Budget 2017: An IEA Briefing

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Executive Summary:

- When applied to investments in company shares, capital gains tax is generally a double tax because it taxes anticipated profits and retained profits that are taxed elsewhere in the system. It should therefore be abolished. Where investments are designed to hide income as capital gains, income tax should be charged on investment returns as already happens in some cases. Capital gains tax raises relatively little revenue and, as a tax on transactions is highly distortive.
- If capital gains tax is not abolished, price indexation allowance should be re-introduced so that investors are not taxed on illusory gains.
- The government should reconsider the future of inheritance tax. The UK is an outlier in charging a tax on estates at death and at such a high rate. Taxpayers go to great lengths to avoid paying it. Taxes on estates are a form of double taxation (on income accumulated as savings and passed on at death) and favour consumption over investment.
- One option would be to follow the example of a number of developed countries and abolish the tax altogether.
- Alternatively, it could be reasoned that people who inherit money or are given large gifts should be taxed on the income they receive from gifts and estates in a similar way to how they are taxed on other forms of income. The government could move to a system that taxes large gifts at a rate closer to 20 per cent over a lifetime tax-free limit. Countries that retain taxes on transfers of capital use such a model. This would reduce the burden on estates that are widely disbursed and, with a lower rate of tax, reduce the incentives for avoidance.
- Land and property taxes in the UK are high but extraordinarily inefficient. In particular, stamp duty, as a tax on transactions, reduces labour mobility and also makes it more expensive for people to downsize or move home for other reasons. Council tax is regressive in many respects and business rates act as a disincentive to investment in business property.
- There are now approximately ten different sets of rules of stamp duty depending on the value of the property; how it is owned; and whether it is a second property owned by a married couple or by an individual (a situation which discriminates against married couples). There are eight different rates of duty, again depending on the nature of ownership. Just 20 years ago, there were two rates (one being zero) and one set of rules.
- The government should abolish stamp duty, council tax and business rates and replace them with property taxes that are much less economically harmful. Such changes could easily be phased in over five or ten years.
- Changes to these three groups of taxes would considerably simplify the tax system and make taxes more economically efficient. The changes would be largely self-contained. The proposals would represent a radical reform of, and a huge improvement to the UK tax system.

1. Introduction

In the 2017 budget, land and property taxes, inheritance tax and capital gains taxes could be reformed in such a way that simplicity and economic efficiency could be promoted. Furthermore, such reform and modernisation would help secure the tax base by making the tax system more rational and therefore less prone to avoidance (which tends to happen when different economic activities are taxed in different ways). Currently, these three sets of taxes are especially problematic in the UK. The reform of these taxes could be radical whilst not having significant implications for the rest of the tax system.

2. Abolition of capital gains tax

It is often argued that the rates of capital gains tax (CGT) and income tax should be aligned. This argument is conceptually flawed. The case against CGT on investments is overwhelming. Capital gains tend to arise when investors anticipate future profits or if companies retain profits for investment. But the profits that are retained have already been taxed and, if profits are expected in the future, they will be taxed too – when they materialise. CGT on equities is therefore simply a double tax. Furthermore, since price indexation allowance was abolished, CGT has been levied on those gains which only arise as a result of inflation. So, for example, an individual who held a portfolio of shares from 2000 to 2010 would have had to have seen the value of those shares rise by over 30 per cent just to keep pace with inflation. Under the then current CGT rates, that increase in value which was necessary simply to maintain the real value of the assets would be taxed at up to 28 per cent. In other words, purely illusory gains would be taxed.

The main legitimate justification for CGT is to prevent investors hiding income as capital gains. However, the tax authorities already have ways of dealing with this problem which were not available when the tax was first introduced in 1965.

Higher rates of CGT also discourage investment, discourage entrepreneurship and encourage avoidance. Both individuals and institutions can devise methods to avoid the tax, one of which is simply to hold on to investments for longer in order to time their sale more carefully. This can have the effect of reducing the yield from the tax at higher rates. CGT is effectively a tax on transactions (under certain conditions) and, as noted below with regard to stamp duty, such taxes are especially inefficient.

Because of the possibilities of avoidance or reducing tax through the timing of disposals, the revenue and welfare maximising rates of CGT are much lower than the respective rates for income tax or corporation tax. As CGT affects behaviour to a greater degree, even if it is thought sensible to have a CGT (which I do not believe it is), it should not be set at the same rate as income or corporation taxes. A report of the US Congressional Budget Office, was clear that low rates of capital gains tax may well increase revenues because of the behavioural effects. Thus, both empirical evidence and prior theory both point in the direction that capital gains tax rates should not be set at income tax or corporation tax rates. The only questions are the extent of the appropriate diversion and whether it should exist at all.

If CGT is to remain, then it should be used with the explicit aim of taxing investments that are not otherwise taxed. Second homes and works of art as well as those deep discount investments that do not have income tax charged are obvious examples. Price indexation allowance should be reintroduced.

Reforming or abolishing estate duty

The current Inheritance Tax in the UK, is not, in fact, a tax on inheritances but an estate tax, though with very many exemptions. Estate taxes are difficult to justify and have been abolished in a large number of countries. They tend to cause perverse behaviour, encouraging consumption, investment in those assets that are exempt and avoidance techniques. For example, parents might choose to spend money through buying private education to realise the full value of the assets they have instead of saving and bequeathing the assets value less the deduction to pay for the inheritance tax liability. There are methods of avoidance available, but they are either expensive of involve investment in risky asset classes which would not be suitable except as part of a diverse portfolio of the very rich.

A strong moral case can be made against an estate duty. Why does somebody have to pay tax on capital he or she passes to their children, but not pay tax if the money is spent on conspicuous consumption? In fact, very few countries have an estate tax these days – the UK is an exception, as well as having a very high rate. In the past, although estate duty was an important tax in the UK, other taxes were much lower. Until 1941, people were more likely to pay estate duty than income tax. In other words, at one time accumulated wealth was taxed when passed on, but today we tax it as people accumulate it.

However, if we view a bequest from the perspective of the heir, the matter can be viewed differently. Why should a recipient of an estate not be taxed on the money that is received from an estate whereas they would be taxed on income received from other sources? When someone earns money, tax is normally paid on that income and then again on consumption when it is spent. Viewed from the perspective of the heir, an inheritance can be seen as tax-free income. It can be argued that it should be subject to income tax or some kind of inheritance tax levied on the recipient. Not doing so breaches the neutrality principle that is one of the features of a good tax system because different sources of income will be treated differently for tax purposes. Though a case can be made that bequests and gifts are not income in the proper sense of the word (but a voluntary transfer from one person to another) and that all gifts, including bequests should not be taxed.

Although few countries have an estate duty, many do have taxes on inheritances. As at July 2015, there were 15 OECD countries without an estate duty or inheritance tax and the vast majority of countries with an estate duty or inheritance tax had a rate lower than that in the UK.

If bequests were taxed in the hands of the recipient, this would lead to bequests being taxed more heavily than gifts during somebody's lifetime unless they were also taxed. This then leads to the question of how to treat gifts in somebody's lifetime. Most countries do not tax gifts. The UK did, between 1975 and 1986, when the 'capital transfer tax' replaced the estates tax and then was itself replaced by our misnamed inheritance tax (Mirrlees et al. 2011). Practical difficulties involved with monitoring transfers of value, especially between family members, go some way to explaining why the tax did not last long.

Of course this debate cannot be resolved from the perspective of economic reasoning alone. It depends how one regards gifts from a philosophical point of view. If it is not possible to resolve this debate, some would argue that Adam Smith's principles of convenience and efficiency support exemption of bequests and gifts from tax on the ground that it is inconvenient for families dealing with death to be concerned with tax (which may partly explain why inheritance tax is so unpopular), and that the administrative effort required by extending tax to bequests and lifetime gifts would be significant. Furthermore, the taxation of bequests and gifts can often be avoided in complex ways which make the tax system less efficient and less transparent.

Thus, though the preferred position might be to have no estate or inheritance tax, a movement towards taxing beneficiaries and away from taxing estates (that is to a classical inheritance tax from our misnamed inheritance tax) would be a considerable improvement on the current positions.

Such a system could work as follows. Each individual could have a lifetime exemption of £500,000 (indexed to increases in average wages). This would be roughly equal to the amount of tax-free assets an estate can currently pass on for a family with two children and where a house if part of the estate. When this allowance is exhausted, any further gifts received could be taxed at a flat rate of 20 per cent. Of course gifts to charity would not be taxed and small gifts of a few thousand pounds should not count towards the lifetime allowance, and gifts would not count towards the allowance if they did not take an individual above the personal income tax allowance in any particular year tax year. Transfers between husband and wife, of course, would be entirely exempt. A lower rate of tax would remove the perceived need for complex exemptions.

The broad principle would be that those receiving substantial gifts would pay tax, but at a lower rate than currently. Further, estates split between many beneficiaries would incur less tax, as the recipients would each be receiving less money. The tax would be at a rate that would be less worthwhile avoiding, and monitoring would be relatively straightforward as only a small number of people would pay the tax and it would relate only to substantial transfers.

Land and property taxes

The way in which the UK taxes land is especially problematic. There is almost unanimity amongst economists that the taxation of transactions is extremely inefficient. The UK government collects around £10bn from Stamp Duty. This tax artificially depresses property values, discourages investment and distorts the allocation of assets. This happens, for example, by discouraging older people from moving to smaller accommodation when they no longer need as much space; discouraging people from living closer to work; discouraging people from changing the locations of their jobs; discouraging people from owning, as opposed to renting; and, simply, discouraging people from moving to a house in which they would prefer to live regardless of work opportunities or changes in circumstances. The tax has correspondingly damaging effects on business, though these are ameliorated by the fact that businesses tend to rent property.

The increase in the rates of duty and the attempts by government to discriminate against activities of which they disapprove (such as renting property or owning a second property) has led to a situation where there are now approximately ten different sets of rules of stamp duty depending on the value of the property; how it is owned; and whether it is a second property owned by a married couple or by an individual (a situation which discriminates against married couples). These different sets of rules are complemented by eight different rates of duty, again depending on the nature of ownership. Just 20 years ago, there were two rates (one being zero) and one set of rules.

As Paul Johnson, Director of the Institute for Fiscal Studies, commented in 2014 (after noting that other authors regarded the tax as the worst designed in the British tax system): “Yet, as we have seen, [Stamp Duty Land Tax] SDLT is a tax that governments of both persuasions have seen fit to increase time and time again and whose structure has got worse over time, not better.” And it has got worse since that time.

In principle, Council Tax is a better designed tax than Stamp Duty because it taxes housing consumption rather than transactions. However, it is based on a complex system of thresholds and is, in fact, regressive, at least in part. Furthermore, the bands which determine the amount of Council Tax paid have never been updated to reflect changes (both relative and absolute) in house values.

The third major UK property tax is business rates. These have some merit, but suffer from serious design faults. To the extent to which business rates are a tax on location, they have very low inefficiency costs, for the reasons land value taxes in general have low inefficiency costs (see below). By contrast, to the extent to which they tax improvements or structures that are used for business (e.g. offices, factories, shops, etc.), they represent an arbitrary distortion discouraging the use of property by businesses in the production of goods and services for consumption. Commercial property is consequently underused in the production process because it is over-taxed (rents are taxed directly in the same way as wages and interest on the capital employed in the business, but business rates are an additional tax on property use). This is likely to reduce business property use in the production process and therefore reduce productivity (and hence wages). Business property use could still be taxed via a location land value tax (see below). This would have far fewer distortions.

It would be possible to reform land taxes in a way which would be hugely beneficial from the point of view of economic efficiency.

Existing property taxes should be replaced by a property consumption tax. Owner occupied property is currently under-taxed relative to rented property and other forms of consumption. An individual who owns their own property is effectively consuming the property services by renting it to themselves. There is a strong case for taxing such consumption and this was supported by the Institute for Fiscal Studies Mirrlees report (Mirrlees et al, 2011). Neutrality in the tax system could be achieved by a tax of 20 per cent on the imputed rental value of owner-occupied properties and a similar tax on rents. Economists have long favoured a location land-value tax because of the way it does not impair economic efficiency. In fact, a property consumption tax at this level can be thought of as being equivalent to a 1 per cent tax on land value and property values if the rental yield is 5 per cent (20 per cent of 5 per cent of the rental yield being 1 per cent).

There would clearly be enormous resistance to this, but there are pragmatic ways forward. Furthermore, it should not be thought that continuing with the current combination of property taxes is a sensible option – it is an easy option politically, but one which causes considerable economic damage as well as being regressive.

The pragmatic proposal would be to abolish council tax and stamp duty and replace them both with an annual property-based tax which was set at a fixed percentage of a property's value, with a cap of 1 per cent (but set not higher than the level necessary to replicate the revenue from the existing taxes). A tax based on a property's value, however, has the disadvantage of varying widely with fluctuations in market values which tend to be more volatile than rental values. Another practical approach would be to phase such a tax in so that it applied to new property purchases bought after the abolition of stamp duty land tax with full roll-out after 10-15 years.

The cost of this would mainly be borne by the rich, those who move less often and those who are currently able to avoid stamp duty. In particular, there would be substantial charges levied on foreign non-residents own UK property. There is also a strong argument for levying such a charge on unfinished development.

Though the issue is not pursued further here, there is also a case for replacing business rates with a location land value tax on business property. This would be much less distorting and would discourage business investment in property to a lesser degree than the current system of business rates (see Meakin in Booth, ed 2016, pages 203-204).