The Revenue and Growth Effects of Britain's High Personal Taxes

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“Nor should the argument seem strange that taxation may be so high as to defeat its object, and that, given sufficient time to gather the fruits, a reduction of taxation will run a better chance than an increase of balancing the budget. For to take the opposite view today is to resemble a manufacturer who, running at a loss, decides to raise his price, and when his declining sales increase the loss, wrapping himself in the rectitude of plain arithmetic, decides that prudence requires him to raise the price still more--and who, when at last his account is balanced with nought on both sides, is still found righteously declaring that it would have been the act of a gambler to reduce the price when you were already making a loss.”

1933 Essay: The Means to Prosperity, section I: The nature of the problem, p338, *The Collected Writings of John Maynard Keynes*, Macmillan Cambridge University Press, 1972

1 Introduction

The UK has become one of the highest taxed countries in the world. Our competitiveness has suffered and economic growth is being stifled. Since 1997, most OECD countries have reduced their tax burdens. But British taxation has risen, causing the country to lose its competitive position as a low tax regime. More taxpayers are being forced into higher rate tax bands. The number of taxpayers in the 40% band nearly doubled from just over 2m in 1997 to almost 3.7m by the end of the 2008 financial year. Fiscal drag (that is, raising allowances and thresholds by less than the rate of earnings growth) has made more people subject to higher tax rates. Quite apart from the new 50% 'additional' rate of income tax, some people with lower incomes are taxed at a marginal rate of 60%, due to the removal of allowances. The June 2010 budget reduced the threshold at which people pay the 40% rate of tax from £43,875 to £42,475. As a consequence another 750,000 people are to enter the higher rate tax net, soon extending to a quarter of all taxpayers.

Louis XIV's finance minister, Jean Baptiste Colbert, famously said that "the art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing." Colbert's approach led to the French Revolution. In Britain today many are tired of losing their feathers and are taking avoiding action, moving overseas or beyond the reach of the taxman in other ways.

The largest indirect cost of the tax system is the behavioural response to taxation. As Adam Smith said, taxes "obstruct the industry of the people, and discourage them from applying to certain branches of business which might give maintenance and employment to great multitudes." There are many behavioural responses to Britain's high tax regime, where income tax rates are now higher than those in France. This paper aims to describe some of those and estimate their fiscal and economic effects.

Evidence from Britain and around the world tells us that punitive tax levels raise ***less*** revenue than modest rates. This makes us confident that when the UK data is released it will show the same of the high rates recently introduced here. Our problem, however, is the interval before data is available. Tax returns for the 2010-11 tax year are finalised in January 2012, so no clear data from HM Revenue and Customs (HMRC) are planned to be available until two more budgets are held. This paper aims to provide earlier estimates of the revenue effects of the high tax policies. We have taken several approaches, including a review of the evidence from overseas; surveys of UK companies and tax advisers; and the migration, demographic and economic data which underpin our own calculations of the revenue consequences.

Our research has found that the behavioural response to the new higher rates of tax is strong and that this is bound to hurt tax receipts. While many people saw the previous top rate of income tax as too high at 40%, most put up with it. The same cannot be said of the new 50% top rate (actually 52% after the extension of National Insurance payments), which on the evidence constitutes a tipping point. The policy risks flat growth over the next decade. It also risks a cumulative fall in tax receipts of £350bn or more over the same period.

2 Executive Summary

The country is suffering from a 50%-plus marginal tax rate which even its architect admits was imposed without economic purpose. Now our analysis shows that the policy is set for failure: at best leading to flat growth for a decade and £350bn of lost revenue. The Chancellor should seize the occasion of the 2011 budget to reverse this disaster promptly, for the benefit of public revenues, economic growth, the government's standing with domestic wealth-creators, and the UK's reputation with world business.

- **International tax rate comparisons**. Numerous international surveys suggest the UK has fallen into the trap of having an uncompetitive tax regime, with a top tax rate worse even than our notoriously high-tax neighbour across the channel.

- **Examples from overseas**. Evidence from the UK, US, Canada, France, India, Hong Kong and Russia is consistent. High top rates of tax fail to produce public revenues and injure economies. Taxpayers are first of all wealth -creators, who don't take kindly to fiscal spite.

- **Behavioural consequences**. Survey evidence from finance, industry, sport, entertainment and elsewhere tells us that high-earners are inclined to take the rational course of minimising their tax liability. It is unrealistic to imagine anything else occurring after last year's increase in the UK's top rate.

- **Financial effects**. We calculate that the policy risks flat growth for a decade and raises the possibility of a recession at the end of that period. The net effect upon government finances is harmful from the outset, gets worse from year to year, and ends up with losses to the public purse of some £350bn after ten years. This is equal to one fifth of the tax receipts expected in 2020 without the 50p tax rate.

- **Policy proposals**. We need to reverse our dysfunctional tax regime. Specifically, the Chancellor should: eliminate the additional 50% rate of tax and the revenue-losing £30,000 non-dom charge immediately; reduce the higher rate of income tax from 40% to 35% and announce an intention of further reductions over time; reinstate the personal allowance that is currently phased out between £100,000 and £115,000; and reduce the level of capital gains tax from 28% to 18% or below.

3 Britain's uncompetitive tax regime

3.1 Introduction.

In the first instance we explore the competiveness of our tax regime. To do so, we look at the evidence provided by international bodies and global accountancy firms.

3.2 International comparison of tax rates

Britain's tax regime is now uncompetitive internationally. This has been highlighted by the OECD which has recommended that Britain should "consider reducing the top rate of personal income tax, which is well above the OECD average and likely to damage work incentives and entrepreneurship, particularly of high skilled workers".[1]

a. KPMG survey. KPMG's Individual Income Tax and Social Security Rate Survey 2010 shows just how poorly Britain now compares with other countries regarding income tax levels. Table 1 on the following page sets out top rates of personal income tax. The UK is ranked 83rd out of 86th.

The KPMG survey points out that although 50 percent is the top rate of tax in the UK, the phase out of personal allowances on income over £100,000 results in a marginal tax rate of 60 percent for some higher rate taxpayers. Only three countries in the European Union, itself the highest taxed region of the world, have higher income tax rates than Britain's 50% rate: Denmark, the Netherlands and Sweden. (And according to the Heritage Foundation, these countries have significantly freer economies in other respects than Britain.) No OECD country outside the EU has a higher tax rate. The tradition of Colbert is confounded by the circumstance that France should have become a tax haven relative to the UK. The KPMG survey concludes by highlighting just how uncompetitive Britain now is:

> *"Rate increases in countries like the UK have provided an impetus for some exodus. Both from an individual and corporate level, countries like Switzerland, Hong Kong and Singapore may seem more tax attractive now than ever. While everyone may have a role to play in supporting their national deficit reduction measures, the fact that high income earners often have more mobility options should not be overlooked. Attracting such individuals, including their tax revenues and disposable income, via a competitive personal tax rate market while tackling budget deficits remains the challenge."*[2]

b. BKR survey. BKR International, an association of worldwide accountancy firms, has reviewed 19 countries and calculated how much revenue large shareholders in private companies are left with after tax.[3] The UK performs poorly in this comparison. The BKR index identified two figures for each country: the first for dividend income from a corporate entity and the second for income earned by an individual, partner or sole trader.

In Russia, Mexico, Turkey and South Africa private company shareholders can keep between 55.7% and 61.7% of their income. In Indonesia, France and India individuals, partners and sole traders keep between 60.5% and 76.5% of their income. In Britain by contrast they keep less than 41%. As BKR's UK representative Bob Rothenburg commented: "Privately-owned businesses usually are driven by the owners expectation of the sums left in their pocket after tax." These figures show that current UK policy is set to drive many away from Britain.

c. ABN Amro survey. ABN Amro Private Bank has completed another international survey of tax competitiveness,

1 United Kingdom: Policies for a Sustainable Recovery, OECD, July 2010
2 KPMG's Individual Income Tax and Social Security Rate Survey 2010
3 'Best tax-efficient countries revealed in indices', Financial Times, December 4, 2010

Table 1: Eighty six largest economies. Top tax bands

Country	Top tax rate	Rank	Country	Top tax rate	Rank	Country	Top tax rate	Rank
Argentina	35.00%	48	Guernsey	20.00%	24	Peru	30.00%	40
Armenia	20.00%	22	Hong Kong	15.00%	16	Philippines	32.00%	43
Australia	45.00%	70	Hungary	32.00%	42	PNG	42.00%	67
Austria	50.00%	80	Iceland	46.30%	76	Poland	32.00%	44
Bahamas	0.00%	1	India	30.00%	37	Portugal	45.90%	74
Bahrain	0.00%	2	Indonesia	30.00%	38	Qatar	0.00%	7
Belgium	50.00%	81	Ireland	47.00%	77	Romania	16.00%	20
Bermuda	0.00%	3	Isle of Man	20.00%	25	Russia	13.00%	13
Brazil	27.50%	34	Israel	46.00%	75	Saudi Arabia	0.00%	8
Bulgaria	10.00%	10	Italy	43.00%	68	Serbia	15.00%	18
Canada	29.00%	35	Jamaica	35.00%	50	Singapore	20.00%	28
Cayman Is	0.00%	4	Japan	50.00%	82	Slovakia	19.00%	21
Chile	40.00%	59	Jersey	20.00%	26	Slovenia	41.00%	66
China	45.00%	71	Kazakhstan	10.00%	11	South Africa	40.00%	62
Columbia	33.00%	45	Korea (South)	35.00%	51	Spain	43.00%	69
Costa Rica	15.00%	14	Kuwait	0.00%	5	Sri Lanka	35.00%	53
Croatia	40.00%	60	Latvia	26.00%	32	Sweden	56.60%	86
Cyprus	30.00%	36	Lithuania	15.00%	17	Switzerland	40.00%	63
Czech Rep	15.00%	15	Luxemburg	39.00%	58	Taiwan	40.00%	64
Denmark	55.40%	85	Malaysia	26.00%	33	Thailand	37.00%	57
Ecuador	35.00%	49	Malta	35.00%	52	Turkey	35.00%	54
Egypt	20.00%	23	Mexico	30.00%	39	UAE	0.00%	9
Estonia	21.00%	29	Netherlands	52.00%	84	UK	50.00%	83
Finland	49.60%	79	New Zealand	33.00%	46	Ukraine	15.00%	19
France	41.00%	65	Norway	47.80%	78	Uruguay	25.00%	31
Germany	45.00%	72	Oman	0.00%	6	US	35.00%	55
Gibraltar	40.00%	61	Pakistan	20.00%	27	Venezuela	34.00%	47
Greece	45.00%	73	Panama	25.00%	30	Vietnam	35.00%	56
Guatemala	31.00%	41	Paraguay	10.00%	12	Average	29.40%	NA

Source KPMG

concerning rates of tax for those who want to retire to another country, live off investment income and then pass assets on to their heirs.[4] The tax climate for retirees in many countries is preferable to that in the UK. For example, retirement income incurs a flat tax in Austria (25%), in Spain (21%), in Belgium (dividends at 25% and interest at 15%), and in Cyprus (dividends at 15% and interest at 10%). In the UK, by contrast, the highest rates are 42.5% for dividends and 50% for interest income.

d. Contrast with US. In the USA, President Obama recently decided to retain the tax cuts enacted under his predecessor. The 2010 Tax Relief Act preserves the 2001 cuts for a further two years. The top rate of income tax is planned to continue at 35% rather than the 39.6% rate to which it would have otherwise reverted. Similarly, the maximum 15% rate on long-term capital gains and on qualified dividend income is also legislated to continue. These rates are lower than those in the UK and place the US in a correspondingly strong competitive position.

4 Ibid

4 International evidence

"It should be known that at the beginning of the dynasty, taxation yields a large revenue from small assessments. At the end of the dynasty, taxation yields a small revenue from large assessments."

Ibn Khaldun, *The Muqaddimah*, 1377.

4.1 Introduction.

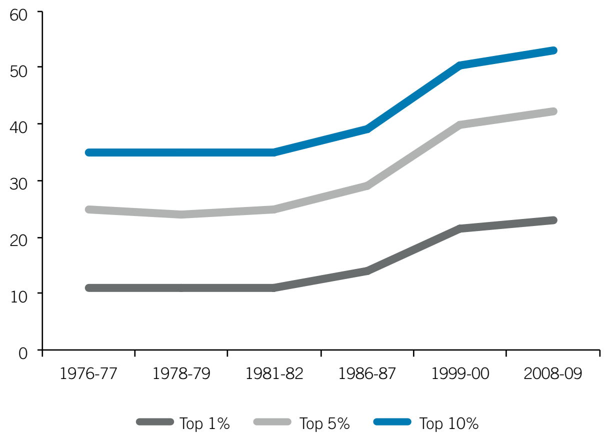
The quotation above comes from a 14th century Muslim philosopher and historian. It demonstrates that knowledge of the relative incentive and revenue effects of high and low tax rates upon wealth-creators is not new. (See appendix 1 for fuller details of Ibn Khaldun's supply-side approach to tax policy). In this section, however, we present more recent evidence from a wide range of countries, including the UK itself, the US, Canada, France, Hong Kong, India and Russia.

4.2 Evidence from the UK

a. The Howe-Lawson tax cuts. In 1979 Chancellor Geoffrey Howe cut the top rate from 83 percent to 60 percent. Before the cut, the top 1 percent of taxpayers paid only 11 percent of the total income tax take. By 1988 they were paying 14 percent of income tax revenue.

Then Nigel Lawson cut top rates even more, from 60 percent to 40 percent, and receipts rose further. By 1997 the top 1 percent of earners paid a huge 21 percent of the total tax bill. By more than halving the top rate of tax from 83 percent to 40 percent, Geoffrey Howe and Nigel Lawson doubled the proportion of income tax paid by the top 1 percent of earners, as shown in Figure 1.[5]

Figure 1: UK – share of total income liability, selected years



Source: HMRC
Note: from 1999, taxpayers counted as individuals not families

Latest estimates from HMRC predict that in 2010-11 the top 1% of taxpayers is expected to contribute over a quarter of total income tax receipts. We doubt this, as the evidence of this paper tells us that it is more likely that the percentage is set to start heading down again.

b. Reduction in revenue from non-doms. The first evidence of the behavioural effects of the introduction of the £30,000 non-dom charge is beginning to be seen. HMRC responses to Freedom of Information requests have shown that the number of non-doms (who do not pay tax on offshore income or capital gains) declined from 139,000 in the year prior to the introduction of the £30,000 charge to 123,000 in the year after it was introduced in April 2008. The 11.5pc decline was the first for five years.

The Treasury estimates that non-doms pay around £7 billion in tax every year. This suggests that some £800m has been lost as

5 'Why Nigel Lawson was the most redistributive Chancellor of the Exchequer', Fraser Nelson, Spectator, 26th September 2008

a result of the 16,000 reduction in the number of non-doms, a figure well above the £162m raised by the charge in the 2008/9 year. The total immediate net loss is £640m. This does not include indirect effects, such as corporate tax lost and the wider effects of lower economic activity.

4.2 Evidence from the USA

Evidence from the USA of the revenue effects of tax cuts and increases extends over almost a century.

a. The Harding-Coolidge tax cuts. Income tax was first introduced in America in 1913 at 7%. It was then raised to 73%, the justification being that revenue was needed to pay the costs of World War I. The effects on the economy were dire and the two subsequent Presidents, Harding and Coolidge, brought the top rate down to 25%. As President Calvin Coolidge explained:

> *"Experience does not show that the higher [tax] rate produces the larger revenue. Experience is all the other way. There is no escaping that when the taxation of large incomes is excessive they tend to disappear."*[6]

His Treasury Secretary, Andrew Mellon, correctly predicted that the lower rates would create increased growth, saying:

> *"It seems difficult for people to understand that high rates of taxation do not necessarily mean large revenues to the government and that more revenue may often be obtained by lower tax rates… A decrease in taxes causes an inspiration to trade and commerce, which increases the prosperity of the country so that revenues of the government, even on a lower basis of tax, are increased."*[7]

As a result, revenues nearly doubled. The share paid by those earning over $100,000 rose from 28% in 1921 to 51% in 1925.

b. The Kennedy tax cuts. By the time President Kennedy took office in 1961 the highest marginal tax rate in America was an astonishing 91%. The drive to reduce taxes was a Democrat one, opposed by Republicans. Kennedy showed a keen understanding of the effect of tax cuts on growth and pushed through a tax cut package which reduced taxes at all levels, cutting the top marginal rate from 91% to 70%. Kennedy stated in 1963:

> *"It is a paradoxical truth that tax rates are too high today and tax revenues are too low and the soundest way to raise the revenues in the long run is to cut the tax rates… An economy constrained by high tax rates will never produce enough revenue to balance the budget, just as it will never create enough jobs or enough profits."*

The Democrat Chairman of the House of Representatives Ways and Means Committee, Wilbur Mills, argued that tax cuts would raise receipts:

> *"There is no doubt in my mind that this tax reduction bill… can bring about an increase in the gross national product of approximately $50 billion in the next few years. If it does it will bring in at least $12 billion in additional revenue."*[8]

Wilbur Mills was right. The economy received a boost from the tax cuts. Moreover, the rich ended up contributing a larger share. Those earning over $50,000 increased the amount of taxes they paid by 40%, with their share of the tax burden going up from 12% of the total in 1963 to 15% in 1966. Total income tax revenue increased from $68.8 billion in 1964 to $95.7 billion in 1968. Walter Heller, who had served as the chairman of President Kennedy's Council of Economic Advisers explained the overall impact to Congress in 1977:

> *"The tax cut… did seem to have a tremendously stimulative effect, a multiplied effect on the economy. It was the major factor that led to us running a $3billion surplus by the middle of 1965… It was a $12 billion tax cut, which would be about $33 or $34 billion in today's terms, and within one year the revenues into the Federal Treasury were already well above what they had been before the tax cut."*[9]

c. The Reagan tax cuts. In 1981 President Reagan signed into law the largest tax cut in US history. This reduced rates across the board and the top rate from 70 percent to 50 percent. In the 1986 the tax reform act consolidated and reduced tax brackets to 15% for lower and middle income tax payers and to 28% for higher-income taxpayers.

Inland Revenue Service (IRS) data shows that after the high marginal tax rates of 1981 were cut, tax payments and the share of the tax burden borne by the top 1 percent climbed sharply. In 1981 the top 1 percent paid 17.6 percent of all personal income

6 Quoted in Jude Wanniski, Supply Side U, Spring 1998.
7 Quoted in Robert E. Keleher and William P. Orzechowski, "Supply-side Fiscal Policy" in Supply-Side Economics, a Critical Appraisal, e. Richard H. Fink (University Publications of America, 1982).
8 Quoted in Bruce Bartlett, "The Kennedy Tax Cuts," in " in Supply-Side Economics, a Critical Appraisal, e. Richard H. Fink (University Publications of America, 1982).
9 Quoted in Robert L. Bartley, The Seven Fat Years, (New York: Free Press, 1992).

taxes, but by 1988 their share had jumped to 27.5 percent, a 10 percentage point increase. The share of the income tax burden borne by the top 10 percent of taxpayers increased from 48.0 percent in 1981 to 57.2 percent in 1988. By contrast, the share of income taxes paid by the bottom 50 percent of taxpayers dropped from 7.5 percent in 1981 to 5.7 percent in 1988.

d. The George H.W. Bush tax increases. George H.W. Bush was elected on a platform of "no new taxes." However, he decided to break his promise and go along with the Democrat majority in Congress by supporting the passage of the Omnibus Budget Reconciliation Act of 1990 which replaced some of the fuel taxes with a 10% surtax on the top income tax bracket (thus raising the top marginal tax rate to 31%) and also included new excise taxes on alcohol and tobacco products, automobiles and luxury yachts.

The stated reason was to reduce the deficit. The only problem was that the tax increase had the opposite effect. While federal receipts as a percentage of GDP were 19.3% in 1989, by 1991 they had slipped to 19.1%. The Wall Street Journal pointed out that the rich paid $6.5 billion less taxes in 1991, after the tax increase, than they did in 1990 before the increases took effect.

e. The George W. Bush tax cuts. In 2003 George W. Bush persuaded Congress to reduce the highest rate of income tax from 39.6% to 35% and the dividend tax from 39.6% to 15%. The economy powered ahead as did tax revenues. From 2004 to 2007 federal tax receipts increased by $785 billion with the bulk of that coming from the better-off.

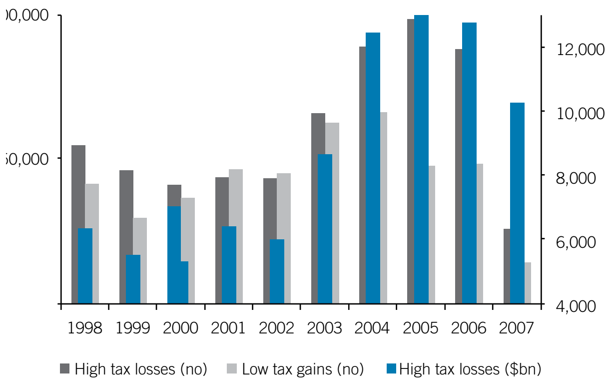
In 2000, the top 60 percent of taxpayers paid 100 percent of all income taxes. The bottom 40 percent collectively paid no income taxes. From 2000 to 2004, the share of all individual income taxes paid by the bottom 40 percent dropped from zero percent to minus 4 percent, meaning that the average family in the bottom 40 percent was sent money through tax credits.

During the period 2003 to 2006 the number of people filing tax returns claiming income of over a million almost doubled, from 181,000 to 354,000. The total taxes paid by these millionaire households rose by 107% in just two years, from $132 billion to $273 billion.

f. Movement of people and income between high and low tax states, 1998–2008. Research in the US shows the effects of tax rates imposed by US states. In the US wealth-creators can easily avoid higher state taxes by moving to another state. There are nine states with no income tax – Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington and Wyoming. In 2008 alone these states gained a net total of over 80,000 new residents from the other 41 states. These migrants brought with them over $900 million of net adjusted income according to IRS data.

By contrast, the ten states with the highest tax burden – California, Connecticut, Hawaii, Maryland, New Jersey, New York, Ohio, Vermont, Wisconsin and Pennsylvania – lost around 129,455 residents and $10.2 billion of net-adjusted income in 2008 alone. From 1998 through 2008, the ten states with the highest tax burden lost over 3 million residents. These residents took with them a huge $92 billion in income. During the same period over 2.3 million migrants moved to the states with the lowest tax burden, bringing more than $97 billion with them. The ten lowest tax burden states – Alaska, Arizona, Florida, Louisiana, Nevada, New Hampshire, South Dakota, Tennessee, Texas and Wyoming – gained 71,888 new residents and $8 billion in adjusted gross income in 2008 alone.[10]

Figure 2: US – residents moving between states and revenue effect (RH scale), 1998 to 2007



Source: IRS

The situation in the UK is not an exact parallel with the US. While there is freedom of movement within the EU, there remain language and cultural differences which make moving between European countries more difficult than moving between US states. Even so, English is now the language of commerce and has been adopted by most multinationals, so highly skilled people can move between countries more easily than in previous time periods.

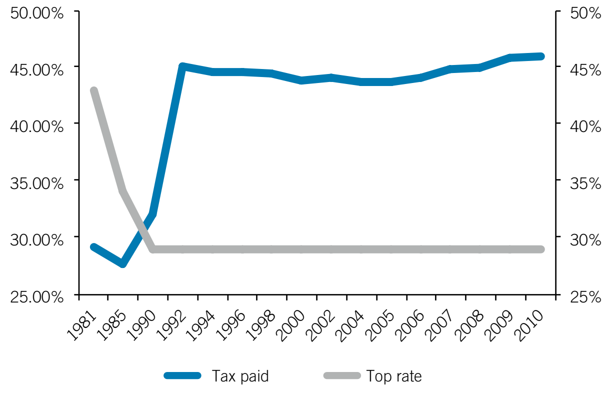
4.3 Evidence from Canada

a. Federal income tax cuts. Evidence from Canada shows a similar picture to that in other countries. When the top federal tax rate was cut from 45% in 1981 to 29% in 1990, the share of tax

10 Figures are set out in 'Cost of government Day', Americans For Tax Reform, 2010.

receipts paid by the top 10% of taxpayers grew from 29% in 1981 to 45% in 1992, where it has remained.

Figure 3: Canada – tax paid by top-rate taxpayers & top marginal rates (RH scale), 1981 to 20107



Source: The Fraser Institute's Canadian Tax Simulator 2010; Treff, Karin and David B. Perry, Finances of the Nations (various issues).
Note. Over this period, the threshold for the top tax band fell from C$119,981 in 1981 to C$62,161 in 1982, then falling to 20o0 and thereafter rising

b. Income tax cuts in British Columbia, 2001. For most of the past 30 years, British Columbia's economy has lagged behind those of the other Canadian provinces. Its performance was unsatisfactory between 1982 and 1996 when it experienced Canada's lowest per person growth rate. In 2001, however, a newly elected government brought in a series of incentive-based tax cuts and as a consequence the provincial economy became one of the fastest growing in Canada.

The corporate income tax rate was initially reduced by 3 percentage points from 16.5 percent to 13.5 percent in 2001, then in 2005 further reduced to 12 percent. The general corporate capital tax was also abolished in 2001. A 25 percent across-the-board personal income tax rate reduction was enacted in 2001, changing British Columbia's status as the province with the second highest top marginal personal income tax rate (19.7%) to the second lowest (14.7%), behind only Alberta.

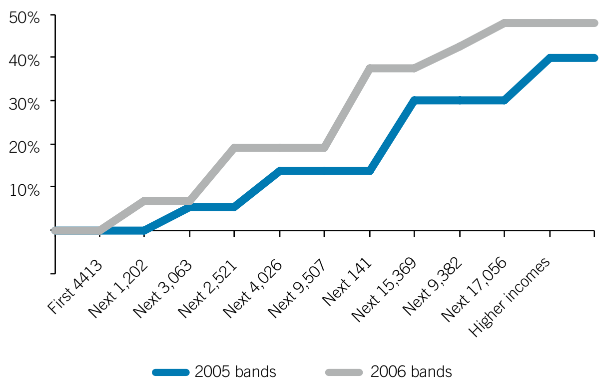
The economic effects were studied in detail by the University of Alberta and published in 2008.[11] The statistics showed that higher provincial corporate and personal income taxes caused lower per person GDP growth rates. They found that a 10 percentage point cut in a province's corporate income tax rate was associated with a 1 to 2 percentage point increase in the per person GDP growth rate, and a 10 percentage point reduction in the top personal income tax rate caused a one percentage point increase in the growth rate. They found that a 10 percentage point cut in the top personal income tax rate was related to a 5.96 percentage point rise in the ratio of private investment to GDP.

The results showed that provincial corporate and personal income tax cuts spurred economic growth and that provincial revenues did not decrease as a result of the tax cuts. In fact, the opposite was true – they went up.

4.4 Evidence from France

French income tax rates have been gradually reduced since 1996. A substantive reform took place in 2006. The top marginal rate was reduced from 48.09% to 40.00% and all other rates were cut too. The number of bands was reduced from 7 to 5. The situation in 2005 is set out in Figure 4 (below).

Figure 4: France – personal income tax brackets, 2005 and 2006

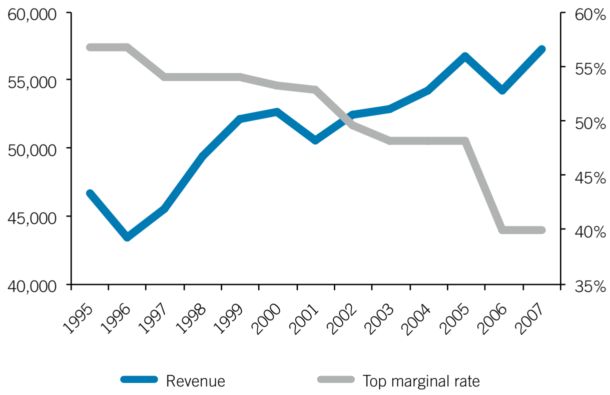


Source: IREF based on DGFiP data (available at http://www.impots.gouv.fr/)

At the same time that the top rate was reduced from 48% to 40%, other changes were made. In particular the deduction from taxable income of the first 20% of gross income was removed. This meant that the actual taxable rate was about the same. The effect on public revenues is best seen from the picture over time. Data from the French Public Finances General Directorate (DGFiP), illustrated in Figure 5 (below), show that the successive cuts in marginal tax rates between 1995 and 2007 have resulted in higher tax receipts.

11 Assessing British Columbia's Incentive-Based Tax Cuts by Professor Bev Dahlby and Ergete Ferede, Fraser Institute, Canada, February 2008
12 The amount of tax revenues and the marginal tax rate corresponding to year "X" are the tax revenues collected in year X+1 for income realized in year X and the rate applied to those year-X income. Thus in 2008 the French state collected € 57.304 billion from PIT based on income realized in 2007; and the top marginal rate applied to the taxable 2007 income (that is to taxable income above € 66 680) was 40%

Figure 5: France – tax receipts and top marginal rates (RH scale), 1995 to 2007 [12]



Source: IREF based on DGFiP data (available at http://www.impots.gouv.fr/).

4.5 Evidence from Hong Kong

Hong Kong has a simple tax system. There is a low-rate optional flat tax of 16 percent on personal income. Taxpayers can choose an alternative system with graduated rates, though the top rate in this system is only 17 percent. There is no PAYE (that is, no withholding of tax on income from employment) in Hong Kong, meaning that taxpayers pay their entire income tax liability themselves (usually twice a year). This means that overseas taxpayers have a clear idea of how much they are paying in tax to the state. The wealthy pay most of the tax in Hong Kong. The bottom 60 percent pay no income tax at all while the richest 100,000 taxpayers (the top 8 percent) pay 57 percent of the total tax burden. Government spending is held to about 20% of GDP.

Partially as a result of this, Hong Kong has long been one of the world's fastest growing economies. Per capita income today is about $30,000, up from less than $2,000 after World War II. Despite its small land area, Hong King's economy is bigger than that of Israel and the Czech Republic. Its GDP per capita at purchasing power parity is the 7th highest in the world, more than Switzerland and Netherlands and almost the same as that of the USA.

4.6 Evidence from India

India has shown time and again that lowering tax rates leads to increased revenue. Comprehensive tax reforms were first implemented in the 1985 budget. Corporate tax was cut, income taxes simplified and lowered for high-income groups, and wealth taxes reduced. The top rate was reduced from 65% to 50%. As a result, tax revenue in the 1985 fiscal year rose by 20 percent over fiscal year 1984, as taxpayers responded to lower taxes with greater compliance.

Further lowering of rates over the years always resulted in increased receipts. One of the more dramatic reductions occurred in 1997, when tax rates were reduced for all taxpayers. The effective tax rate declined from 22 to 16.3 percent. Nay-sayers at the time did simple calculations and warned that public revenues would decline by 25%. They were proved wrong. A year later figures showed that instead of declining by 25 percent, tax receipts stayed constant, mainly due to improved compliance – from 5.5 million taxpayers the year before to 6.8 million in 1997-98. Over the following six years, overall compliance increased by 50 percent. Revenue rose over that period. For each 10 percent decline in the tax rate, the government was able to raise aggregate revenue by 14 percent.

Tax-cutting Indian Finance Ministers have been firm adherents of the Laffer curve. (The Laffer curve is an economic theory that posits that tax revenues will often increase with a decline in tax rates. The mathematics behind the theory is simple – at a zero tax rate, the government receives no revenue and the same is true at a 100 percent tax rate). In 2005 Finance Minister P. Chidambaram chided opponents, saying: "There's a Newton's law of economics: For every economist, there is an equal and opposite economist," adding that his opposition shadow Sinha ``should not be carried away by what economists will tell him, that the Laffer Curve won't work. The Laffer Curve will work."[13.] The tax cutting Finance Ministers have been proved correct. For example:

- Income tax collections in India increased from Rs 166.5 billion in 1991-92 to Rs 1,226 billion in 2008-09.
- The personal income tax-GDP ratio itself has nearly trebled to 2.6 percent since 1991-92.
- In 1996, personal income tax collections were a mere Rs. 180bn, and constituted only 9 percent of total tax revenue. Just 12 years later, personal income tax receipts exceeded Rs. 1,220bn, a near seven-fold increase, reflecting an annual growth rate of 16 percent per annum. In contrast, overall tax revenue has increased at a 13.5 percent rate, and GDP at an annual rate of 11.4 percent.[14]

13 'India's Tax Plan May Again Bet on Laffer Curve' Andy Mukherjee, Bloomberg, February 10, 2005
14 Tax compliance and tax rates: India 1996-2010, Surjit S. Bhalla, February 6, 2010

4.7 Evidence from Russia

In January 2001, Russia introduced a radical reform of its personal income tax, becoming the first large economy to adopt a flat tax. The Tax Code of 2001 replaced a conventional progressive rate structure with a flat tax rate of 13 percent. In the year following the reform, while the Russian economy grew at almost 5% in real terms, receipts from the personal income tax increased by over 25% in real terms.[15]

4.8 Conclusion

The evidence from the UK, US, Canada, France, India and Russia is consistent. High top rates of tax fail to produce public revenues and injure economies. This should be no surprise as – unlike geese – taxpayers do not sit still for plucking. In the next section we introduce the evidence of UK taxpayers' responses to increases in taxes.

15 Lessons from Russia's Tax Reform, Yuriy Gorodnichenko, Jorge Martinez-Vazquez , Klara Sabirianova Peter, 2008

5 Behavioural responses

5.1 Introduction

Most high-rate taxpayers are wealth-creators. They have a keen eye to their economic wellbeing, with the inclination and resource to pursue it. Taking away larger proportions of their income in tax changes their incentives. Some just pay the higher taxes, but most are more likely to take a variety of measures in order to keep more of their own income. These measures include:

- Working less and retiring earlier.
- Emigrating to other countries where tax rates are lower.
- Contributing more into their pension or other tax shelters, such as ISAs, VCTs, EIS schemes, etc.
- Incorporating and holding funds within companies, planning to sell companies at a later date at lower rates of capital gains tax.
- Transferring income-producing assets to lower-rate taxpayers within the family.
- Deferring income to later years, e.g. by not paying out bonuses or dividends.
- Investing time and money in more sophisticated forms of tax avoidance.

The measures taken differ from person to person and as between different businesses or professions. We do not argue that Britain's punitive tax rates are having an immediate impact by forcing all those affected to move to Switzerland. There are many options short of such a drastic approach. Some may emigrate and some already have. Others will plan for it in the future, shifting parts of their business overseas if they can, or accelerating retirement to a more tax friendly jurisdiction. Foreigners who have moved to the UK, but have few ties to it, are more likely to leave. But others have children in school, jobs that are difficult to move and emotional ties to Britain. It is the net migration effect that is important, not just the numbers leaving, but the numbers arriving. (In particular the evidence we present below suggests there is a decline in the willingness of high earners to move to the UK). Persons affected and their behavioural reactions include the following:

5.2 Finance industry

The finance industry is a key contributor to the UK economy. It provided £66 billion in tax receipts in 2009, employed 1 million people, accounted for 10% of GDP and contributed a £40bn surplus to the country's balance of payments.[16] The finance industry is mobile compared to other activities: other financial centres provide alternative bases to which professional companies can shift. London was not always the prominent financial centre that it is today, only becoming a global hub after the introduction of policy decisions in the US that undermined the status of New York City. An even more drastic decline could easily occur to the British sector under the right circumstances.

a. Policy Exchange/YouGov survey. Financial services professionals were surveyed by YouGov on behalf of Policy Exchange, who published the results in December 2010.[17] 43% of those surveyed have either considered or are currently considering whether to leave the UK. Over a quarter of those (11% of the total respondents) have already considered their positions and are either definitely

16 'Taxation of the Financial Services Sector in the UK.' City of London Corporation, October 2010.
17 Not with a Bang but a Whimper: Are we undermining the future of financial services in Britain? Policy Exchange, December 2010

departing or likely to do so. This is a large number that is bound to hurt public revenues. It is the younger professionals who are most interested in leaving. Of the 25-34 age bracket a full 15% are leaving or likely to do so, compared to only 7% in the 55 and over age group. 63% of those surveyed cited the overall burden of tax as a key factor in their departure.

The Policy Exchange/YouGov survey also looked at the plans of financial sector institutions and found that 23% of institutions have either considered or are currently considering whether to relocate their businesses out of the UK. 2% of respondents were in the process of planning to relocate or considered themselves likely to do so. Moreover, some 25% of the senior managers surveyed by YouGov thought it likely that over the next few years their organisation would move parts of teams out of the UK. Only 2% thought their organisation would add to their UK operations over the next few years. Clearly if major organisations were to depart, the impact would be very large. It has recently been suggested that it is 'more likely than not' that HSBC will leave the UK. This would put at risk over £3b of the UK's tax base.[18]

Evidence is mounting that this shift in personnel has started. This was most recently highlighted by Channel 4 News, which revealed data from the Swiss Federal Migration Office showing that 383 UK citizens working in banking and financial services moved to Switzerland in 2010, an increase of 28 percent on the previous year. Combining the overall banking, insurance and consulting sectors, including IT, 1,379 Britons were given permission to work long-term in Switzerland in 2010, up 29 percent.

b. Hedge funds and other financial businesses. Data from professional services firms serving the hedge fund industry indicates that a partial exodus is underway. Over the last 4 years, 80 firms have moved – in whole or in part – out of the circa 650 Hedge Funds in the UK.[19] Most firms shift a part of their operations overseas, with only medium-sized firms moving all of their operations overseas. Some 500 individual hedge fund managers (HFMs) have already moved, the bulk to Switzerland, and 150 are in the process of doing so. Recent reports reveal that dozens are moving to Malta.[20] The rate of departure is increasing. Of the 80 firms that have moved, over half moved in the last year. Given the current rate of departure, we may reasonably expect that some 20% to 25% of UK-based hedge funds will move offshore over the next two or three years.

Although there are some high profile departures, (e.g. Bluecrest and Brevan Howard which have each moved over a hundred HFMs), the majority of firms move under the radar as they seek to avoid publicity. Only a few have made strong public statements. Stephen Hedgecock is a partner at Altis, a hedge fund with assets under management of over £1 billion, which is moving to Jersey. He said:

> *"The UK model is broken. It's not just the 50% rate - it's National Insurance, the treatment of pensions... everything. It's just a ridiculous amount of taxation."*[21]

We expect the total revenue loss to be considerable. Calculating the average amount earned by an HFM is difficult, given the wide disparity in earnings. Some earn £200m to £300m or more, others £150,000 to £200,000. (The magazine Business Insider calculated in mid-2010 that the move to Switzerland of just a small number of traders in two hedge funds had already cost the UK Treasury £400 million in lost revenue.)[22] Across the piece, an estimate of average earnings of £1.5m per HFM is reasonable.[23] Thus the total revenue loss from this small exodus is set to be between £1bn and £1.5bn.

Turning to insurance, nine of the top ten operators in the specialist London Market, where UK companies have a world lead, have moved their tax domicile residency outside the UK in the past decade. Only nine out of more than 50 Lloyd's managing agents remain domiciled in the UK as of July 2010. This has reduced the UK's tax base by more than £1bn.

5.3 Industrialists and other executives

Manufacturing companies are less mobile than the financial sector. Nevertheless, movement does frequently occur, particularly as the largest firms are global and have the capacity to relocate to save money in the long run. By the same token, new operations or expansion of existing operations can take place outside the UK. New recruitment can take place outside the UK. The evidence below conveys that all these things are happening amid a background of increasing hostility to the UK tax system.

a. CBI Deloitte survey. The CBI Deloitte survey of senior business leaders in FTSE 100 & 250 companies in September 2010 revealed the depth of the problem.[24] The report stated that:

18 Warning: More tax could risk a City exodus, Stuart Fraser, Evening Standard, March 4, 2011.
19 Of these some 50 were assisted by Kinetic Partners and 30 by other professional services firms.
20 Hedge funds head for Malta to escape regulation, Financial Times, March 3, 20100
21 'Ten entrepreneurs a week quit UK to avoid 50pc tax rate,' Daily Telegraph, December 13, 2009
22 'More Capital Execs now also leaving London,' Business Insider, July 30, 201
23 Estimates by professional services firms.
24 CBI-Deloitte Ipsos-Mori Survey, September 2010 'Britain as a place to invest.'

Verbatim responses to surveys

CBI-Deloitte survey (2010)

"We're finding it difficult to attract employees from overseas to the UK because of the 50% tax rate and the amount of allowances you can claim in the UK."

"Highest tax rate. No one wants to work here; everyone wants to work in Latin America, America, or Asia. It's a big issue, people that weren't internationally mobile changed their minds in the last six months and want to work abroad because of tax levels. It's impossible to attract staff to the UK"

"We have gone on record as a company saying taxation levels in general are too high, we can't attract talent to the UK. Company was domiciled in the UK in 1988 and has got progressively worse since then. Generic corporate tax and unpredictability of tax is one of the things that has damaged confidence in tax system, overseas nationals tax inhibits our business."

"Fundamentally people in UK are over-taxed."

"Again our tax rates are higher than most of our competitors."

"Tax levels high and low return. Quality of life isn't as high as tax would suggest it should be. Other countries have a better quality of life and much lower tax."

"It's high and it's getting higher. Increasing political desire to increase taxes on high earners is ultimately not good for business productivity at all levels."

"We're seeing in our sector some highly qualified people deciding to go elsewhere because of taxation levels. Changes in capital gains tax and income tax make the UK punitive compared to other countries."

"The effective tax rate is much higher than in US or Western Europe. As our HQ is in the UK and not one of those countries our tax rate is higher than other HQs in same sector."

"Because at the moment we don't have a stable or predictable environment in the UK. Not competitive compared to other territories, doesn't enable UK multi-nationals to compete on a level playing field."

"Highly unpredictable. Levels of tax too high both with income tax and unpredictable capital gains tax. Much less attractive than three years ago, especially for us as global company."

Adam Smith Institute survey (2011)

"The international tax regime and policy of our parent company jurisdiction needs to provide:

- a competitive tax rate on broad categories of income
- an environment where the business can operate free of tax complexity
- the benefit of long term stability, consistency, transparency and certainty of corporate tax policy

Taking all of those factors together the UK tax regime has not met those conditions. Our move predates the introduction of the 50% income tax band in the UK. Clearly, this is currently a significant factor in our ability to attract, retain and incentivize the talent and expertise needed to our organisation compared to countries offering not only lower rates of income tax but also significant personal tax reliefs against that income".

"As a group that invests heavily in its human capital, the 50% tax rate can be problematic in attracting senior executives to the UK. This is not surprising given the competition from a number of other countries in the EU with much lower personal tax rates. Further, some senior executives who were expats working in the UK have now moved back overseas".

"Taxation is an inflammatory issue for the UK's business elite. Interestingly, where companies are operating in more than one country both business and personal taxation become more important, with the importance of personal taxation increasing steadily with the number of countries involved. Just as striking is the fall in the perception of the UK's performance once a company operates in more than one country… High levels of personal taxation make it difficult to attract internationally mobile key staff.

Taxation appears to be the key issue for most companies, especially global companies that are internationally mobile. Relatively high levels of business and personal taxation have resulted in a significant perceived decrease in attractiveness over the past 10 years"

Verbatim quotations from company leaders interviewed are shown in the on the opposite page; they provide a good indication of corporate feeling on this issue. They were asked: "Why do you say the UK is less attractive compared to its competitors?"

Some companies have decided to relocate overseas, with the main reason usually cited as Britain's uncompetitive corporate tax regime. The reductions in corporation tax announced in the June 2010 budget do not seem to have done much to prevent that flow of departing companies, with new announcements every month.

b. Adam Smith Institute survey The Adam Smith Institute has surveyed major companies that have moved out of the UK. Responses regarding the UK tax regime were negative as shown on the opposite page.

c. Research by HMRC, Sunday Times and others. Research commissioned by HMRC and completed in August 2010 estimated that 20% of large companies were considering relocation overseas for tax reasons.[25] In 2010 alone, over 20 large companies moved abroad for tax reasons, including: Ineos Runcorn UK, WPP, Shire, Informat, PepsiCo, Hendersons Ireland, Charter, Regus, Brit Insurance, Wolsely plc, McDonalds (European HQ), UBM, Kraft Foods, Gallaher, Experian, Catlin, Hiscox, Shell and Cadbury.

More recently the luxury goods retailer, Mulberry, announced that punitive tax rates were the main reason why it had decided not to open a second factory in Britain. "We would love to make more in the UK but over the last 10 years the political and economic climate has not been conducive to investing in the UK," said Mulberry Executive Chairman Godfrey Davis. He said the government should encourage investment in the UK by lowering taxes, rather than giving handouts for capital investments. "The government needs to understand that it's not about giving people money to set up factories, but about changing the tax structure," he said.[26]

It is not just large companies that are leaving. Research by Philip Beresford, compiler of the Sunday Times Rich List showed that during 2009 ninety-one UK companies moved their registered address to Jersey, Guernsey or the Isle of Man. During the same year at least 498 directors of UK companies changed their addresses to the same locations, showing that they had moved with their companies.

The statements from corporate leaders demonstrate that it is not just high corporate tax levels that drive companies overseas but high income tax levels too. Moreover, companies may not move their corporate headquarters overseas but still recruit more to non-UK locations. There is evidence that a difficulty in attracting staff to the UK is forcing UK companies to shift functions overseas. For example, Paul Walsh, chief executive of the drinks company Diageo, recently said it was increasingly difficult to relocate people to the UK and warned of the urgent need to reform tax rates, saying:

"We have dramatically reduced the amount of people we bring into the UK. We're asking whether we can put more of our analysts in Budapest, for example, rather than Britain."[27]

5.4. Other high earners

This includes fashion, the arts and the media .To take the example of entertainment industry stars, some vote with their feet while others take avoidance measures. For example, Sir Michael Caine commented recently on his earlier decision to leave the UK and threatened to repeat it:

"I left for eight years when tax was put up to 82 percent. The newspapers said: "Michael Caine's leaving: let him go, the stupid, overpaid, loudmouth idiot, who cares where he goes?" Well, you didn't get 82 percent tax from me for eight years and a quarter of a billion dollars worth of movies were made outside this country instead of inside it. Now, that is just one stupid, loudmouth moronic actor. Imagine what happens with companies that disappear."

In recent years, three of the Rolling Stones have transferred much of their earnings to the Netherlands, where there is a favourable tax regime for earnings from royalties. Research by the New York Times showed that they had paid $7.2 million in taxes on earnings

25 'Tax regime drives 20pc of big businesses to consider leaving UK' Daily Telegraph, August 25, 2010.
26 'Tax rates deter Mulberry from bagging new factory in Britain' Daily Telegraph, February 25, 2011
27 'Taxes force Diageo to slash number of staff it brings to UK', Daily Telegraph, February 11, 2011

of $450 million, an effective rate of 1.5%, well below British rates of income tax of 40% and 50%.[28]

5.5 Top sportsmen and women

The new high rates of tax and the way they are being implemented is hurting the British sports industry. A paper issued by the National Bureau of Economic Research (NBER) shows compelling evidence of a link between taxation and migration of top footballers. Combining the evidence from tax reforms in all 14 countries, the NBER found that the location decisions of players are responsive to tax rates and, indeed, that taxation is the primary factor in migration decisions.[29] For example, star player Christiano Ronaldo is said to have moved from Manchester United to Real Madrid in 2009 to avoid the announced 50% tax in the U.K. and instead benefit from the so-called "Beckham's Law" in Spain under which foreign residents pay tax at a rate of 24%. Arsene Wenger, manager of Arsenal FC, stated that the introduction of the 50% tax rate would mean that "the domination of the Premier League will go, that is for sure."[30]

In circumstances where players are not moving, many are demanding higher pay from clubs to compensate for higher taxes – negotiating on net pay rather than gross pay. This is adding a considerable amount to clubs' wage bills and placing them under commercial strain. If we take the example of a player currently earning a salary of £1 million a year under a net pay agreement, the cost to the club in 2009/10 was roughly £1.91 million (including employee's and employer's National Insurance) From 6 April 2010, the cost of this same deal rose to £2.3 million, an increase of 20% on the club's already hefty wage bill.

A related difficulty involves the attempts of HMRC to tax the worldwide income of foreign sports professionals when they compete in the UK. This was the reason for world record holder and Olympic champion Usain Bolt's decision not to compete in the UK. He would be taxed not only on prize money won, but also on part of his global endorsement income, calculated on the proportion of the events he played in Britain. If, for example, he races 10 times in a year with just one event in the UK, HMRC would claim 10 percent of his multi-million dollar global earnings at the UK's high tax rates. Other sportsmen understood to have avoided UK events because of the tax issue include Roger Federer and Sergio Garcia. Questions have been raised as to whether major events such as the Ryder Cup are under threat because of the unwillingness of foreign star players to come to Britain.

Britain's sports superiority, exemplified by franchises such as the Premier League, is a huge contributor to the British economy and to the quality of life of many British sport fans. Leaving aside the immediate negative revenue effect and looking at the bigger picture, does it make sense to put it under threat?

5.6 Young professionals

Young professionals are mobile. Today they can be excused for wondering if high tax, low service quality Britain is the place where they want to build their careers. Gallup surveys in 2010 show one in three Britons say they would like to leave Britain permanently if they had the opportunity. Britons are among the most likely in the European Union to say they would like to move. Younger, working-age Britons and those with secondary or higher education are the most likely to say they would like to migrate. One in three or more with secondary educations (33%) or the equivalent of a bachelor's degree or higher education (36%) say they would like to move if they had the chance. Some already have.[31]

Research by foreign exchange broker Currency UK in 2010 showed that some 75% of Britons have considered becoming expats in 2010 because of the poor state of the economy and a lack of job prospects. Australia is the most popular destination, followed by Canada, the US, New Zealand, Spain, France and Thailand. The survey was last conducted in 2005 when only 25% said they were considering emigrating.[32] A recent NatWest survey suggests that those who wish to leave the UK are right to do so. Nine out of ten of expats surveyed said that their quality of life had improved and they were earning more and enjoying better conditions in their new homes than they would have in Britain.[33] On average, wages for managers and professionals who choose to work abroad are up to £20,000 higher than they would get if they remained in Britain.

Robert Hiscox, Chairman of the Lloyd's insurer Hiscox plc, said that the government's tax policy had "lowered the barrier to exit," pointing out that his company had been surprised by the volume

28 'The Netherlands, the new Tax Shelter Hot Spot,' Lynnley Browning, the New York Times, February 4, 2007. The article also describes how the saintly Bono and U2 are also taking advantage of the Netherlands to reduce the amount of tax they pay.
29 'Taxation and international migration of superstars: Evidence from the European football market', Henrik Kleven, Camille Landais, Emmanuel Saez NBER Working Paper 16545, November 2010
30 'Arsene Wenger warns of premier league tax bomb' The Times, April 25, 2009
31 For example, Corre Myer, the 30-year old Director of Sales and Marketing for TBM Glass Inc., blogged of her move to the USA: "I am leaving London to the true Londoners…But I am less loyal and more opportunistic than that, so I shall go, along with all the others who wish to hold on to a little more of their hard earned money." 'Leaving London: An Easy Decision,' Here is the City Life, 19 January 2010.
32 http://www.dailymail.co.uk/news/article-1275878/Three-quarters-Britons-want-emigrate-Australia-popular-destination.html
33 http://www.dailymail.co.uk/news/article-1267641/9-10-UK-expats-say-quality-life-better-abroad.html#ixzz18b6ZqnjK

of its staff requesting to move to its foreign operations in recent months: "People are becoming downbeat as the government makes the UK less competitive, which is scandalous in a country where footballers can earn £9m a year and nobody even flinches. Worse still, many of the people looking to leave Britain are not our highest earners, most hold middle-ranking jobs and are willing to uproot their families to leave the country.»[34]

5.6 Specific actions

a. Working less or retiring. Some have already accumulated enough capital that they can live off it comfortably. In these cases, high tax rates create an incentive to work less or stop working altogether. If the government is taking 60% of one's income, the incentive to work hard is reduced, as is the opportunity cost of leisure time. For those who do need to continue working, the incentive to work more to earn that extra amount is also reduced.

President Ronald Reagan used to describe the days when he worked as an actor in the times of 90% marginal tax rates. After a certain point in the year he and fellow actors just stopped making films. What was the point, he asked? We have no doubt that many in Britain currently feel the same.

Academic research confirms this obvious point. A 2004 study by Nobel prize-winning economist Edward Prescott, for the National Bureau of Economic Research (NBER), found that people work more when tax rates are lowered.[35] Another NBER study found that among richer taxpayers, the lowering of tax rates that occurred in the USA in the 1990s led to an increase in hours worked and an increase in the number of people in the labour force.[36]

b. Putting more into pension or other tax shelters. Many, particularly those with taxable income between £150,000 and £200,000, and of between £100,000 and £122,950, are able to avoid the higher rates by using normal tax shelters, particularly pensions. This is likely to have the effect of reducing tax receipts, by prompting greater use of such tax shelters and their income tax rebates.

The largest tax shelter available is the pension. The last government introduced restrictions on the amount of money that higher rate taxpayers could put into a pension with full tax relief. These restrictions were complicated, in essence restricting the amount to between £20,000 and £30,000. The current government has simplified the system and increased the annual allowance for higher rate taxpayers to £50,000. Anecdotal evidence from firms running private pension schemes suggests that there is a huge increase in the amount of funds being directed into pensions.[37]

Larger sums are going into Venture Capital Trusts (VCTs) which offer 30% income tax relief and subsequent tax free dividends and capital gains. Whereas only £135m was raised in the 2008–09 year, £350m was raised in the 2009-10 tax year, when the introduction of the 50% tax rate was known. Based on the quantity of funds raised to date, tax professionals expect at least £450m to be raised in the current tax year.

Although ISAs do not offer income tax relief on the sum invested, but only tax free dividends and capital gains, it is clear that larger sums are flowing into ISAs, as people seek whatever tax shelters are available. With the annual ISA allowance now at £10,200 a couple can shelter £20,400 from tax each year. High tax rates are driving people to make maximum use of ISAs.

Some have investments in excess of the annual ISA limit. Tax advisers report that higher tax rates are pushing many more people to use simple avoidance tools, such as putting investments in the name of the lower earning spouse. Other lawful approaches involve using onshore or offshore investment bonds, where no tax has to be paid until the bond is exchanged for cash, by which time one might have moved offshore or be in a lower tax band.

Using some combination of the above tools, with pension investment as the primary one, it is clear that almost all people earning in the £150,000 to £200,000 band can avoid paying the 50% rate of income tax altogether.

For other higher earners, other more sophisticated but more expensive tax avoidance techniques are available. Although the government has tried to block off many opportunities for tax avoidance in recent years, experienced advisers can always keep one step ahead in formulating tax avoidance schemes that fit within the letter of the law. The range of legal possibilities is still immense, although costly and time-consuming.[38] Where serious sums are at stake, however, we expect most people to prefer spending smaller amounts of money on tax advisers than larger amounts on tax.

Tax advisers report increased avoidance activity. Mike Warburton, senior tax adviser at Grant Thornton, has commented that "people are taking obvious avoidance measures because they are not prepared to pay 50 percent tax. People were prepared to pay 40

34 'Hiscox attacks UK's 'scandalous taxes,' Daily Telegraph, June 10, 2009
35 Edward Prescott, "Why Do Americans Work So Much More Than Europeans?" National Bureau of Economic Research Working Paper No. 10316, February 2004.
36 Steven J. Davis and Magnus Henrekson, "Tax Effects on Work Activity, Industry Mix, and Shadow Economy Size: Evidence from Rich-Country Comparisons," National Bureau of Economic Research Working Paper No. 10509, May 2004.
37 Author's conversations with major UK firms supplying pension products.
38 E.g. see http://www.guardian.co.uk/business/2011/jan/16/premier-league-footballers-tax-avoidance

percent but the Treasury don't seem to understand what drives people." [39] Richard Jordan, a partner at law firm Thomas Eggar, said: "I would say that 40% of my work involves advising people on ways to leave the country. We have reached a tipping point, in terms of hostility to the UK tax system."[40] The Adam Smith Institute has undertaken a survey of tax advisers and we present the results later in this report.

5.7 Conclusion.

The evidence is compelling that where possible, high earners take the perfectly rational decision to minimise their tax liability. It is unrealistic to expect otherwise after last year's increase in the UK's top rate of income tax. In the following section, we work up some sums to gauge the fiscal loss to the UK.

39 http://www.timesonline.co.uk/tol/news/politics/article7011728.ece
40 http://www.efinancialnews.com/story/2010-01-04/wealthy-face-up-to-a-high-tax-world-1

6 Economic and fiscal costs

6.1 The net revenue issue

When Chancellor Alastair Darling introduced the 50% tax rate, he had no notion of the economic impact it would have, admitting that he introduced it without detailed analysis but because it seemed right at the time. “There is no science behind it. It’s simply my judgment that I thought that figure was an appropriate one,” he said, in a notable abandonment of evidence-based policy-making.[41] Most observers have suggested that the motive for the higher taxes was political rather than economic. Estimating the net revenue effects at this time depends on analysing the behavioural impact of higher taxes on a small number of people. Roughly 2% of adults (750k) have incomes above £100k and a little under 1% of adults (275k) have incomes above £150k.

The Treasury subsequently estimated that the new tax would raise £2.4bn, but this was a rough and ready figure based on back-of-the-envelope calculations of taxable income elasticity (see below). These estimates already assumed that the government would only receive only 31 percent of the possible total income from the tax increase announced in the Budget because of the behavioural impact. In February 2010, City minister Lord Myners revealed that the Treasury had “significantly reduced” its estimate of the revenue that the new 50p rate of income tax would bring in, citing the “behavioural consequences” of taxation change. “We still believe it will be beneficial”, he said.

Subsequently, ministers in the coalition government have suggested that the higher rate is unlikely to raise any revenue at all. For example, Business Secretary Vince Cable said in September 2010: “I think I would surprised if the higher rate of tax does actually raise much revenue.”[42]

We argue, however, that the higher rates of tax is set not so much to fail to raise but rather to lose revenue, both directly and indirectly. The increases are not “beneficial” but harmful.

6.2 “Taxable income elasticity”

Robert Chote, now Head of the Office for Budget Responsibility, then Director of the Institute of Fiscal Studies, has pointed out that the Treasury’s estimate of £2.4 billon excludes the effect of consumer spending. Even if the Treasury’s original estimate is correct, indirect tax receipts could fall by up to £1.5 billion as a consequences of changes in consumer spending, thus bringing the total revenue raised by the 50% rate to a mere £900 million, far below the original Treasury estimates.

However, the Treasury’s estimates are unlikely to be correct, as they are based on optimistic estimates of taxable income elasticity (TIE). Brewer, Saez and Shepherd, economists associated with the Institute for Fiscal Studies, tried to estimate taxable income elasticity (TIE) of the top 1% of taxpayers (i.e. by how much their taxable income falls when the effective marginal tax rate rises), utilising data from the 1980s.[43]

The IFS has produced a cautious analysis to show that a higher TIE should be used than that employed by the Treasury. They concluded that the “rate of 40% is estimated to be the revenue-maximising rate,” meaning that higher rates lose revenue. We doubt, furthermore, that thirty-year old data is the most appropriate basis on which to calculate TIE today. Section 4 of this report, above, has pointed to many more recent examples from around the world where public revenues rose following

41 http://www.telegraph.co.uk/news/politics/5244756/Alistair-Darling-admits-he-plucked-50p-tax-rate-figure-from-thin-air.html
42 http://www.moneysavingexpert.com/news/family/2010/09/50-tax-rate-unlikely-to-raise-revenues-says-cable
43 ‘Means-testing & tax rates on earnings’,Mike Brewer, Emmanuel Saez and Andrew Shephard, in the Mirlees Report, Institute of Fiscal Studies, 2010.

Table 2: Key assumptions

Assumption	Source
Rates of and allowances for income tax; rates of National Insurance, VAT and corporation tax	As gazetted by HMRC
Number of higher and additional rate taxpayers inside and outside London	HMRC report of tax liabilities, December 2010
Rate of growth in additional rate taxpayers	As above
Employment in London's financial services sector	Office of National Statistics' Business Register and Employment Survey, December 2010
Incidence of corporation tax by sector	Corporation tax receipts by sector, HMRC, republished by Office of National Statistics, December 2010
Incidence of VAT	Household Income Survey, Table 14 (Appendix 1), Economic & Labour Market Review, Vol 2, No 7, July 2008; adjustments for subsequently gazetted rates.
Revenues per employee and profit rates	Selected annual reports
Taxpayers intentions	ASI survey of accountants (and see narrative in following paragraph and table)

Sources: *As set out above*

tax reductions. Globalisation has advanced and the mobility of high-earners is correspondingly enhanced. For example, internet-based communications technology, unavailable in the 1980s, now means that many people can work almost anywhere without much difficulty.

It is important to take into account the immediate effect on indirect and direct tax receipts, the wider effects on the economy and their knock-on revenue implications. The important actors are not just those who emigrate, don't immigrate, retire early, or decide to increase their leisure time. Equally if not more important are those who don't set up new businesses or expand their existing ones as energetically because of these changes. Similarly, when international sportsmen avoid Britain on tax grounds and international events shift elsewhere, we lose the associated economic activity. These effects include less investment into the UK, less employment, less income tax and other taxes paid by those individuals, and less corporate tax paid. Worst of all, time diverted from productive activity towards tax avoidance is wasteful. The culture of defection from the tax regime is easily created but hard to reverse.

6.3 Economic costs

We have prepared estimates of the revenue effect of the increase in the tax rate upon additional and higher rate taxpayers. In doing so we have estimated the effects upon economic activity. Our estimates take account of the effect not just upon the new group of "additional-rate" taxpayers but also the more numerous group of taxpayers qualifying for the existing "higher" rate. This is because both are affected by the new rate of tax: higher rate taxpayers wish to avoid coming in for the additional rate and their number is to be altered by the knock-on effect of changes in the number of additional rate taxpayers on business activity and employment. The sources of our principal assumptions are set out in Table 2 (above).

Table 3 (overleaf) below shows our modeling assumptions about changes in the number of taxpayers. First, our assumptions for taxpayers outside London, for both our minimum impact scenario, in which taxpayers show relatively limited response to the change in policy, and our maximum impact scenario, in which their response is relatively far-reaching. The figures we use are in line with our survey of the intentions reported by corporate taxpayers and far more conservative than the intentions reported by personal taxpayers. The same applies to our assumptions for London taxpayers for our minimum impact scenario. In the case of a relatively far-reaching response by London taxpayers we use figures approaching the maximum in our survey.

a. Growth costs

Figure 6 compares the Adam Smith Institute's default assumptions for ten-year growth, as set out in our recent paper *On borrowed*

Table 3: UK – Estimates of emigration

	Min	Max
Results of ASI survey		
Personal taxpayers contemplating non-residency	25%	32%
Corporate taxpayers contemplating non-residency	15%	25%
Reduction in additional/higher rate taxpayers after five years on ASI modeling assumptions		
London's financial services	17%	31%
Other UK	12%	23%

Sources: ASI survey of tax advisers, February 2011; appendix 2, table 1

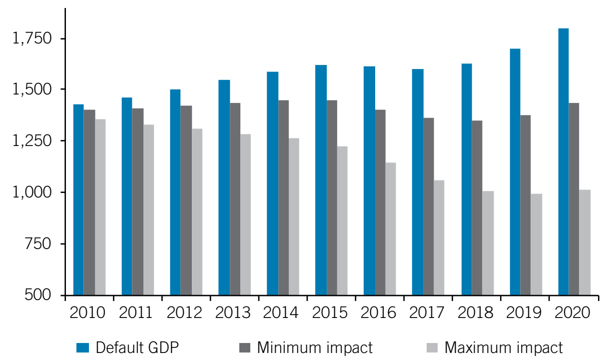
Table 4: UK fiscal costs. Ten year total net revenue loss of increase in tax rate, 2010-2020 - £bn

	London		Rest of UK		All UK	
	Min	Max	Min	Max	Min	Max
Net	86.6	167.2	269.4	475.4	356.1	642.5
Gross	107.2	187.7	321.0	527.0	428.3	714.7

Source: Appendix 2, table 3

time, to those arising on our assumptions of minimum and maximum impact. It shows that if taxpayers' responses to the new rates are relatively limited, the level of economic activity is likely to be flat over the decade, with the possibility of a recession towards the end of the period. If taxpayers' responses are relatively far-reaching, we estimate enough of a collapse in economic activity as to force an emergency reversal of policy.

Figure 6: UK growth costs. Annual net effects of increase in tax rate, 2010-2020 - £bn



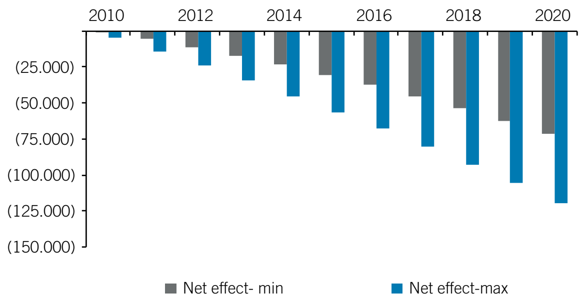
Source: Appendix 2, table 2

If taxpayers' responses to the new rates are relatively limited, we estimate that economic activity is set to fall by 2% in the first year of the new policy to some 20% in the tenth year below the estimated level without the 50p tax rate. This means that over the decade, the level of economic activity will be 19% below that estimated without the new rates. If taxpayers' responses to the new rates are relatively far-reaching, we estimate that economic activity is set to fall by 5% in the first year of the new policy and ten percent in the second year, rising further thereafter. As mentioned above, such figures would force an early U-turn.

b. Fiscal costs

Table 4 (above) shows that if taxpayers' responses to the new rates are relatively limited, the ten year effect of the change in tax rates is estimated to be public revenues forgone of approximately £350bn, after netting out the additional receipts from taxes, or approximately £430bn gross. If taxpayers' responses are relatively far-reaching, the ten-year effect of the change in tax rates is estimated to be approximately £640bn of net receipts forgone, or approximately £700bn gross.

Figure 7: UK fiscal costs. Annual net revenue loss of increase in tax rate, 2010-2020 - £bn



Source: Appendix 2, table 3

The year by year effect of these changes is set out in Figure 7 (above), which shows that if taxpayers' responses are relatively limited, the net effect grows from approximately £380m of public revenues forgone in the first year of new tax rates to approximately £71bn of receipts forgone in the tenth year. If taxpayers' responses are relatively far-reaching, public revenues forgone grow from approximately £4.7bn in the first year of new tax rates to approximately £119bn in the tenth year – equivalent to the current cost of the NHS or all pensions paid by government.

The composition of the receipts forgone is 56% income tax, 7% National Insurance, 8% VAT and 29% corporation tax.

6.4 Conclusion.

The increase in the top tax rate may prove disastrous for revenue raising. At a minimum, the policy risks flat growth for a decade, and a possible recession at the end of the period. The net effect upon government finances, adverse from the outset, gets worse from year to year and ends up with net losses of some £350bn after ten years. In the worst-case scenario, approximately £640bn of revenue would be forgone. The UK simply cannot afford such an ill-judged policy.

7 Conclusions and recommendations

7.1 A counterproductive tax policy

Our tax policy has become counter-productive, with tax rates above revenue-maximising levels which cause economic damage. We must be clear about the purpose of our tax system. That purpose should be to raise revenue for the exchequer, not to punish high earners or make political statements. As a minimum policy objective, taxes should never be above the revenue-maximising level.

That said, the revenue maximising rate is different to the "growth maximising level" of taxation, and a balance must be struck between these two considerations. The public is best served by a tax rate closer to this lower level, with government spending reduced to allow for long-term economic growth. This may seem an obvious point, but it is often lost. Lower tax rates have a positive impact on work, output, and employment, and thus the long-term tax base itself, by providing incentives to increase these activities. Raising tax rates has the opposite economic effect by penalising participation in the activities that are taxed. In general, the more you tax something, the less you get of it.

The point of a good tax system should be to make poor people rich, rather than making successful people poor. It is unfortunate that some politicians seem to want to use the tax system to punish the successful, even if that means less revenue overall. Penalising success penalises the poorer too.

- This report demonstrates that Britain's tax system has become a barrier to economic growth.

- Sixteen specific examples are cited from seven separate countries to demonstrate that, when high tax rates go down, public revenues go up.

- Tax rates make Britain uncompetitive compared to other countries. Only 3 OECD countries have higher rates than the UK. The UK is 83rd out of the 86 largest economies.

- Business leaders are hostile to the UK tax system, personal taxes in particular, and this is affecting both the investment decisions of companies and the location decisions of individuals.

- There is already significant emigration from the UK finance industry, much of which is highly mobile.

7.2 Policy recommendations

1. Eliminate the additional 50% rate of tax immediately. Do not merely state that it will be eliminated at some time in the future. It makes no sense to want to continue losing revenue for a day longer.

2. Reinstate the personal allowance that is currently phased out between £100,000 and £115,000.

3. Remove the revenue-losing £30,000 non-dom charge immediately.

4. Reduce the higher rate of income tax from 40% to 35% and announce an intention of further reductions over time.

5. Reduce the level of capital gains tax from 28% to 18% or below. The only argument the Treasury had for increasing the rate in the June 2010 budget to 28% (which they said was the revenue-maximising rate) was the differential between the CGT rate and the top rate of income tax. It follows therefore that if the top income tax rate comes down, so should the CGT rate.

Based on international experience and the analysis contained in this report we may expect these measures to raise more public revenues, not less. They also offer the opportunity to deliver a major boost to economic confidence and growth.

7.3 Conclusion.

The coalition has inherited a 50% plus marginal tax rate, which its creator admits was introduced on the basis of a political whim. Our calculations show that the policy is set for disaster, causing reduced public revenues and growth rates. The coalition government should reverse this policy promptly. Doing so would make it clear that the UK offers an attractive home for wealth creation and entrepreneurship, and in so doing give our growth prospects a sorely needed shot in the arm.

Appendix 1: Ibn Khaldun on tax policy

When tax assessments and imposts upon the subjects are low, the latter have the energy and desire to do things. Enterprises grow and increase, because the low taxes bring satisfaction. When enterprises grow, the number of individual imposts and assessments mounts. In consequence, the tax revenue, which is the sum total of (the individual assessments), increases.

When the dynasty continues in power and their rulers follow each other in succession, they become sophisticated….. As a result, the individual imposts and assessments upon the subjects, agricultural labourers, farmers, and all the other taxpayers, increase. Every individual impost and assessment is greatly increased, in order to obtain a higher tax revenue. Then, gradual increases in the amount of the assessments succeed each other regularly, in correspondence with the gradual increase in the luxury customs and many needs of the dynasty and the spending required in connection with them. Eventually, the taxes will weigh heavily upon the subjects and overburden them. Heavy taxes become an obligation and tradition, because the increases took place gradually, and no one knows specifically who increased them or levied them. They lie upon the subjects like an obligation and tradition.

The assessments increase beyond the limits of equity. The result is that the interest of the subjects in enterprises disappears, since when they compare expenditures and taxes with their income and gain and see the little profit they make, they lose all hope. Therefore, many of them refrain from all activity. The result is that the total tax revenue goes down, as (the number of) the individual assessments goes down. Often, when the decrease is noticed, the amounts of individual imposts are increased. This is considered a means of compensating for the decrease. Finally, individual imposts and assessments reach their limit. It would be of no avail to increase them further. The costs of all enterprise are now too high, the taxes are too heavy, and the profits anticipated fail to materialize. Thus, the total revenue continues to decrease, while the amounts of individual imposts and assessments continue to increase, because it is believed that such an increase will compensate (for the drop in revenue) in the end. Finally, civilization is destroyed, because the incentive for activity is gone. It is the dynasty that suffers from the situation, because it (is the dynasty that) profits from activity.

If (the reader) understands this, he will realize that the strongest incentive for activity is to lower as much as possible the amounts of individual imposts levied upon persons capable of undertaking enterprises. In this manner, such persons will be psychologically disposed to undertake them, because they can be confident of making a profit from them.

Ibn Khaldun, *The Muqaddimah*, 1377

Appendix 2: Tax and growth calculations

Table 1: Survey of emigration and ASI assumptions
Since April 2010, what percentage change has there been in the number of your clients who

	Min	**Max**
have become non-resident	5%	7%
are planning to become non-resident	5%	5%
are considering becoming non-resident	15%	20%
Total individuals contemplating non-residency	**25%**	**32%**
are planning to or have started moving business interests overseas	10%	15%
have already moved some business interests overseas	5%	10%
Total businesses contemplating non-residency	**15%**	**25%**
have undertaken other measures to reorganise their tax affairs in order to reduce the impact of the higher rates	50%	85%
have accelerated retirement plans or taken other action which will involve earning less	20%	35%

Source: *Adam Smith survey of tax advisers, February 2011*

	Min	Max
Results of ASI survey		
Total individuals contemplating non-residency	25%	32%
Total businesses contemplating non-residency	15%	25%
Effects of modeling assumptions after five years		
Reduction in taxpayers in London's financial services	13%	24%
Reduction in other UK taxpayers	12%	23%

Sources: *Survey of tax advisers, February 2011; ASI assumptions*

We wish to acknowledge the co-operation of the ACCA in extending this survey to their members. Needless to say, our conclusions are our own and do not represent those of the ACCA or its members.

Table 2 GDP impact

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Default	1,430	1,463	1,504	1,548	1,589	1,620	1,613	1,604	1,630	1,703	1,803
Min impact	1,402	1,410	1,424	1,439	1,450	1,448	1,407	1,361	1,348	1,380	1,435
Max impact	1,356	1,329	1,308	1,288	1,263	1,223	1,144	1,059	1,006	997	1,010

Table 3: Summary of tax receipts

Default											
	2010	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
Income tax	88.883	93.488	98.341	103.458	108.853	114.542	120.541	126.868	133.541	140.581	148.008
NI	19.240	20.110	21.021	21.974	22.973	24.018	25.112	26.258	27.458	28.715	30.031
VAT	17.959	18.833	19.752	20.717	21.732	22.799	23.920	25.099	26.339	27.643	29.014
Corp tax	24.703	25.965	27.294	28.694	30.169	31.723	33.361	35.087	36.906	38.823	40.844
Total	**150.786**	**158.396**	**166.408**	**174.844**	**183.727**	**193.082**	**202.934**	**213.312**	**224.244**	**235.762**	**247.897**
With extra rate											
	2010	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
Income tax	94.476	99.435	104.665	110.183	116.004	122.145	128.626	135.465	142.683	150.302	158.345
NI	19.240	20.110	21.021	21.974	22.973	24.018	25.112	26.258	27.458	28.715	30.031
VAT	17.103	17.922	18.783	19.687	20.637	21.634	22.682	23.783	24.939	26.154	27.431
Corp tax	24.703	25.965	27.294	28.694	30.169	31.723	33.361	35.087	36.906	38.823	40.844
Total	**155.522**	**163.433**	**171.764**	**180.539**	**189.782**	**199.521**	**209.781**	**220.592**	**231.986**	**243.994**	**256.651**
Theoretical increase in tax receipts											
£bn	4.737	5.037	5.356	5.695	6.055	6.439	6.847	7.280	7.742	8.232	8.753
Prop'n	3.14%	3.18%	3.22%	3.26%	3.30%	3.33%	3.37%	3.41%	3.45%	3.49%	3.53%
Change in tax receipts on minimum impact assumptions - £bn											
	2010	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
Income tax	3.274	6.782	10.536	14.552	18.846	23.435	28.336	33.569	39.154	45.112	51.465
NI	0.504	1.040	1.612	2.219	2.865	3.552	4.281	5.055	5.876	6.748	7.671
VAT	0.543	1.122	1.741	2.402	3.106	3.857	4.657	5.508	6.415	7.380	8.407
Corp tax	0.793	1.643	2.553	3.526	4.567	5.679	6.866	8.134	9.486	10.928	12.466
Total	**5.114**	**10.587**	**16.441**	**22.699**	**29.384**	**36.522**	**44.140**	**52.266**	**60.931**	**70.167**	**80.008**
Change in tax receipts on maximum impact assumptions - £bn											
	2010	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
Income tax	5.949	12.127	18.551	25.235	32.198	39.456	47.029	54.938	63.202	71.844	80.888
NI	0.964	1.964	3.003	4.082	5.204	6.370	7.584	8.847	10.163	11.534	12.962
VAT	1.009	2.057	3.147	4.279	5.457	6.685	7.963	9.296	10.687	12.139	13.656
Corp tax	1.510	3.078	4.706	6.399	8.161	9.996	11.909	13.904	15.986	18.162	20.435
Total	**9.432**	**19.227**	**29.406**	**39.995**	**51.020**	**62.507**	**74.485**	**86.985**	**100.038**	**113.678**	**127.941**

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