BONFIRE of the INANITIES

Britain's tax system is not fit for purpose. We should think again about the principles that should underlie it and introduce radical reform. And such reform could actually benefit the poor more than the rich, says RORY MEAKIN

Most of us believe that some tax is required to fund government spending and some taxes are better than others.

Given this starting point, how might economists weigh up whether a tax system is a 'good' system or a 'bad' system?

In this article we look at the principles which underlie a good tax system, what taxes emerge from those principles (and which existing taxes would not), and what implications the implementation of such a system would have across income groups.

Principles

The principles on which a tax system should be based were laid out by Adam Smith in 1776 and have largely stood the test of time.

They are: certainty, proportionality, convenience and efficiency. In summary, taxes should be known in advance, levied in proportion to ability to pay, payable in a convenient manner and inexpensive to administer.

These principles are sound, but further insight has been gained subsequently by economists including N. Gregory Mankiw and Sir James Mirrlees. Using their ideas, we can propose reformulating Smith's lessons as follows:

1. Taxes should be as transparent as possible, a core component of which is certainty.
2. Taxes should be as neutral as possible, thus applying the same tax at the same rate to different activities wherever possible.
3. Marginal tax rates should be as low as possible, except for taxes designed to ensure people pay for 'externalities' caused by their behaviour.

Simplifying the UK tax system

How would applying these principles change the UK's current tax system?

Firstly, it would be radically simplified to maximise transparency and neutrality. So there would only be a single income tax, at a single rate, on all income types, however received.

Corporation tax, national insurance and capital gains tax are all, fundamentally, variations of income tax and should all be abolished.

Distributed profits (such as dividends) should be taxed like any other income. National insurance is effectively a duplicate income tax and has no useful distinct function. And capital gains often arise from investors anticipating increases in the income an asset will produce and that will be taxed in the future - therefore capital gains tax is normally a double tax and should also be abolished.

Inheritances can be viewed as a transfer of income from one person to another. However, the income that is transferred has already been subject to income tax and should not be taxed again.

Transaction taxes such as stamp duty on shares and property depress values, gum up markets and lead to assets and houses not being held by those who value them most. They should be abolished, along with business rates, which arbitrarily push business into unnecessarily cramped use of property.

So-called 'Pigouvian taxes', whereby we try to tax activities that lead to social costs that are higher than private costs or 'externalities', generally fail to stand up to the scrutiny – certainly if we consider those taxes which actually exist in the UK system such as taxes on alcohol and tobacco.

Even in the context of socialised healthcare financing, the costs incurred by others associated with alcohol and tobacco are too weakly correlated to individual consumption to be useful.

As a result, the relevant duties effectively operate as arbitrary and distortive 'sin taxes', reducing welfare and falling disproportionately on the poor. They should be abolished entirely.

Because wealth is normally so mobile, wealth taxes are particularly damaging. They should be avoided. An exception is a tax on the value of land which is attributable solely to its location – a location value land tax.

A property's location value is the amount it would be worth if the land were found in a state of wilderness but the state of all other properties remained as they were.

Taxing this value alone ought not to disincentivise landowners from improving land by clearing it or building structures and it has long been promoted by economists.

A good tax system should therefore introduce such a tax in a phased manner, to account for the unfairness imposed on those who have previously bought land in good faith. This should replace a range of other taxes including council tax.[1]

There should also be some further reforms to property taxes. These are discussed in part three of *Tax, Government Spending and Economic Growth*, published by the Institute of Economic Affairs.

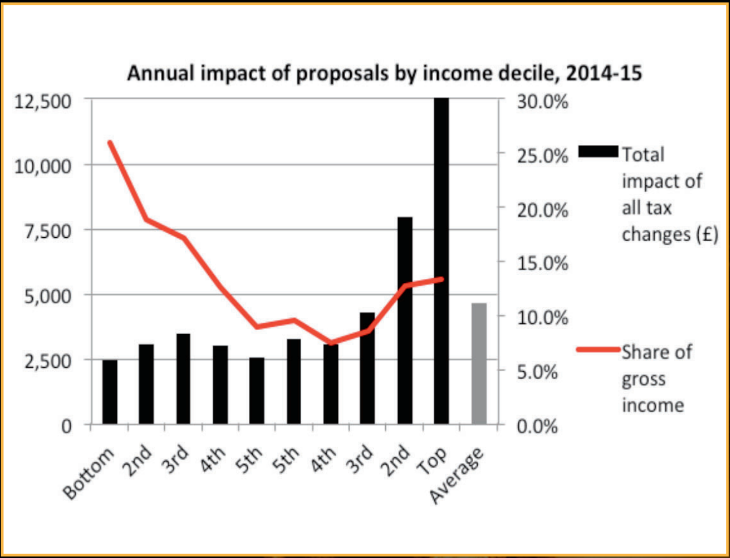
Various other fiddly, opaque or distortionary taxes should also be abolished, such as air passenger duty, the television licence and the climate change levy.

Some taxes to be reformed

Consumption should be taxed with a broad consumption tax, probably a value added tax (VAT), as at present. VAT should apply universally to all consumption with no exemptions or reduced rates, unlike currently where there are wide-ranging exemptions.

Although it has been suggested that existing Pigouvian taxes should be removed, there is one area where they could be retained but at a lower level – that is in the case of externalities caused by carbon emissions and other pollutants.

Here, a single carbon tax would be the best way to ensure emitters cover the costs to others of their emissions. In addition, limited local fuel duties could be used



to cover the cost to others of congestion, the impact on the local environment of car use and the cost of road building and maintenance.

Current fuel duty rates are set at least twice as high as a reasonable estimate of the level necessary to deal with the externalities caused by cars (including reasonable estimates for the social cost of carbon emissions) and the rate should fall accordingly.

Vehicle excise duty performs no useful function in most cases and should be restricted to particularly heavy vehicles which damage roads disproportionately compared with their fuel usage.

Impact of a reformed tax system

Reform of tax systems is often avoided on the ground that it creates winners and losers and the losers scream more loudly than the winners.

Of course, if the overall tax burden is reduced, the discussion then becomes one of who wins the most – in other words, what are the distributional consequences of the change?

It is often assumed that any reduction in taxes must disproportionately benefit the better off. However, a change of the kind proposed has been modelled and this is found not to be the case.

It was assumed that there would be a 15 per cent single income tax above a personal allowance of £10,000; a 12.5 per cent VAT, including on both residential rental property and the rental value of owner-occupied property, and a location value tax aimed at capturing 75 per cent of the location value of land.

The impact on households would be largely progressive due to the substantial cuts in highly regressive sin taxes and the reform of property tax.

The biggest winners would be households in the bottom three income deciles, gaining tax cuts worth 26, 19 and 17 per cent of gross household income, continuing to fall to 7 per cent at the fourth richest decile.

The richest two deciles would enjoy tax cuts worth 13 per cent of gross income. This is illustrated in the figure where the line shows the proportionate increase in income from introducing such a system (right hand scale) and the bars show the total amount of additional income that will be received from a proposed change in the tax system (left hand scale).

Conclusion

Tax need not be nearly as complex and incoherent as the UK system currently is.

There are some sound economic principles that have, in recent years, been forgotten by politicians. Also, the poor pay more taxes than they think and a reduction in the tax burden in the context of a reformed system may well help the poor more than the rich.

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FOR MORE:

You can download the IEA's *Taxation, Government Spending and Economic Growth* for free at

www.iea.org.uk/publications/taxation-government-spending-and-economic-growth/

[1] There should also be some further reforms to property taxes as discussed in Part 3 of *Taxation, Government Spending and Economic Growth*, published by the Institute of Economic Affairs