generally, including on middle and higher earners. This in turn is an overt quid pro quo for introducing a tax on wealth.

A fair and consistent tax on earnings

The new unitary earnings tax regime would be consistently applied across all other types of earnings, minimising disparities in treatment and remaining differences in rates.

The new tax rates and thresholds would apply all types of unearned income – dividends, rent profits, interests, trust earnings and so on – without exemptions, special allowances or deductions. Capital gains would now also come under the same rates and single allowance. The 27.5 per cent standard rate also extends to the main corporation tax rate, with the two pegged together (see section 5.3).

The standard tax rate for unearned income therefore increases by between 7.5–17.5 per cent. This is mitigated, however, particularly for those with low unearned incomes (such as pensioners) by the big increase in the personal allowance. The higher rates for most types of unearned income would also be lower than they are today, except for dividends and most capital gains. This decrease in the higher rates reflects the general shift of the tax load from earnings to wealth, part of the overt quid pro quo.

Closing off avoidance

Finally, the mitigating and avoiding of personal income taxes would be sharply curtailed. As part of rooting out the legitimating means for such practises (see section 5.4), this would target company and trust sheltering of income, use of offshore and residency statuses, personal charities (not real ones), and curtailment of excessive use or abuse of allowances and relief schemes.

5.3 Rebalancing company taxes

The second axis of comprehensive reform is to rebalance company taxes towards substantively productive in preference to rent-seeking and financial activities. In exchange for reduced front-end labour tax costs and greater public support focused directly on productive enterprise, growth and investment, companies will be required to contribute more from their back-end profits and wealth.

Increasing corporation tax

The main Corporation Tax rate for company earnings (profits and gains) would be increased to 27.5 per cent, bringing it into line with the now unitary standard rate for personal earnings. This merely returns it to earlier (unproblematic) levels and would have only limited effect on output, growth or competitiveness, even if it were not for the countervailing benefits of reduced labour taxes.

At the same time, the underlying effective of rate would be driven up by the combination of:

- the increase in the main company tax rate
- reducing general permitted deductions (particularly of interest) and general allowances (in scope more than rate)

- revoking or reducing some of the present specific tax breaks and schemes
- curtailing favourable capital gains treatment
- vigorously closing off legitimated avoidance and the 'offshore' realm within.

Critically, there is also a new wealth component to Corporation Tax. Based on 'net retained capital' (see section 5.4), this is a significant additional imposition on companies, although again it is part of the trade-off against reduced front-end payroll taxes.

Reduced labour taxes

The increase in tax on company earnings and wealth is, however, in the overriding context of companies first benefiting from reduced labour taxes.

The abolition of National Insurance sharply cuts employer labour taxes and increases the threshold at which these kick in. British employers, private and public, are relieved of 60 per cent of the £62 billion currently paid in employer National Insurance contributions. This is on average a 5–6 per cent reduction in total payroll costs.

The benefits feed directly through to increased margins, competitiveness and profitability. Companies also benefit indirectly as the reduction in earnings taxes generally reduces the wider costs of labour and the lowering of higher-rate income taxes mitigates regressive costs and disincentives.

In the process, tax impositions are moved from front-end costs and competitiveness to back-end profits. The increases in Corporation Tax bite only after labour tax savings have already reduced tax outgoings and enhanced profits. For many companies – those with material labour costs and a large part of their operations in the UK – these tax savings outweigh the countervailing increase in tax on corporate profits and wealth, with any increase in company performance or competitiveness an added bonus (see section 5.6).

Incentivising the productive and enterprising

Meanwhile, various measures would refocus tax advantages towards productive and enterprising activities over the rent-seeking and financial.

Corporation Tax would have sharper progression. A 15 per cent small company rate is reintroduced (providing a discount of 45 per cent) and extended to qualifying start–ups, together with marginal relief on taxable earnings up to £1 million (or over three years from starting).

Deductions, allowances and the numerous specific schemes would be overhauled to emphasise the productive. Some would become less indiscriminately available (such as capital allowances) or tightened (such as the deduction of interest); others would be made more generous, on a more targeted basis. This would include reintroducing high first-year capital allowances, but only for demonstrably productive activities, as well as deeper but narrower R&D and product development allowances.

A wider financial transactions tax

Tax on financial transactions – currently Stamp Duty and SDRT – would be broadened and extended, taking in a wider sweep of transactions to become a general financial transaction tax, at a slightly lower level than was recently proposed by the EU. The usual objection – that this might competitively disadvantage the City – is met by Britain's joining the nascent broad international consensus in favour of taxing financial transactions. Indeed, Europe has been irritated by our reluctance to do so already.

An assault on avoidance

Finally, a vigorous and robust assault is made on avoidance and the 'offshore realm within' – not just the loopholes but on their embedded, legitimated means. This includes:

- adhering vigorously to the principle, 'if it is here or operates here or is owned by a UK business then it's strictly taxed here and taxed equally'
- restricting who can use offshore ownership or residency statuses
- shutting down transfer pricing (including fully disclosed national accounts as a statutory requirement)
- robust controlled (and deemed controlled) foreign company rules
- curtailing the rights of tax-haven offshore entities and those who use them to own or operate in the UK
- stronger, better resourced exchanging of information and enforcement.

Domestic measures would need buttressing internationally (building on existing initiatives) and, equally, would spill over into ongoing banking reform.

5.4 Taxing wealth: the decider

The final axis of the proposed reforms is to introduce a general tax on wealth. This closes the circle by both raising sufficient tax revenues for the fiscal sums to add up and providing a fairer, more effective progressive dimension to tax.

Having decided to tax wealth, the issue becomes one of how much tax imposition is shifted onto wealth. This determines how far wider reform can go. The extent work taxes can be reduced, the level and progression of the new unitary earnings taxes and how far company taxes can be rebalanced all turn on the tax generated from wealth.

At one end of the scale is a narrow tax that raises limited amounts and is merely supplementary to existing taxes; at the other end is a broad substantial tax that raises transformative amounts. The reasons for taxing wealth, the UK's fiscal, economic and inequality challenges, the inherent dynamics of such taxes and the lessons of experience all pull towards a substantive, well-grounded tax in its own right, not just a bolt-on to existing taxes. A better wealth tax embraces breadth of ownership, captures all types of wealth equally, balances a broad base and progressive bite, and brings benefits as well as impositions – ideally framed as a clear quid pro quo.

The wealth tax proposed here therefore moves a significant tax burden onto wealth, including critical aspects of the tax regime's overall progressive taxation. It is substantial enough to provide the equivalent of 9 per cent of today's total tax receipts. By leveraging a big enough reduction in employment taxes, this makes it possible to simultaneously enhance economic performance, sustain necessary public investment, and start to get to grips with the UK's marked inequalities.

The general wealth tax

The specifics of the proposed general wealth tax are:

- **Ownership:** The tax applies to all owners of wealth of British nationality or residing or operating in the UK, including individuals and bodies corporate (companies, trusts and so on) without differentiation (particularly, without exemption for offshore ownership or non-domiciles).

- **Total net wealth:** It would embrace all assets of value, wherever located, without differentiation, deductions or exemptions, at their open market value less stipulated liabilities.

  This includes company wealth on the basis of 'net retained capital': total assets at market value, plus net current assets/liabilities excluding debt, less a fixed proportion (here 80 per cent) of equity and debt at its original subscription value (hence excluding subsequent attributable earnings, interest or appreciation).
- **Above £150,000:** Only net wealth above the threshold is liable to tax, whether for companies or individuals. This best balances the breadth of tax base, liability only starting at a substantive level of wealth, and avoiding excessive, less cost-effective administration. Numerically, 70 per cent of individuals and 75 per cent of companies would have nothing to pay.
- **Progressive rate:** A progressive rate of 0.5–1.5 per cent a year above the threshold then best balances between acceptable tax rates, graduated impositions but with enough progressive bite, and the total amount of tax raised.

Table 5.1
Proposed general wealth tax: thresholds, rates and progression

	Threshold	Rate
Starting…	£150,000	0.50%
Top-rate…	£1,000,000	1.50%

Net wealth	Tax payable per annum	Tax rate on total
£150,000	£0	0.00%
£250,000	£618	0.25%
£375,000	£1,721	0.46%
£500,000	£3,191	0.64%
£750,000	£7,235	0.96%
£1,000,000	£12,750	1.28%
£1,500,000	£20,250	1.35%
£2,500,000	£35,250	1.41%

Notes:
Assumes taxpayer below retirement age.
This is a straight-line progression, not bands, as this is a superior approach – but the difference is not material.

Substantial tax revenue

Pro forma UK net personal wealth is £7.7 trillion. After adjustments, particularly for pensions, and allowing a margin for error, this translates into a tax pool for the wealth tax of £5.6 trillion. Similarly, after necessary adjustments and margin for error, UK companies hold £1.3 trillion in net retained capital (as defined above); and trusts and other institutions have net wealth of £152 billion.

Allowing for wealth distribution, the progressive rate and non-collection (particularly at the outset), the new tax would raise £50 billion in 2013/14: £33 billion from individuals, £15.7 billion from companies, and £1.6 billion from trusts and institutions. Critically, this is the magnitude of resources, hence onward leverage to address the wider fiscal and economic problems.

Table 5.2
Wealth tax revenues, estimated 2013/14

	Taxable wealth (£bn)	Wealth in… Below £150k threshold	£150k–£1m band	Above £1m threshold	Liability to tax (£bn)
Personal wealth	£5,641	£1,434	£3,046	£1,161	£33.0
Average rate	n/a	0.00%	0.54%	1.42%	0.79%
Corporate wealth	£1,281	£126	£179	£975	£15.7
Average rate	n/a	0.00%	0.70%	1.48%	1.36%
Trusts and other assets	£152	£19	£39	£94	£1.6
Average rate	n/a	0.00%	0.80%	1.40%	1.22%
Total: all wealth	**£7,074**				**£0.3**
Average rate	**0.71%**				**0.92%**

Dovetailing with inheritance tax

While the wealth tax and inheritance tax serve different purposes, attaching to the lifetime and intergenerational benefits of wealth respectively, the two need to dovetail to avoid inconsistency and duplication – death triggering a one off 'capital' levy in place of the ongoing lifetime 'benefit' tax.

Meanwhile Inheritance Tax needs reform to return it to being a meaningful tax (see section 3.3).[3] Its wholesale exemptions and avoidance would be curtailed, significantly widening the tax net, while a progressive element is introduced to the rates, with the standard rate pegged to the new unitary Earnings Tax rate and the top rate pegged to the present 40 per cent rate – together taxing a lot more wealth at generally lower but progressive rates.

Wealth tax avoidance

To prevent avoidance there would be general intent or purpose and common and deemed ownership provisions as well as the more general curtailment of the current legitimated means of avoidance. Avoidance, however, is as much a question of the carrot as the stick, that is of the extent to which the new imposition here also brings countervailing benefits (see section 5.6).

5.5 Better and fairer tax

The proposed reforms together offer the UK the potential to meet its otherwise intractable and conflicting fiscal and economic problems.

Fiscal payoffs

The all-important litmus test is that the sums add up. Amounts raised under the reforms from new and increased taxes cover the lost revenues and costs of the other measures. Crucially, the tax reforms are broadly fiscally neutral at the outset. As their effects are then felt in terms of economic performance, increased demand, employment and growth will in turn generate additional taxes, helping to improve the public finances.

Table 5.3 (over) summarises how the proposed reforms come together. It is vital to stress, however, that this is indicative only. Forecasts are necessarily hostages to the future and here depend on bringing together the impact of complex, far-reaching tax changes. For comparative purposes they also (unrealistically) assume that all the reforms are fully in effect immediately.

3 Or, alternatively, replaced entirely with a capital receipts tax collected with the new wealth tax – see Dolphin T (2010) *Death and Taxes: Why Inheritance Tax should be replaced with a Capital Receipts Tax*, London: IPPR. http://www.ippr.org/publication/55/1818/death-and-taxes-why-inheritance-tax-should-be-replaced-with-a-capital-receipts-tax

Subject to these caveats, the reforms initially make only a small but helpful contribution to closing the fiscal gap (in the first year primarily thanks to the reduced work taxes also reducing public sector labour costs). As, however, the changed fiscal dynamics and enhanced economic performance feed through over time, the fiscal benefits increase to levels where they can also underwrite much-needed public investment.

Economic gains

Just as critically, significantly reducing work taxes and other of the reforms enhance economic performance, reducing costs and disincentives and boosting profitability, incomes, employment and competitiveness, in turn helping drive demand, output, investment and growth. Equally, rebalancing the economy towards productive activities and putting the public sector on a sounder footing underpinned by economic reinvigoration strengthens long-term performance and promotes the development of new economic capabilities.

Table 5.3
Indicative fiscal impact of proposed tax reforms (estimated £bn)

	2013/14	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Estimated change in GDP growth with reforms	0.25%	0.50%	0.75%	0.57%	0.46%	0.41%	0.36%
Changes to Personal Taxes:							
Merger NI into unitary standard Earnings Tax (net)	-£17	-£17	-£17	-£19	-£20	-£21	-£20
Increase in personal and age-related allowances	-£19	-£20	-£21	-£23	-£24	-£25	-£23
Revised unitary higher rates and thresholds	-£10	-£11	-£11	-£11	-£11	-£11	-£11
Revised unearned and avoidance closure	£5	£6	£6	£6	£7	£7	£7
Capital gains tax merger and other measures	£3	£4	£4	£4	£5	£5	£4
Wealth Tax: individuals and trusts etc	£32	£33	£35	£36	£38	£39	£40
Combined personal tax changes	-£7	-£5	-£5	-£6	-£7	-£6	-£2
Accruing from economic performance (to all above)	£1	£3	£7	£11	£14	£16	£18
Total changes to personal taxes	**-£6**	**-£2**	**£3**	**£5**	**£8**	**£10**	**£15**
Changes to Business Taxes:							
Employer NI foregone: Non-businesses	-£9	-£9	-£9	-£10	-£10	-£11	-£11
Employer NI foregone: Business	-£27	-£28	-£30	-£33	-£35	-£37	-£36
Corporation Tax: all earnings changes	£9	£12	£13	£14	£15	£16	£16
Corporation Tax: on retained capital (wealth)	£15	£16	£17	£18	£19	£20	£20
Financial transaction taxes	£6	£6	£6	£7	£7	£7	£7
Combined business (only) tax changes	£3	£6	£7	£5	£5	£5	£7
Accruing to economic performance (all business)	£0	£2	£3	£5	£6	£7	£8
Total changes to business (only) taxes	**£3**	**£7**	**£10**	**£10**	**£11**	**£13**	**£15**
Inheritance Tax changes	£3	£3	£3	£3	£3	£3	£3
Effect of reforms on other taxes: as is	£3	£3	£3	£3	£3	£3	£3
Effect of reforms on other taxes: from changed economy	£1	£3	£7	£11	£14	£15	£17
Savings top unchanged public expenditure (NIC etc)	£12	£12	£14	£14	£14	£14	£14
Total fiscal changes in year	**£5**	**£17**	**£29**	**£36**	**£42**	**£48**	**£57**
CUMULATIVE FISCAL BENEFIT	**£5**	**£22**	**£52**	**£87**	**£130**	**£178**	**£235**

Again subject to the all-important caveats, analysis suggests that these reforms would add 1.75–2.25 per cent cumulatively to GDP growth in the three years after their introduction, and then 0.35–0.5 per cent a year to ongoing growth. Equally, the reforms increase employment and its sustainability, reducing immediate unemployment faster and further than at present while cutting into long-term structural unemployment.

Conversely, the wealth tax is clearly an economic imposition on wealth. Putting flight risk aside for the moment (see section 5.6), the tax's relatively low level should, however, only have limited impact on investment and wealth accumulation. Indeed, it should have some positive benefits, by encouraging efficient use and deployment of capital. Some of the tax's effects are also offset by increased returns from assets, particularly those with a work component in their returns/value.

Similarly, increases in corporation tax, standard rate tax on non-work earnings and financial transactions each have their economic downsides as impositions and disincentives. But again this is limited and legitimate (as well as rectifying existing unfairness or favour). And again there are important offsetting positives, such as the increased allowance and reduced higher rates on the personal income side or reduced labour taxes and targeted support on the business side.

Overall ongoing economic benefits from the reforms would more than offset the negatives of the new tax impositions, improving overall economic performance and growth.

Addressing fairness and inequalities

Last but not least, the reforms are fairer and more effectively address inequalities, and can legitimately be presented as fair in terms of who, what and how the new regime taxes. This extends from rectifying the unfairness of overtaxing work while undertaxing other earnings, companies and wealth, through more equitable progressive taxation, to working directly on the wealth that is at the nexus of entrenched inequalities.

Figure 5.2
Income tax progression, with and without reforms

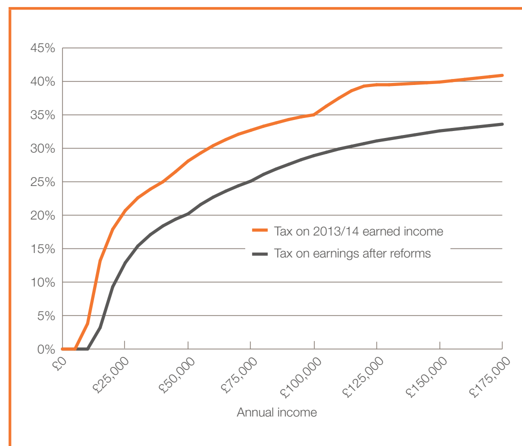
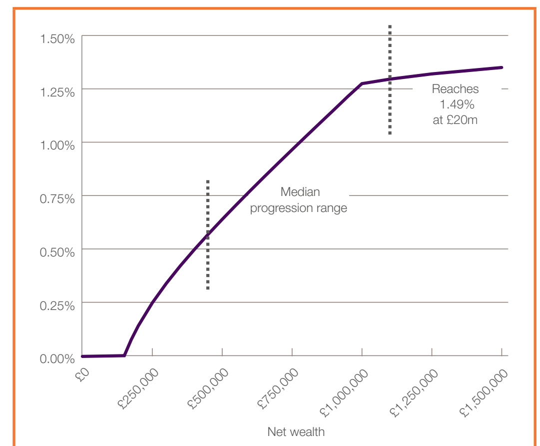


Figure 5.3
Wealth tax progression



5.6 Winners, losers and quid pro quos

The far-reaching changes proposed here necessarily produce winners and losers – in a sense, that's precisely the point. And, of course, we all gain from the country's finances and economy being put on a sounder, more positive footing; although the losers won't necessarily see it that way.

Overall, the reforms give rise to numerically more winners than losers. As well as politically essential (see section 5.7), this confirms the reforms as both non-zero-sum and redistributive. Given, however, that the reforms are broadly fiscally neutral before any improved economic performance kicks in, this necessarily means that the losers are losing out proportionately more heavily than the gainers are gaining.

Earned incomes

Work, employment and earned income is the big winner. At the rates and thresholds proposed here, those at all levels of pay see meaningful reductions in taxes and increasing take-home pay.

Those on low incomes gain most from the increased personal allowance; those in the middle gain from a combination of allowance increase and more graduated progression; and those at top gain most from the reduced higher-rates taxes. Low earners gain most proportionately while high earners gain most in absolute terms. To the extent that income is entirely earned, with no assets behind it, the effect is deliberate, reducing the regressive disincentives against carrying out or adding value to all work at all levels.

For the majority of taxpayers – those with little unearned income and net wealth of less than £150,000 – this is as far as the story goes. For others, reduced employment taxes then intersect with changes in the taxing other types of earnings and exposure to the new wealth tax.

Non-work earnings

The impact of the reforms on those with unearned income is more mixed. On one hand, there is a significant increase in the standard tax rate on non-work earnings; on the other, there is a substantial personal allowance increase and lower, less sharply progressive higher rates. These calculations are then complicated by the present diverse treatment of different types of earnings (see section 2.2). For given taxpayers, the impact therefore turns on the proportion of income that's unearned; the present classification of the earnings; and their total income.

Overall, those with lower incomes and/or a modest proportion of unearned income still come out ahead. However, the higher the income or greater the proportion of income that is unearned, the more these gains are eaten into. The amounts or proportion of unearned income, however, need to be high before income taxes increase overall.

Wealth

For the one-third of taxpayers with over £150,000 in net assets, changes to earnings tax then intersect with their liability to the wealth tax, where wealth is progressively the big loser.

The vast majority who primarily work for a living still see their total tax bill fall, even those with relatively substantial wealth. Conversely, as wealth increases, both overall and relative to any given income, the more the wealth tax liability overtakes the income tax gains. At the same time, the more income that is unearned, the less the benefits of the new earnings tax regime mitigate the wealth tax.

Critically, there are offsetting benefits for the wealthy. They still share in the benefits of the improved earnings taxes, particularly the reduced higher rates. Equally, returns from wealth are enhanced to the extent that they include a labour component in their earnings/value or benefit from the company tax reforms. There is, therefore, an explicit economic and political quid pro quo on offer, reducing the risk of capital flight. Counterintuitively, this speaks to a broader rather than narrower wealth tax – only a sufficiently substantial wealth tax makes it possible to offer enough 'in return', where a more limited tax would merely serve as a fiscal band-aid.

The final variable is how productively wealth is being used. The more productive the use, the less burdensome the imposition as a proportion of the returns and/or the more likely it is to benefit from the reforms insofar as they are targeted at enhancing productive activities. Conversely, the more wealth is being used unproductively and/or the value lies in ownership alone, the fewer offsetting benefits there are to counter the new impositions.

The relatively few who lose in all respects are those with excessive underproductive wealth – in other words, precisely the kind of indolent (often inherited) wealth where inequalities are least justified and most economically and socially damaging.

Businesses

For companies, there's a trade-off between benefits gained from reduced front-end costs and support measures and, conversely, the extent to which they lose out from increases in Corporation Tax on earnings and corporate wealth (that is, retained capital).

For any given business, then, the key factors are:

- size of the business (overall and amount of profit)
- proportion of labour in the costs and investment mix
- amount of retained capital
- net gain/loss from increasing targeted measures while tightening general ones
- whether activities are in the UK or overseas
- current use of avoidance and 'offshore' mitigation.

All of these interact in the context of changed cost and competition dynamics feeding through to output and profitability.

For most British businesses – those with payroll costs, asset levels and profitability reasonably within the norm – the overall effect of the tax changes is positive even before any anticipated performance improvement: the reduction in labour taxes and encouragement of UK investment outweigh the increase in taxes on profits and retained capital.

Conversely, for large businesses with little employment or few domestic UK activities and high levels of underproductive retained capital, the additional impositions outweigh the benefits. Many would be net losers, potentially heavily so at the extremes, particularly those who are heavily reliant on purely rent seeking activities and/or currently make extensive use of avoidance or offshore measures.

Meanwhile, the wider reforms are also about paying for necessary public expenditure to underpin the economy and growth – with British companies the first in line to garner the benefits of re-establishing the virtuous, mutually complementary dynamic that can exist between the public and private sectors – at least when done well.

5.7 The political opportunity

The political as well as economic need and opportunity for far-sighted comprehensive tax reform is now upon us.

Current policies are demonstrably failing and the Coalition government is running out of road. Nonetheless, the Labour opposition is perceived as lacking a credible plan for the economy – and, therefore, for addressing the deficit or delivering aspirations for greater fairness, where it's up against the limits of the existing tax system. There is widespread, visceral resentment at the tax regime's failings and unfairness, as well as deep foreboding about the stagnating economy and whether the country can surmount its challenges.

The reforms proposed here put – and would be seen to put – economic performance centre-stage, providing a clear strategy for improving employment, growth and competitiveness. And across the board cuts in employment and income taxes have obvious broad political appeal, making common cause between all who work for a living while stealing traditional Conservative thunder. Yet the reforms also provide succour to all who work in and support the public sector. Equally, redressing unfairness and inequality are here integral parts of the economic solution, not just social choices – fairness and economic improvement become synonyms not oxymoronic.

The reforms might, therefore, attract broad support across the political spectrum. Conversely, business and wealth interests that otherwise impede much-needed reform and fairer tax are offered enough by way of offsetting advantages to undermine opposition weaken resolve and divide ranks. Outflanked and stripped of usual allies, critics can be portrayed as defending not just unfair but, more importantly, economically detrimental privilege and inequality merely for their own sake – as selfishness not sense.

> **'Ought not, nor can in conscience defer beyond this time both so much need at once and so much opportunity to try what can be best determined.'**
>
> John Milton