Economic viewpoints

THE REPORT OF THE CONSERVATIVE PARTY TAX REFORM COMMISSION

Four economists give their views on the economics and political economy of the Conservative Party Tax Reform Commission Report.

A pleasant surprise but will it be implemented? – David B. Smith[1] and Eugen Mihaita[2]

Nowadays it comes as a pleasant shock to read a serious, economically literate, analysis from a group associated with a British political party. Unfortunately, the semi-detached nature of the Conservatives' Tax Reform Commission (TRC) means that it may have lost in political relevance what it has gained in objectivity and analytical quality. Some senior Conservatives apparently regard parts of the report as political hot potatoes that are best dropped immediately. In fact, the TRC authors were relatively cautious in their discussion of the 'flat tax' and in the allowance they were prepared to make for the dynamic second-round effects of tax changes on economic activity and the tax base and it is possible to ask whether they should have been bolder. It is a dilemma facing all market liberals (see Smith, 2006) whether one should pull one's punches and understate the evidence against the big-government policies implemented in Britain in recent years in order to stay *persona grata* with the Conservative Party's big-government appeasers – or objectively present the evidence, regardless of whether this condemns one to political irrelevance.

One reason for boldness is that Britain is now a worryingly high-government-spending economy by international standards. Only nine out of 28 OECD member nations will have a government spending burden higher than Britain's this year. The ratio of UK general government outlays to nominal GDP is expected to be 15.5 percentage points (pps) higher than in Korea; 10.4pps above Ireland; 8.4pps above the USA; and 4.8pps above the OECD average. Britain's projected 45.3% spending ratio is expected to remain below the 46.9% Eurozone average in 2007, but has already overtaken that of Germany. Britain also appears to have unsound public finances by international standards, once allowance is made for the level of economic activity relative to its trend. Thus, the OECD's estimate of the cyclically adjusted general government deficit in Britain this year, is equivalent to 4.4% of the non-socialised element of GDP – this is the relevant concept because no government can tax itself – the same as in the USA but well above the 3.5% OECD average and the 2.1% in the Eurozone. This is why Britain is uncompetitive in world markets and why the country's structural fiscal imbalance is unlikely to be resolved by trimming at the margin.

The TRC report contains many good things. In particular, it provides a clear account of the present system of direct taxation in the UK and can be read as a primer for those who wish to understand the system's mind-boggling complexity. It also gives a lucid account of the supply-side literature and the flat-tax debate – also brilliantly covered in Heath (2006). The TRC want more flatness, but not the 'Full Monty'. To date, all the EU member states that operate flat taxes have been former communist states. The states concerned have been growing strongly and their performance ranking has been improving.

The earliest adopters of flat taxes were the Baltic states, followed a decade later by Slovakia. These four countries feature strong fiscal positions, modest debt and small government. Romania is the latest EU adopter of flat taxes and stands apart from the other EU flat-tax experimenters because of its far larger population. Romanian social insurance contribution rates remain high, at 47.5% of gross wages, and the government has subsequently raised capital gains taxes. Nevertheless, the flat tax rate of 16% for personal and corporate income has improved tax compliance and generated higher tax revenues – in 2006, personal income tax revenues were up by 30% whilst corporate income tax revenues were up by 18%, compared with 2005 levels.

Two final comments on the TRC report from a British perspective are as follows. Firstly, the marked regional disparities in the UK's living costs, median earnings and house prices – which affect stamp duty and inheritance tax – suggest that the UK tax system is now massively unjust, and provides an independent justification for adopting flat taxes. Secondly, certain parts of the TRC's proposals, such as those dealing with business taxes and stamp duty, may be more likely to be implemented by any future Conservative administration than others.

Intellectually, the TRC report is an excellent contribution to political debate. Whether its recommendations will be adopted is another matter.

References

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Smith, D. B. (2006) 'Living with Leviathan: Public Spending, Taxes and Economic Performance', *IEA Hobart Paper 158*, London: Institute of Economic Affairs.

A lost opportunity – Tim Congdon[3]

What is government for? That is the implicit question whenever the tax burden is discussed. The dominant view in the second half of the twentieth century was that government should defend the nation and enforce its laws, help the poor and disadvantaged, and supply public services – particularly health and education – from a state-owned infrastructure on a universal basis. More pithily, government should police, redistribute and produce.

The Conservative's Tax Reform Commission under Lord Forsyth was a solid and in many ways impressive piece of work. It proposed a number of sensible tax reforms which – like those in the best years of the 1979–97 Thatcher and Major governments – would reduce complexity, expand the tax base and lower rates. However, the Commission's report was far from being a revolutionary document. Crucially, it took for granted the validity of the dominant view of the state in the late twentieth century. If the tasks of policing, redistributing and producing health and education services are taken as defining 'what government does', a tax burden of not much less than 40% of national income is inevitable.

How is the current figure – which is about 42% – split between policing, redistributing and producing? A fair summary is that policing (including defence and unavoidable administration) is 6% to 7% of national income, transfer payments 18%, and production of health, education and other social services 17% to 18%. The phrase 'transfer payments' has been used instead of 'redistribution', because many people both pay tax and receive transfer payments. As these people's net receipts from the state differ from their gross receipts, the state churns part of national income and transfer payments are larger than true redistribution. The Office for National Statistics has estimated that the redistributive effect of state action is about 10% to 11% of national income, with most of this occurring on the expenditure side rather than via taxation. Roughly speaking, the transfer payments figure of 18% can be split between 'churning' of about 8% and net redistribution of about 10%.

How much of this 42% is really necessary? In an ideal world 'churning' should not exist, since it requires the employment of tax inspectors and civil servants to oversee the expenditure, and involves all the misallocations and disincentives due to taxation. (Lord Saatchi – one of the Conservative Party's former treasurers – criticised churning in an excellent 2001 Centre for Policy Studies' pamphlet with Peter Warburton, called *Poor People Stop Paying Tax: A War of Independence*.) But far more important is the question why the state should be so heavily engaged in the production of health and education services.

Britain's Conservatives led the way in the 1980s and 1990s in showing that privatisation – not just of the big energy and transport utilities, but also of more modest local government functions such as rubbish disposal – always led to better productivity and lower costs. The feasibility of private supply of health and education cannot be doubted. In the UK's own past health and education services were predominantly supplied by the private sector and paid for directly by their customers, while at present many nations have a greater role for the private sector than government in these areas.

A radical programme of change would be to eliminate churning, and to privatise health and education. The state's role in health and education could be restricted to helping the less well-off by the distribution of education vouchers and the topping-up of health insurance premiums. If a future Conservative government achieved democratic endorsement for reforms which would expand choice, increase ownership and promote efficiency, transfer payments could be cut from 18% of national income to under 10%, and the state's role in production (now 18%) could be replaced entirely by redistributive vouchers of various kinds. The state could withdraw from production, and limit itself to policing and redistributing. Taxes could be lowered by the best part of 20% of national income, *and the state could still redistribute more to the less well-off than it does today.*

The Conservatives' Tax Reform Commission was trapped in the assumptions of the late twentieth century. In the twenty-first century, Britain, like other European nations, will have to compete with nations – many of them in Asia – with much lower tax burdens. The Commission's report was a missed opportunity. Mr Cameron's rejection even of the modest £21 billion tax reduction it proposed reinforces the message that today's Conservatives have lost the intellectual momentum given them by Lady Thatcher in the 1980s.

The curate's egg – Patrick Minford[4]

The Conservative Commission has laboured mightily and produced a nice-looking report that recommends some important tax cuts. The key recommendations it makes are on corporate taxation where it wants to bring down the main rate of corporation tax to 25% and install the lower (19%) small company rate as the rate on the first £300,000 of profits for all companies. It wants all rates eventually to be harmonised at 20%. It also proposes getting rid of various discriminatory benefits such as film credits on the accurate grounds that no industry should get special treatment however much media or other support it may gather.

The Report should be applauded just for this major set of suggestions. If one had to find the key way in which the UK tax system is now badly failing it would be corporate taxation. The UK is now an expensive place for mainstream firms to do business; UK mainstream corporation tax has become one of the higher ones amongst OECD countries and is therefore no longer attractive to multinational firms. The fact that small companies get a lower rate of tax highlights the lack of neutrality in the system; on what possible grounds does one subsidise 'small' versus 'big' business? The Report rightly rejects this and wants to get to a neutral and lower-tax system whenever possible.

It is striking, however, by contrast, how little the Report says in the end about cutting other taxes. There is no suggestion to cut personal taxation except the taxation of savings where it recommends a universal taper of Capital Gains Tax over ten years and the abolition of Inheritance Tax in favour of CGT on death. Basically the Report rejects the idea of a flat tax even though it gives a nice and well-informed account of the flat tax literature; it also rejects the idea of only taxing consumption, but on the curious grounds, quite unsupported, that it is 'naïve and would lead to tax evasion'. Had the Commission looked at the extensive literature on consumption taxation, starting with the Meade Report, it would have found these grounds to be non-existent. Evasion of the consumption tax base is extremely hard because there is hard data on people's cash flows which is all you need to get the necessary data on income and net asset acquisitions. If all consumption is taxed, including the flow of services from owner-occupied housing, then a consumption tax base would not – as some think – switch taxes from the rich to the poor.

The Report says it favours flatter taxes but then balks at the flat tax. It agrees that savings should not be taxed on the usual consumption–tax grounds that there is repeated taxation of consumption via the taxation of savings, creating a serious disincentive to save; and then it balks at the idea of a consumption tax. It is quite puzzling. It is like the man who says to your suggestions for changing his behaviour: 'I agree with you entirely in principle, old chap; but I can't do it in practice, very sorry'. You wonder why he will not do what he agrees he ought to!

Of course the answer is that in rebranding the Conservative Party, David Cameron has emphasised his commitments to public spending and a desire for tax cuts to pay for themselves in direct revenue cost terms. This is, of course, an absurd position since, as the Commission points out, there will be substantial dynamic benefits from tax cuts: rising revenues as a result of higher growth, increased labour supply, reduced emigration and less tax evasion.

Thus the Commission found the ground cut from under its feet before it could get its views out. It was left just with the suggestion that if tax cuts could be afforded on those stability grounds, then the priority should be given to business taxes. Hence its one and virtually only suggestion, to cut the main corporation tax rate and eventually unify it with the lower rate, while largely paying for it out of scrapping particular corporate subsidies.

In the circumstances the Commission did well, putting down some markers and setting out some useful analysis. The topic will return under the impact of fierce international competition for business through the means of tax reform. We are already hearing both Germany and France discussing cuts of corporate and personal tax rates. They are doing it because on or close to their eastern borders they face competition from reforming Eastern European economies. Do not lose heart, flat taxers: the topic will return in spades!

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