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# BRIEFING

## SIMPLER TAXES

*Tax Simplification as a Systematic Policy*

### 1. The Justification

Finance ministers and Treasury officials sometimes enjoy jokes about taxation which compare it to plucking geese or squeezing oranges. They talk of the art of taking off feathers without having the bird squawk, or of extracting juice until the pips squeak. The analogies which they see as humorous gloss over the essential difference that although geese and oranges might be kept to serve human purposes, taxpayers are not kept to serve Treasury purposes. They are autonomous agents with minds of their own, and independent goals and purposes which do not necessarily coincide with the goals and purposes of finance ministers.

All taxation involves taking money from people. The money belongs to them because they have earned it, or been given it, or acquired it in other legitimate ways. If they have acquired it illegally, they are not regarded as its lawful owners. Although taxation involves appropriating money from those to whom it belongs, we do not call it theft because it has the support of law. The laws of the land permit finance ministers to take our money, if necessary against our wishes and without our consent. The law makes this action legitimate, but it does not make it moral. We construct arguments to give taxation a moral case, and a justification beyond the bald fact that laws have been passed to enable it.

The case is made that people can acquire and enjoy wealth, and have some security in its possession, because of the presence of a civilized society which allows it and protects it. Those who do acquire and enjoy wealth are therefore obligated, it is said, to help defray the costs of the society which makes this possible. Taxation is further justified if there are institutions in place which allow people freely to consent to it, and to accept the obligations of living in such a society.

**For more information contact:**

**Dr Madsen Pirie:**  
020 7222 4995





There are problems, of course, when society is divided into groups and classes such that those who consent to the taxation are not those who will be called upon to pay it. But a balance is usually struck in democratic societies that taxation will be accepted provided that it is levied according to rules and principles generally perceived to be fair. Democratic consent and the sanction of law are not themselves enough to make any taxation right and proper. It is neither acceptable nor is it accepted that the state can arbitrarily confiscate the wealth of one individual and leave that of a similarly placed individual untouched. Nor is it accepted that the state can suddenly decide on a whim and after the fact which acquired property it will take. Taxation requires not only consent and legal process; it needs to follow acceptable rules.

## 2. The principles

The general rules which should apply to taxation are widely accepted, although they do not carry the force of law to guarantee their adherence. It is not thought right that taxation should be arbitrary, applying to some but not others similarly-placed. It is similarly thought wrong that taxation should be retrospective, with activities subject to tax which were not taxed at the time they were engaged in. Few people would regard it as just to tax some groups but not others on the basis of categories such as race or religion. There is less agreement on how far taxation should be used to restrain behaviour, as opposed to raising revenue. Although a punitive tax, very expensive to collect and police, could be used to discourage certain types of behaviour, many would suppose that these might be areas more appropriate to regulation by law rather than through the tax system.

These feelings about what varieties of taxation are just and reasonable, and which ones are not, have from time to time been set out as a series of principles which purport to guide its incidence. Adam Smith, the 18th century Scottish thinker and father of modern economics, set out the principles which he thought should govern sensible and just tax policy. He identified four of them.

Firstly, he said, people should contribute in proportion to the income they derive under the state's protection. This is straightforward: the more benefit you derive from the state, the more you should pay towards its upkeep. Instead of charging everyone a fixed sum of money each year, we charge them a proportion of their gains. This satisfies the feeling that those deriving most advantage should contribute more to the upkeep of the system that made it possible. It has the added advantage that those who pay most are those who can most readily afford to do so. Someone near the bottom of the pile who has benefitted little from civil society should perhaps not be asked to make as substantial a contribution as those who have made great gains because of it. The principle, if it were reduced to one, would be that a proportion of every pound earned is owed to the maintenance of the society which enabled it to be done. It justifies percentage taxes, with the rich paying more because they are richer. It should be noted, though, that it does



not by itself justify 'progressive' taxation in which the rich pay not only more money, but also a higher percentage of their total earnings.

Smith's second principle is that taxes should be certain, and not arbitrary. There should be no excessive discretion given to tax gatherers, and certainly no arbitrary power. The time and manner of payment should be clear to all. What is not acceptable is to have tax officers decide on their own initiative how much is due, or when and how it should be paid. For taxes to be equitable, they must be both public and plain. People should know in what circumstances tax is due, and how much of it falls upon them. Good tax systems are not made up of individual cases decided by discretion. That way lies not only uncertainty, but corruption. The tax officer is there to interpret and apply the levies due, not to determine them.

Taxes, said Smith, should come at a convenient time. He suggested that any taxes on rents should fall due when rents are paid and there is money to pay them with. This suggests that taxes payable in advance are, in general, a bad thing, since there is no guarantee that the money to pay them is there until it has been earned or received. Taxes on consumable goods fall within this rule if they are charged little by little as the goods are purchased. A small additional tax added to each sale price is easier for a person to pay than a massive lump sum levied on the sum total of annual purchases. US state sales taxes follow this rule, being generally collected at the time of purchase by shop assistants using programmed cash registers to calculate the additional charge to be added for state coffers. Members of the public can more readily add a few cents to each light bulb or garment than they can find a lump sum annually.

The fourth principle Smith mentioned is that taxes should not be excessively costly to collect and administer. They should not require a multitude of expensive tax collectors, or a costly apparatus of assessment and collection. Smith added to this that they must not be such as to discourage industry and destroy capital. This raises an interesting point because taxes do in fact modify behaviour. On the margins they make some activities more or less expensive to engage in, and therefore alter the degree to which people participate in them. It is a bad tax which does this to a degree disproportionate to the revenue collected. Smith added something to which most would assent – that taxes should not be such as to require frequent, odious, and vexatious visits from tax gatherers in order to collect them. He also said that taxes should not be such as to encourage evasion, as excessively high taxes tend to do.

### **3. The performance**

Not many dispassionate observers would conclude that HM Treasury in the UK has been fully in accord with Smith's four principles of sound and equitable taxation. Indeed, many commentators have suggested that UK taxation has moved away from these principles rather than closer into line with them. Stealth taxes, for example, break rule two, in that they are far



from being as clear to everyone as the maxim requires. The time and the manner of the payment should be known to all, whereas the purpose of a stealth tax is to raise revenue without the subject being aware that he or she is paying more because the Treasury is taking a cut. Deceitful finance ministers might prefer such taxes because the Treasury gains the revenue without the odium of increasing taxes, but they are in clear violation of the principle of transparency and clarity.

The Treasury would also be guilty of increasing taxes to the level which promotes both evasion and avoidance. The degree to which they have acted to discourage industry and destroy capital is open to argument, but comparison with lower tax economies, such as the Republic of Ireland, suggests that our volumes of both would have been considerably higher save for the tax increases to which they have been subjected.

While this is arguable, few would deny that both have been driven abroad by tax increases imposed in the UK at a time when most of our competitors have been reducing their tax burdens. A number of high profile businesses have transferred their operating headquarters overseas, many of them explicitly citing the need to move to a tax-friendlier environment.

#### **4. The fifth principle**

There is a fifth principle implicit in what Adam Smith said: it is that taxes should, wherever possible, be simple. Complexity imposes compliance costs of its own, both on those who pay and those who collect. For taxes to cost no more than necessary, they have to be simple, but in the UK they have grown progressively more complex. According to the Taxpayers Alliance, the UK's tax code is now the longest in the world. At 9,973 pages it is equivalent to seven unabridged editions of *War and Peace*. It contrasts with the 1,700 pages of Germany's tax code (which comes out even smaller once allowance is made for the fact that it takes longer to say things in German).

Complexity brings two principal problems amongst others. The first is that business firms, and many individuals, have to employ expensive accountants to take the time to go through the tax code to ensure compliance. This diverts time and resources which could otherwise have been productive. The second is that the complexity diverts and channels economic activity into complicated tax-minimization strategies, utilizing time which might have been spent in boosting output and profits.

The costs of this are real. KPMG puts the administrative burden of the UK's tax regulation at £5.1bn a year. Although some commentators claim that taxes have to become more complex as the economy becomes more sophisticated, some countries in central and Eastern Europe have shown that a simpler system can bring not only faster economic growth, but increased revenues with it.



There is another powerful argument in favour of tax simplicity. It is that people should know their liabilities and assent to them. Instead of having finance ministers take money covertly from wage packets and back pockets at will, it makes for a more mature and responsible citizenry if they understand their obligations, and know the burden which they shoulder on behalf of their society. Complex taxes thwart that understanding and that acceptance. Simple taxes, on the other hand, make clear the duties of citizenship, and allow people to feel that they are partners with government, making the sacrifices required to enable society to function, and knowing what that involves on their part.

### 5. The start of simplification

The tax code accumulates complexity, like junk stored in an attic or basement. Things are added little by little over the years without anyone appreciating what a heap of different items results. Often from a simple start exemptions and allowances are added and altered year by year until any original clear expression is lost in a welter of subordinate clauses. Some of the task of tax simplification involves cutting through that accumulated clutter with a stroke, much as the intricate Gordian knot was severed by a sword.

An obvious candidate for this approach is the UK system of National Insurance (NI). There was a pretense that it represented real insurance or, as the Treasury put it, “an important element of real insurance.” This was never true. There is no fund, and never was. Money paid in NI contributions is not invested to achieve growth for the future needs of policy holders. On the contrary, it is paid out the same day from current contributors to current beneficiaries. It is in all but name a social security supplement on income tax. Yet calculations are made separately from those of income tax, with different thresholds and according to different rules.

National Insurance is a completely unnecessary layer of complexity. It should be treated as income tax, and calculated on the same rules and base levels as income tax. In an ideal environment it would be integrated wholly into income tax, absorbed into the same rules and thresholds as applied to income tax. In a less than ideal political world, governments might balk at what it would do to the headline tax rate. Having spent years claiming to have reduced the basic rate of income tax, most would blanch at the thought of the sudden increase in the basic rate that would stand exposed. The political solution, if governments want the fig-leaf of not counting it in the basic rate, is to call it a social security surcharge on income tax, and publish the figure as two separate rates rather than add them together. There would be a policy change implicit in this: it is that the cap on NI payments would be lifted, with top rate income tax payers paying a simple percentage without limit. This might have been a more serious objection had Gordon Brown, when Chancellor, not already lifted the cap for the increase in NI payments he introduced. The saving in complexity makes it now worthwhile to abolish the separate status of NI; it is an anachronism whose time is long overdue.



## 6. Simple taxes on business

The rules for calculating the tax liabilities of business are very complicated and arcane. They give accountants ballroom space for a merry dance, shuffling figures across the floor from one heading to another. The exercise is not done to boost turnover, or to sell more goods and services. Its purpose is to put figures into the column which gives them the greatest benefit of the tax rules.

On Smith's first principle, what should interest the Treasury is the amount of money made under the state's protection, and the tax levied should be in proportion to this. Thus the figure that actually matters is how much profit is being made. We are not interested in the alternative methods of computation which the complexity of Treasury rules offers; we are interested in the real bottom line – how much money did they make? Business profit should be the basis of tax liability, rendering legions of pen pushers and number crunchers unnecessary.

## 7. Lower taxes can be simple taxes

A high tax breaks Smith's fourth principle by diverting attention into avoidance or evasion. Some media commentators think up worlds in which people willingly pay high taxes because they believe that government can spend their money more wisely and more efficaciously than they can themselves. In this real world, however, people resent it when government tries to take too much, and take steps to keep more of what they have earned.

Low taxes can stimulate growth by broadening the tax base in two ways. Firstly, they raise the cost of evasion and avoidance by making them less worthwhile. The effort might be justified to save a lot of tax, but not to save a little. Secondly, they make effort and incentive more worthwhile by increasing the rewards that accrue from them. The less that is taken by government, the greater is the gain to the individual, and the higher the motivation.

Tax simplification can lead to lower taxes. Without the exemptions and allowances which qualify a person's tax liability, there is less expense involved in the administration of taxes, and greater incentive for people to earn more. The net effect is that the same revenue, or more, can be raised from a lower overall rate than was taken from the higher rate with its added complexities.

The Republic of Ireland has shown that low corporate tax levels can contribute to spectacular growth rates, and others among our EU partners are setting the trend to lower levels. With their low corporation tax, the Irish have gone from the poorest in the EU to the richest. Supporters of EU grants and subsidies who claim that EU grants were fundamentally behind this success fail to explain why countries (such as Greece) which received no less, failed to match Ireland's economic success. The countries of Eastern and Central



Europe which have followed the low tax route have achieved spectacular economic growth. Among the most successful are those which have followed one of the simplest tax systems – flat taxes in place of graduated ones.

### **8. Competitive pressures**

The moves to lower and simpler taxes by many of our EU partners is exposing the UK to tax competition. In a world economy where capital is unprecedentedly mobile, it tends to seek out favourable tax regimes, moving to where taxes are simpler and least burdensome. This is especially true in a Europe constituted as a single market, with mobility guaranteed. The current Chancellor and his successor will have to respond to this competitive pressure, and could easily seize the opportunity to simplify at the same time by putting corporation tax onto a parity with income tax.

There was a time in which income earned from investments was thought less noble and worthwhile than income derived from labour. Investment income used to be penalized with a 15 percent surcharge (called “Super-tax”). In fact it makes little difference to finance ministers whether income is taken in the form of wages or salary, or as capital gains. If it were simply treated as income and taxed on a similar basis, the distorting effects of the difference would be reduced.

It may well be that the downward pressure our competitors are putting on corporation and capital taxes will lead UK finance ministers toward a simplification which taxes all income on the same basis, whether it comes from earnings, investment dividends, or capital gains. The widely disliked death tax, currently called Inheritance Tax, could be abolished by having it absorbed into the same treatment.

### **9. The exemptions**

The tax system has been used to reward what was seen as socially worthwhile activity by subjecting it to favourable tax treatment. There are innumerable tax exemptions, allowances and tax credits which have crept in and added to complexity. A reformist Chancellor might well decide to scrap the lot and put the saving in both outgoings and administration to lowering the rates instead. The same could be done with huge swathes of the tax-free benefits currently allowed. Each vested interest might grumble, but could be shown the general benefit if all were given the same treatment.

It will necessitate the abolition of the vastly over-complicated tax credit system, despite the amount of political capital Gordon Brown spent in building it up. Nonetheless, there is a good case for replacing the entire system by something much simpler.



The detailed rules about pension contributions are a typical case of over-complexity. They are there partly to prevent pension funds being used as tax bolt-holes. Because the state permits some of the money going into pension funds to be tax exempt, it takes a keen interest in exactly how much and under what conditions this can take place.

The rules could be simple: if people put money from taxed income into a fund up to a set level, the government will match it, but contributions above that level will not qualify for any matching contribution. This is simple, comprehensible, and fair. If money going into pension funds is already taxed, the state loses interest in what happens to it subsequently, and no complex rules are needed to monitor it. Money paid into a pension fund should be from already taxed income, after which any growth is not taxed, nor is any income subsequently drawn from it.

### **10. The threshold**

The most effective way of giving extra income to low earners is not through a cumbersome system of credits and allowances, but by not taxing them in the first place. If their money is not taken by government, it does not need a complex bureaucracy to give some of it back to them.

Some of those earning less than half the average wage find themselves needing benefits only because part of their money is taken in tax. If the threshold at which income tax is levied were raised to half the average wage (which is almost the same as the minimum wage, about £12,000 a year), those earning less than that would not pay it at all. Only income earned above the £12,000 level would come under income tax. This would not only be simpler and more efficient than the present welfare system, it would end most of its poverty traps. There would always be an incentive to earn more, for no additional income would bring with it a reduction in benefits. Even above £12,000, people would only pay the basic rate on each pound earned above it, and none at all on the first £12,000. The incentive would always be there to earn more if people could.

### **11. Conclusion**

The UK tax system is well beyond the point at which complexity itself imposes costs and disincentives. There would be savings from simplicity itself, as well as a more rational understanding by ordinary citizens of their responsibilities and obligations. Tax simplicity is unlikely to be gained by tinkering at the edges, with a few exemptions tightened here and there, and a few allowances revoked. The tendency within the system has been to accumulate complexity, and it would quickly flow around any brief and temporary gains.

Simplicity is to be achieved by thinking through the whole purpose of the tax system, and the morality and principles which should direct it. In the



case of the UK, a holistic approach to simplification suggests that it cannot be done in isolation; rather it has to think through the supporting apparatus of benefits and pensions, as well as a rethink on how the different forms of income might be integrated under one treatment.

National Insurance as a separate entity should cease, as should the different rules governing different sorts of income. Pension contributions should be simplified by being made out of taxed income. And the whole apparatus of benefit provision should be replaced by a policy which ends the taxation of low earners.

Above all, taxes should be made simpler, lower and clearer, and future tax proposals should be tested against understood and straightforward principles.

All of this shows what might be achieved by finance ministers determined to simplify, to make the rules clear and uncomplicated, and to cut the rates as well as the complexity. After a few years under such a regimen, the UK might acquire a culture of simplicity, and be ready to accept further simplification. Eventually it might be ready to join those who have taken the ultimate step: a single flat rate of tax which only kicks in at a threshold high enough to take the poor out of taxation altogether.

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