

Simpler Taxes

A guide to the simplification of the British tax system

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The wisdom of Adam Smith

"The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person. Where it is otherwise, every person subject to the tax is put more or less in the power of the tax-gatherer, who can either aggravate the tax upon any obnoxious contributor, or extort, by the terror of such aggravation, some present or perquisite to himself. The uncertainty of taxation encourages the insolence and favours the corruption of an order of men who are naturally unpopular, even where they are neither insolent nor corrupt. The certainty of what each individual ought to pay is, in taxation, a matter of so great importance, that a very considerable degree of inequality, it appears, I believe, from the experience of all nations, is not near so great an evil as a very small degree of uncertainty."

"Every tax ought to be so contrived as both to take out and keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state. A tax may either take out or keep out of the pockets of the people a great deal more than it brings into the public treasury, in the following four ways. First, the levying of it may require a great number of officers, whose salaries may eat up the greater part of the produce of the tax, and whose perquisites may impose another additional tax upon the people. Secondly, it may 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. While it obliges the people to pay, it may thus diminish, or perhaps destroy, some of the funds which might enable them more easily to do so. Thirdly, by the forfeitures and other penalties which those unfortunate individuals incur who attempt unsuccessfully to evade the tax, it may frequently ruin them, and thereby put an end to the benefit which the community might have received from the employment of their capitals"... "The [tax] law, contrary to all the ordinary principles of justice, first creates the temptation, and then punishes those who yield to it; and it commonly enhances the punishment too in proportion to the very circumstance which ought certainly to alleviate it, the temptation to commit the crime. Fourthly, by subjecting the people to the frequent visits and the odious examination of the tax-gatherers, it may expose them to much unnecessary trouble, vexation, and oppression; and though vexation is not, strictly speaking, expence, it is certainly equivalent to the expence at which every man would be willing to redeem himself from it. It is in some one or other of these four different ways that taxes are frequently so much more burdensome to the people than they are beneficial to the sovereign."

"The Wealth of Nations", Book 5, Chapter 2, Part 2: "Off Taxes", maxims II & IV.

1. Introduction

Today's tax system is as complicated as ever. Over the last half a century the Finance Act has grown from an average of 74 A5 pages, in the years from WWII through 1964, to an average of 289 A4 pages, in the years since 1986¹. And no attention whatsoever has apparently been paid to the advice of Adam Smith. Our taxes are not "*certain, and not arbitrary*", they do "*take out or keep out of the pocket of the people a great deal more than [they bring] into the public treasury*", making them indeed "*much more burdensome to the people than they are beneficial to the sovereign*".

This publication advocates the introduction of a simple and comprehensible tax structure in Britain to replace the current highly complicated and opaque system of taxes. It is also a call for lower taxes, but only because this is what people really want, and what the future will demand. The main argument being that the complexity of the current tax system *hides* from the public the true cost of government. Could people actually see the true cost of the current British tax system as opposed to a simpler one, they would unquestionably choose the latter. And again, could they – in a simple tax system – see the true relation between the level of taxation and the goods and services provided by government, they would realise that the current tax level is too high to be justified by the value of government spending.

A thorough tax reform is long overdue. Every traditional tax base, from capital to labour, as well as individual spending, are all becoming increasingly mobile and will in the near future be increasingly able to avoid most of the taxes imposed by national governments, however stealthy. The future *competition for taxpayers* among governments will force them to tax *only* the beneficiaries of government action – and to do so in the most direct and cost-efficient, that is, *simple* way. It is hoped that exposing the fallacies of government production will sway the electorate in favour of erecting institutional constraints on government spending that could confine it to areas where the quality and quantity of goods and services provided would correspond more closely to the tax paid. Making the tax system simple is thus certainly not the last word to be said on tax (and government) reform, but it is the first. Until taxpayers are able to see how much they are paying for government activities, it is impossible for them to determine whether any further reforms are needed.

¹ Adam Broke: "Simplification of tax or I wouldn't start from here", in "Towards a better tax system", Institute of Chartered Accountants, 2000.

The structure of the paper

Chapter Two presents the *moral* argument for simplifying the British tax system. It will be argued that if the individual is regarded as the base of the society, then the only morally justifiable tax system is one that will allow this individual to value the services of government against the cost of government. This can only be done if the tax system is simple and transparent, clearly exposing the taxes levied. Only people who believe that individual citizens should not – or could not – be able to make decisions on whether government is giving full value for the taxpayer's money can object to that. These are people who believe that important decisions such as government spending and taxes are better left in the hand of experts, i.e. the state. Totalitarian views like this should hold no sway in Western liberal democracies, and should certainly not be the basic justification for the structure of the British tax system.

Chapter Three presents the *economic* arguments for a simpler and more transparent tax system in Britain. It argues that there are two distinct economic problems arising from the current complexity and opacity of the tax system, which could both be solved by simplification. The first problem is the costly administrative burden that comes with complexity. Not only is this true in the public sector, where the current tax system requires an army of civil servants and bureaucrats to administer – paid for by taxpayers' money. In the private sector, too, much time, effort, and money are spent trying to understand and comply with the tax system – or paying others to do so. The second economic problem arising from a complex and opaque tax system is the long term damaging effects it has on the economy. Firstly, the opacity obscures the relation between investments and profits, making sound investments unprofitable and vice versa. Secondly, the complexity diverts valuable labour resources into tax speculation and avoidance in the private sector, and into the prevention and detection of this activity in the public sector. Lastly, the higher levels of taxation, which necessarily follows from a complex tax system, crowd out private investments and activity, thus curbing long term economic growth.

Chapter Four examines the role for governments and taxation in response to production or consumption with effects on third parties; that is, the existence of *externalities*. It is argued that the existence of some externalities inevitably must obscure the simplicity of any tax system because of the legitimate need for government intervention, but one should be careful not to carry this argument too far. The treatment of externalities in the current tax system is more often a testimony to government failure, rather than to government success. In the case of negative externalities, government should step in to levy taxes only if there is no market-solution that could work better. Furthermore, the tax levied should reflect only the cost of the externality rather than an urge for higher government revenues. In the case of positive externalities it is argued that one should be very careful to exempt from taxation private activities with claimed positive externalities – or indeed subsidise such activities. The tax *not* collected from these claimed “positive” activities must be collected from other equally positive activities, normally labour income, elsewhere in the economy.

Chapter Five moves on to expose the opacity of the current tax system and to confront it with the challenges to taxes in the future. It is argued that while the government taxes away almost half of the wealth created in Britain, only a fraction of this bill is presented directly to taxpayers, the rest being raised indirectly through stealth taxation. In the future, however, no matter how stealthily the government manages to extract revenue from the economy, the price mechanism will induce companies and citizens to avoid them. The increasing availability of information will, along with the increasing mobility of traditional tax bases, render the use of excessive indirect taxation impossible, simply because it will be ever easier to avoid. Sooner or later every government will have to face up to the fact that each individual tax, as well as the tax system in its entirety, must correspond to the services provided to the taxpayers. This, it is argued, is done most cost-efficiently through the implementation of a simple and transparent tax system.

Chapter Six assesses how the two main types of *indirect taxes* in Britain: the taxes levied on companies and the taxes and duties on consumption, will most dramatically be affected by the tax competition of the future. These are the taxes most easily avoided and thus they will be the hardest to levy. Since indirect taxes must be levied in competition with other national governments they must be reduced to reflect only the actual advantages to consumers and companies for trading within the British economy. Or, if negative externalities are present, the taxes must only reflect the actual cost of that externality. In either case, they must be simplified so they are levied in the most cost-efficient way.

Chapter Seven deals with the *direct taxes* in Britain: income taxes and taxes on property. Both are arguably harder taxes to avoid and so in future the tax burden must inevitably be shifted towards these direct taxes on citizens if government wants to maintain tax revenues. However, as people become increasingly willing to leave the country to live elsewhere, direct taxes too will have to reflect the actual value of government production to the citizens. To raise the tax burden in the most effective way, *income* should be clearly separated from other gains, such as capital gains, which should not be taxed. The income tax should then be levied at a flat rate after allowing for universally high personal allowances to ensure that the tax and welfare systems do not overlap. Taxes on buildings and lands should only be levied by local government to ensure that competition between councils keeps these taxes at reasonable and economically prudent levels.

Chapter Eight sums up the arguments of the previous chapters and tries to look ahead to see what the proposed tax reform entails for the future of that other government activity: *spending*. Once fully exposed to the British taxpayer, the real level of taxation would undoubtedly create a demand for lower public spending. The main thrust of the argument is that making the true cost of government clear to the citizen will help pave the way for institutional reforms that confine government intervention to the few areas where the market is not able to do a better job.

2. The moral argument for simplicity

Morality and taxation often go hand in hand in the public debate. Rarely are the words “tax” and “taxation” used outside the context of word such as “just”, “fair”, “decent”, or their opposites as the case may be. Normally this moral discussion of taxation centres on the *size* of the tax burden² or on the *division* of the tax burden. Rarely is the morality of the *transparency* of the tax system discussed and the morality of the *opacity* of the current tax structure questioned. While discussions about the superior division or size of the tax burden are often very value laden, with all sides claiming to hold the moral high ground, this should not be the case with discussions on the transparency of the tax system. This is so, because the moral argument for a transparent tax structure rests only on the basic assumption that *the government should be working for the citizens*. While there may be many opposing arguments as to who should be morally obligated to pay taxes, how much they should pay, and to whom, not many people today disagree with this basic assumption.

Not only are the citizens consumers of government goods, they are also the employers of government, paying for the government and the activities it performs – very much like shareholders. Therefore the citizens should be given the clearest possible insight into the working of the government. And this can only be done through the adoption of a simple and comprehensible tax structure that makes it very clear to all citizens when they are paying taxes and how much they are paying. In this regard, *self-assessment* of taxes, which the Adam Smith Institute has advocated for years, can be seen as a first step, without which it will be very hard to raise citizens' awareness to the maladies of the current British tax system.

Citizens in control?

Compared to the relationship between private companies and their customers and shareholders, many things are amiss in the relationship between the people and their government. Even in the Western world it is difficult and expensive for citizens to be disloyal “customers”, switching to another “brand” of government. There is only a limited number of domestic government

² Very good discussions of the immorality of high tax burdens have been offered by Maurice Saatchi and P Warburton: “The War of Independence – A Declaration”, 1999, and by William Hague: “The Moral Case for Low Taxation”, Politea’s Spring Address 2000, in Conservative Party News, 14th March 2000.

alternatives, and if the rest of the electorate does not agree with you, you are forced to endure the costs of moving to another country. And even abroad the alternatives are somewhat limited.

But even before the question of “changing brand” arises, there is the problem of determining whether you have any reason to be dissatisfied with the brand you use – whether the government is actually providing you with what you are paying for. In the market this is normally determined through the price mechanism as the transaction takes place: you pay for a good and receive it at the same time. If the quality of the good does not live up to your expectations signalled by the price paid, you complain, return the good, and start buying from another supplier. But when dealing with the government this signalling effect of price has been severely tampered with. As part of the electorate you vote for a collective package of government goods, including who is to get what and who is to pay. Only later, as a taxpayer, are you confronted with the consequences and costs of this choice *and the choices of everyone else*.

A large part of the Public Choice School has been focusing on the impact this necessarily has on government spending and taxes, inducing both to rise much more than the electorate would demand had the price mechanism been intact. That is, even if it were perfectly clear to people how much they were paying in taxes and how much they were receiving in goods and services, the very nature of the way in which these taxes and the supply of goods and services are determined will prompt people – rationally – to demand more goods and services as voters and members of pressure groups than they would be willing to pay for afterwards as taxpayers. This is because the citizens find themselves caught in a “prisoners’ dilemma”, where they are tempted to free-ride on (other) taxpayers by voting for the public provision of goods that are in fact private goods. When everybody does this, taxes rise more than anyone wanted, had they only been able to avoid the dilemma altogether³.

As if this *inherent* fallacy of government production were not enough, there has furthermore been within all Western democracies a drive towards complicating the tax structure by disguising or hiding taxes, the so-called taxation by stealth, thereby obscuring the relationship between taxes paid and services supplied even further. Why is this?

Traditional economics on taxation has always allowed government to tax the citizenry in any way it saw fit, including the use of stealth taxation. The theoretical argument being that a free hand in taxation would allow the government to extract the needed amount of money from the economy with as little negative effect on the economy as possible and as little perceived grief as necessary to the public⁴. This theory, however, rests on the assumption that government is inherently benevolent and only receives and acts on advice from the most all-knowing and benevolent of experts.

³ For further discussions see James M Buchanan: “Constitutional Economics”, 1991, and David Friedman: “Machinery of Freedom – Guide to a Radical Capitalism”, 1995.

⁴ I.e. the largest amount of utility possible.

Not only has this, rather naïve, assumption been repeatedly refuted by history, it has also been severely challenged by the academic work of the Public Choice School, focusing on personal incentives in the public sector in much the same way as it is normally done in the private sector. Although government *can* be benevolent and *can* take and act on the advice of all-knowing and benevolent advisers, if any, it is by no means necessary or even likely that this will be so at all times. This wisdom, however, is ancient. Adam Smith himself warned us of the government, saying⁵:

“It is the highest impertinence and presumption, therefore, in kings and ministers, to pretend to watch over the economy of private people, and to restrain their expense... They are themselves always, and without any exception, the greatest spendthrifts in the society. Let them look well after their own expense, and they may safely trust private people with theirs. If their own extravagance does not ruin the state, that of their subjects never will.”

As the quotation suggests, one should always expect the worst from government and design the rules accordingly. When dealing with taxes therefore, the government can only be assumed to be a revenue maximizer. And just as shareholders in private companies should always be on the lookout for directors who will put company size and personal prestige over long-term profits, so too should citizens watch out for governments attempting to do the same. With most of the price mechanism suspended due to the very nature of government enterprise, it is vital that the salvageable parts be strengthened.

With the more realistic assumption that government officials behave like the rest of us, the theoretical tax argument is turned upside down. Government should no longer be given a free hand in taxation, as this will inevitably and quite rationally lead to a much higher level of spending and taxation than otherwise. Through stealth taxation, government will be inclined to raise spending as much as possible, as long as the *perceived* level of taxation is kept reasonably low. With the *real* level of taxation being, of course, much higher than is justified by the services provided, the current Labour government being a case in point. As long as the possibility of stealth taxation exists, there is a weaker incentive for the government to make sure the services provided correspond to the taxes imposed. To encourage this correspondence, the tax structure should be kept as simple and transparent as possible, so that it is absolutely clear to the public when they are paying taxes and how much they are paying. Only thus can they decide if they are getting full value for their money or whether they should start looking for a new brand of government, either domestically or abroad.

⁵ Adam Smith: “The Wealth of Nations”, 1776.

Government in control?

The only objection to the approach taken here could come from people who have moral objections against citizens “shopping around” till they find the government they want, and therefore think it “better” for the citizens to be deceived into believing that the current government is good enough. Or from people who do not believe citizens to be capable of taking such vital decisions on their own, weighing taxes paid against services provided, and who therefore believe that such decisions should be kept in the hands of government experts. Such totalitarian views have their roots in the writings of Plato and later Rousseau, and have showed their most hideous consequences in the communist regimes of the 20th Century. In such views society is seen as an organism in its own right, with goals over and above the significance or understanding of the individuals composing it. When the right and just government is in place, and we are to take that this will be a Communist one, no one is allowed to opt out and leave – or even to propose a change to the said government.

Although full blown Communism may be dead as a viable government alternative in the free world, many of the totalitarian ideas still haunt the Socialist and Labour Parties of Europe – as well as some right wing parties too. Seen in this light, it is by no means strange that the New Labour governments, in Britain as well as in the rest of Europe, have all started exploring the seemingly endless possibilities embedded in stealth taxation. They keep a nice consumer-friendly face towards the public, while following the old Big Government strategy underneath. William Hague⁶ recently gave the following illustrative description:

“Tony Blair and Gordon Brown do not want us to know whether we are less free or that our communities are weaker. They want to get on with making government bigger and redistributing more and more income in society, without a great public debate. Like some Giant Squid in a monster movie, the Chancellor wants to gradually extend the tentacles of the Treasury and suffocate our freedom without anyone even noticing.”

Taxation by stealth, and the unnecessary complication of the tax system that follows, cannot be morally justified if one perceives the individual as being the base of society and if one believes that the justification of any government must rest on the consent of a non-deceived citizenry. And this is regardless of one’s views on the size and division of the tax burden. The economist Bryan Caplan⁷ put it this way:

“The best society of all would be one composed of good people who would all have good preferences whose efficient satisfaction we should favor. So in this society we should surely choose free competition. But what about less perfect societies such as our own? I apprehend that the right way to perfect our society is through voluntary, rational persuasion; for of what value is a person who speaks and acts rightly if he or she does it

⁶ William Hague: “The Moral Case for Low Taxation”, Politea’s Spring Address 2000, in Conservative Party News, 14th March 2000.

⁷ Taken from his web-site: www.gmu.edu/departments/economics/bcaplan.

out of fear of punishment, or forced ignorance, denied any opportunity to judge right or wrong with his intellect?"

It should be made clear, however, that a simple transparent tax structure will not entirely eliminate all the moral problems of "government production". Although a clearer insight into the real cost of government will undoubtedly reduce taxes somewhat, citizens will still be tempted to demand more from the government as voters and as members of pressure groups than they will be willing to pay for as taxpayers. With a more transparent tax structure at least the cost of this discrepancy will be clearer, and the incentives among citizens to try to reduce – if not entirely escape – the prisoners' dilemma of voting and paying taxes will be all the greater.

Some, like the American economist Dennis Mueller⁸, fear that simplifying the tax system will not make much of a difference since the logic of political demand and supply will remain the same. This view, however, ignores the *logic of collective action* by which people can contract their way out of zero-sum or even negative-sum games. Proper institutional arrangements *can* be agreed on, which will inhibit the ability of voters and pressure groups to make other taxpayers pay for their pet projects. Although politicians have few incentives to implement such institutions, one can only hope that the increasing competition between countries for taxpayers will eventually force them to do so⁹.

⁸ Dennis Mueller: "Public Choice II", 1989.

⁹ This point is covered more thoroughly in chapter 5.

3. The economic argument for simplicity

The economic argument in favour of a simple and comprehensible tax structure is threefold and follows in part from some of the points made in the previous chapter. First of all, taxation by stealth is more costly for the government than is necessary. Secondly, complying with a complex tax system is costly for the taxpayers - especially the smaller employers. Lastly, and in part because of this, hidden and complex taxation inevitably leads to a higher degree of government spending than would be economically efficient – especially in the longer run. This chapter first deals with the more direct costs of complicated taxes, before turning to the damaging economic effects of the Big Government, which necessarily ensues.

The cost of complexity

As the tax structure becomes ever more complicated, so does the work of the people trying to enforce the payment of the taxes. First of all because more time and effort are needed in order to prepare new tax legislation. Secondly because large amounts of highly educated and expensive manpower must be spent in the public sector *understanding* the new legislation and afterwards assessing whether the taxpayers and employers have been able to do likewise. This is of course not a problem as such for the government, which can and must pass this bill on to the public through even more and higher taxes.

Furthermore, following the argument of turnover maximisation, the individual government departments involved with the preparation, assessment, and collection of these taxes will only welcome the increasing workload of complicated taxes as this will allow them to grow in size and importance. Simple taxes are simple both to prepare, collect and assess, demanding a cut down in the size and importance of individual departments as well as of government overall. Large numbers of well-educated bureaucrats and civil servants would be free to do more productive work in the private or public sector.

Because of this “positive” relationship between the complication of the tax system and the influence and importance of government agencies and employees, simpler and thus lower taxes are generally not welcome with *any* government. But they are of course more welcome within government based on a libertarian philosophy and a preference for free markets, than within socialist or fascist governments, hostile towards the free market and in favour of political control. Just as the complexity of the tax structure inevitably entails increased

costs for government agencies to manage, so too does it increase the costs to private enterprises that are expected to comply with the tax legislation and collect many of the taxes on behalf of the chancellor. This task necessarily entails taking the time to understand the appropriate legislation and following it correctly.

Small enterprises in particular suffer as they are forced to do “slave labour” for the Chancellor collecting taxes. Like all businesses, they are forced to pass the increased costs on to their customers or employers. But unlike larger companies they do not enjoy the economies of scale necessary to spread out the fixed costs involved, and so they face a disadvantage that could force them out of the market. A recent study found that complying with PAYE and NIC was almost 60 times more costly per employee for the smallest companies when compared with the very largest¹⁰. But no matter what size the company has, it will be the citizens who eventually foot the bill, either in the form of higher prices, lower wages, or a decreased number of suppliers and thus less variety and choice¹¹.

A complicated tax structure discourages the establishment of new businesses and thus the creation of new jobs, while simplifying the tax structure shifts the balance in favour of smaller companies, so romanticised in socialist rhetoric, but so penalised under socialist government. The effect this has on employment can be clearly seen by comparing the generally enterprise-friendly environment of the United States with the more business-hostile environment of Continental Europe. In this regard, Britain is probably somewhere in between. Again, the costs of unemployment are passed on to the citizens in the form of lost jobs and taxes to support the unemployed.

The argument against unnecessarily complicating the tax system follows through to the individual taxpayers as well. Like companies, individuals are expected to assess their own taxes and they are thus forced to take the time necessary to read and understand the complicated legislation involved as well as the time to fill out the appropriate forms etc. This is a hidden cost of taxation, which follows directly from the complication of the tax system, not from the overall size of the tax burden. Even before self-assessment was introduced, British taxpayers spent some 90 million hours complying with income and capital gains tax, or the equivalent of some 65,000 man years¹².

Since the complication of the tax structure inevitably creates various loopholes, taxpaying individuals and companies are tempted to use their hard-learned

¹⁰ For the smallest employers this was as much as nearly 8 percent of the revenue collected.

“Compliance costs for employers: UK PAYE and National Insurance 1995-96”, in *Fiscal Studies*, vol. 2, no. 4, 1998.

¹¹ Depending on the elasticities of supply and demand for different factors, part of the costs *can* be carried by the company rather than by consumers and employees. But then the company will be forced to either lower reinvestments or the returns to shareholders or owners. See also chapter 5.

¹² Cedric Sandford et al: “Administrative and compliance costs of taxation”, 1989. US taxpayers, who have self-assessment, devote roughly 20 hours per citizen. Arthur D Little: “Development of Methodology for Estimating the Taxpayer Paperwork Burden”, Internal Revenue Service, 1988.

knowledge of the tax system to *avoid* paying taxes. Having spent valuable time learning the rules, why not use them to your own advantage or sell your knowledge? Many full-time jobs of highly skilled lawyers and accountants are wasted in this “unproductive” way trying to, and succeeding in, avoiding the payment of taxes. Simpler tax rules are harder to bend and the costs of compliance are lower, being only the tax paid, not the effort of learning rules as well. They therefore reduce the demand for – as well as the profit from – hiring tax lawyers and accountants. Estimates suggest that some 25,000 people are currently employed full time in the private sector tax industry in Britain¹³.

Furthermore, complicated tax systems, especially with high rates, invite individuals and pressure groups to lobby for even more loopholes. What difference is one tax exemption going to make, when there are hundreds already? And politicians, feeling the same way, welcome the opportunity to reward loyal supporters. The advantages distributed by government in this way are called *economic rents*, but unlike *profits* accruing from activities in the private market, they are not the results of a positive sum game. Rather they are the result of a negative-sum game, or at best a zero-sum game, in which some are left better off *only* at the expense of others.

For individuals as well as enterprises the complication of the tax system, along with the sizes of taxes, blur the relationship between investments and returns, entailing sub-optimal investments with long term damaging effects to the economy¹⁴. The complexity alone discourages people and companies from making otherwise sound investments that could create jobs and boost the economy. Instead, companies and individuals choose to work and invest abroad in countries with a friendlier tax climate. Or they move some of their activities into the hidden economy, perceiving that the cost of complying with the tax system, *including the costs of learning how to comply*, would be greater than the cost of being caught, if they were ever caught at all. Worst of all, some individuals and companies choose to do nothing at all, leaving their skills or money unused.

The cost of Big Government

To sum up, there are a number of reasons why complicated tax systems and stealth taxation lead to higher government spending.

- Stealth taxation conceals the real price of government and publicly produced goods and services from the citizens, entailing an over-demand for such goods and services even greater than otherwise.

¹³ Adam Broke: "Simplification of tax or I wouldn't start from here", in "Towards a better tax system", The Institute of Chartered Accountants, 2000.

¹⁴ In the US alone, some \$ 100 billion of uneconomical investments are made each year for tax purposes only. Malcolm S Forbes: "Happy Days Will Be Here Again", Forbes, July 18, 1994.

- Complicated taxes are difficult and thus costly for the government to prepare, assess and collect, entailing more bureaucrats and civil servants to be paid for by taxes.
- Complicated tax systems discourage investors and businesses, thus increasing the demand for higher government spending to combat unemployment and help suffering industries.

From Keynes onwards it was believed that government could increase economic growth through investments, better than if those investments were done in the market by dispersed private enterprises and individuals. Government had the knowledge and size to make a difference at the right moment. This belief was spurred on by the apparent success of government planning in the early years of the Soviet Union, Hitler's Germany, and even Britain and the US in WW II. For many years Khrushchev's threat of "burying the West" was taken very seriously indeed, and one may still argue today that government interference can have a positive effect in the short run by pooling all the resources of the country to achieve one goal, such as victory in war.

Government investments, however, "crowd out" private investments. In the short run this is not a problem since the government is building on existing technology and knowledge, but in the longer run this will cause great problems, as clearly demonstrated in the case of the Soviet Union and other long-lasting Communist regimes. As Hayek¹⁵ so correctly pointed out, even a benevolent government cannot, no matter how much information it gathers, incorporate the entire amount of dispersed knowledge available in the market. Neither can any government imitate the innovative environment of the free market. This means that, *inevitably*, countries with big government will, over time, fall behind countries that leave greater room for private investments.

This is not only true in extreme cases such as Communist Eastern Europe vis-à-vis the Western world. Even *within* the Western world, or more accurately the OECD countries, research in the field of Institutional Economics has shown that reducing the government stake in the economy to as little as 10-15 percent of GDP is inductive to long-term economic growth¹⁶. This is of course under the presumption that this government take is spent securing the rule of law, defending property rights, enforcing contracts and producing other pure public goods. Maximising economic growth thus requires not only a *quantitative* limit to government activities but a *qualitative* factor as well: government should do the right thing, *and nothing more*.

Some argue that government should have a higher stake in the economy than this, notably redistributing the wealth from richer to poorer within the country, either through the provision of free services such as health, education, etc., or directly through money transfers. While there are some arguments in favour of

¹⁵ E.g. Friedrich A v. Hayek: "Economic Freedom", 1991.

¹⁶ James Gwartney et al.: "The Scope of Government and the Wealth of Nations", in Cato Journal, vol. 18, no. 2, 1998.

treating a minimal degree of redistribution, especially in the form of basic education, as a public good increasing the welfare of everyone, one should be very careful not to take these arguments too far.

If the degree of redistribution is increased beyond a mere minimum, economic growth will, over time, be so damaged that the poor, although perhaps *relatively* better off, will actually be *worse off in absolute terms*, than if less redistribution had been undertaken. Empirical evidence shows that had the US government's stake in the economy remained at the 1960-level of 28.4 percent of GDP, the increased economic growth would have entailed that real GDP in 1996 would have been 20 percent, *or more than \$ 1.5 trillion*, higher than it actually was, while leaving the *absolute* level of government spending virtually unchanged. And in Britain, when the Conservatives decreased government's share of GDP from 47.2 percent in 1982 to 40.7 percent in 1989, the GDP growth rate nearly doubled¹⁷.

The theoretical trade-off is thus between equality today and prosperity tomorrow – or in other words between maximising the *relative* or *absolute* wealth of the poorer. But put to the empirical test it has been shown that even the relationship between government intervention and equality is not so straightforward after all. In the longer run, countries with a higher degree of economic freedom (less government interference) actually tend to be *insignificantly less equal* – *or even more equal* – than countries with a lower degree of economic freedom. That is, either there has been no statistically significant relationship between government interference in the economy and equality in the longer run, or this relationship has been negative, reducing both the absolute and relative wealth of the poorer as government interference increases¹⁸.

It is therefore a *myth* that economic growth, spurred on by the economic freedom of individuals, increases relative poverty. In fact the reverse has been proven to be the case¹⁹. This, to some counterintuitive, relationship is due in part to the diminishing returns from wealth which, given the economic freedom, enables poorer people, who value wealth more, to catch up with richer people, who value it less. And, in part, it is due to the fact that Big Government is more easily, that is, less obviously and with greater reward, captured by powerful interest groups who can then divert public spending towards themselves. As already mentioned, this is even more so, of course, with big *and* complicated government.

Thus, the arguments for complicating the tax system on grounds of equality, however theoretically appealing, do not hold up to empirical examination. Complicated tax systems are costly to run and leave less to be redistributed to the needy. Their cost, along with their complexity, increases the incentives to avoid taxes by increasing both the benefits to be obtained by avoidance *and* the cost of compliance. Experience in both the UK and the US has shown that

¹⁷ Ibid.

¹⁸ Niclas Berggren: "Essays in Constitutional Economics", 1997.

¹⁹ Steve H Hanke and S J K Walters: "Economic Freedom, Prosperity, and Equality: A Survey", in Cato Journal, Vol. 17, no. 2, 1998.

simplifying and lowering taxes have in fact *increased* the share of the tax burden paid by higher incomes, as well as increasing overall productivity. Thus, the Reagan tax cuts *increased* the percentage of income tax paid by the top 5 percent income earners by more than 25 percent between 1981 and 1984²⁰, and the Thatcher tax cuts *increased* the share of taxes paid by their British counterparts by more than 11 percent between 1978/9 and 1985/6²¹.

The empirical facts that *less government boost economic growth and that there is no significant positive link between economic equality and government involvement in the economy* stands in the face of both those favouring an *absolute* measurement of poverty and those favouring a *relative* one. So, unless one favours a higher degree of *de jure* equality, even though it leaves everybody *including the poor* worse off and hampers economic growth, it is hard to advocate anything but a simple tax system that minimises government interference with the citizen's money.

²⁰ William A Niskanen and S. Moore: "Supply-side Tax Cuts and the Truth about the Reagan Economic Record", Cato Policy Analysis No. 261, October 22, 1996.

²¹ "It Pays to Lower Taxes", Adam Smith Institute, 1986.

4. Tax and externalities

While one may in theory accept the moral and economic arguments in favour of a simpler tax system that favours the citizen at the expense of government and government intervention in the market, it is often argued that real life is more complicated than that. The market, it is said, is not perfect because some of the activities that take place there can impose *costs* on the rest of society while other market-activities may *benefit* the rest of the society. Such extra costs and benefits arising from market activities are called externalities. Many and large books have been written on the subject of externalities, and it is not within the scope of this publication, to present all the arguments²². However, since the concept of externalities plays an important part in the British tax structure today, and will also play a part in the reform later proposed, it is important to be familiar with the concept and the way in which it is being used and abused today.

Externalities are said to exist whenever the production or consumption of a good directly affects a third party, i.e. neither the consumer nor the producer, other than through market prices²³. If the effect on the third party is welcome, the externality is said to be positive. If the effect is not welcome, the externality is said to be negative. In most cases the third party is easily identified and the externality can be internalized in the transaction through negotiations between all the parties. In some cases, however, the third party is not easily identified and so taxation can play a role by either taxing market-activities with negative externalities or giving tax exemptions, and even subsidies, to market-activities with positive externalities. This chapter deals with each of these cases in turn. In some instances the chapter may seem somewhat theoretical, but this is necessary in order to lay the foundation for the more empirical discussions in later chapters.

Negative externalities

In theory there is no reason why government should get involved with the taxation of negative externalities. If information were perfect, all property rights clearly defined, and if transaction costs were insignificant, anyone negatively

²² For a more thorough explanation of externality problems and how to solve them, it is recommend to read Steven N S Cheung: "The Myth of Social Cost", IEA, 1978.

²³ Market prices are a direct result of the aggregated actions of suppliers and demanders in the economy, and market prices negatively affect those third parties that would only have supplied or demanded had the market prices been different.

affected (i.e. anyone whose property rights had been violated) by the production or consumption of any good or service could demand compensation from the consumer or producer of the said good or service. If denied compensation, the affected party could sue on the grounds of property rights violation. In reality, however, the necessary preconditions are far from met. Information is in many cases not perfect, not all property rights are clearly defined, and transaction costs can be substantial.

Many of the problems surrounding negative externalities could be solved by taking measures towards correcting these “root causes” of market imperfection, that is, by clearly defining all property rights and reducing the cost of obtaining the appropriate information and acting on it. While the Internet would clearly help in both of these latter respects, defining property rights is a political task. The goal should be to define the rights to all property so clearly that most externalities could be internalized in the market and any violations could be handled by the civil courts. There will, however, still be instances where property rights are so dispersed that there is a strong case for letting the government collect the compensation for the violation of the said rights.

One such example is the environment: the sea, air, soil, and ground water of a country. Surely we all own these things, as do the generations to come. There are some, like David Friedman²⁴, who will argue that even the protection of the environment would be better off under private ownership, since private owners would think in terms of long term sustainability rather than just to the next election. The private goal would tend to be maximizing long-term profits and not to run down the value of the property, whereas governments would be more inclined to maximize short term profit and be less concerned with running down the value of the property.

Although the arguments presented by these so-called “anarcho-capitalists” do certainly hold some sway, the discussion of them belongs elsewhere. We shall just accept that it is commonly accepted that the government should protect the common property, not just on behalf of the existing population, but on behalf of unborn generations as well. This is done through prohibiting certain violations of the common property or demanding compensation when other violations occur²⁵. In effect, this compensation is the same as a tax on negative externalities. Such taxes are already widely in use today, but there are serious flaws in the way the government tends to use this form of taxation. These flaws run counter to the theory just described.

Firstly, government tends to view taxes on externalities as a source of revenue to cover any and all public expenditures and not only to cover the cost of damaging the common property. This approach is economically wrong because it leads to

²⁴ David Friedman: “Machinery of Freedom – A Guide to Radical Capitalism”, 1995. His radical views should not be confused with those of his father, Milton Friedman.

²⁵ The terms “violations” and “violation” is used, although the terms “use” and “users” might be more appropriate, especially in the cases where the damage to the common property is done in understanding with the government in charge of that property, and is being compensated for.

sub-optimal production²⁶, but it is also *morally* questionable because it gives “green” taxes a bad reputation among citizens and businesses. This is especially true when people learn that, should the taxes work by reducing the amount of damaging activity being targeted, they will only be raised further in order to restore revenues to the expected levels. Secondly, and with the same effects, taxes on externalities are often modified by the government in order to meet goals, normally some sort of redistribution, other than reducing and restoring the damage done to the common property.

A tax on a negative externality should be just that: a tax on a negative externality. The government should try as accurately as possible to assess the damage of a particular action – be it the production or consumption of a good or service – that is inflicted on the common property of the whole of society. A tax should then be levied, reflecting the harm done by each individual action, the revenue of which should be spent only towards the restoration of the property damaged. The tax should as a matter of course be made as clear as possible to the violator, so that he might change his behaviour to avoid both the tax *and* the violation. The government should *not* be able to use the existence of a negative externality as an excuse to (1) raise revenue not used towards the reduction of the externality in question and (2) redistribute wealth amongst the violators of public property.

If the externality tax reflects the true cost to the public, then common property violations will settle at the optimal level, as sub-optimal production or consumption is driven out of the economy by the price mechanism. If it is optimal to avoid the violation altogether, then companies capable of doing so will prosper and the violation of common property will entirely disappear. If common property violations continue at an unchanged high level this could be a signal to government that the tax was too low, but it could also just mean that the current production was all optimal. In either case government should never raise externality taxes in order to use the revenue towards other things than restoring the damaged property. If the government does so, it not only induces sub-optimal production and consumption of the good or service in question, it also gives further credit to the belief that private enterprises would probably make a better job of protecting the common property.

In some cases government argues that it is vital that specific violations of public property be confined to certain minima, because the consequences of overuse could be catastrophic. In such cases the government could just *auction* away vouchers totalling the sustainable amount of property abuse, and only selling, of course, if offered more than the cost of rectifying the entailing damage. The vouchers could thereafter be traded freely on the private market, and to make sure that fine-tuning would be possible, the vouchers could be confined in time to a certain date, whereafter new vouchers would be issued. This sort of voucher system could work not only with pollution, but also in cases like fishing quotas.

²⁶ The whole theory of externalities rests on the assumption that governments should intervene to secure the (pareto-)optimal level of production. Thus, if taxes on negative externalities are too high, the level of production must necessarily be sub-optimal or pareto-inferior.

Lastly comes the question of modifying the externality tax in order to attain other goals. While some activities have negative externalities, the same activities may have positive externalities as well. A textbook example is the plant that pollutes but creates jobs as well, wherefore the plant can be given public financial support, either directly or through tax exemptions. These might be exemptions from some or all of the externality-tax it would otherwise be eligible to pay. However, as we shall see, the theoretical argument for financially supporting activities with positive externalities rests on the flawed perception that the money to pay for this support falls like manna from heaven.

Positive externalities

Theoretically, the case for supporting activities with positive externalities may at first glance look even stronger than the case for taxing negative externalities. If it is difficult for people individually to defend the violations of dispersed or ill-defined property rights, it is almost impossible to get them to pay for the positive effects the activities of others might have on the value of this property, or even on their own well-defined private property. If a company erects a beautiful office building to the delight of everyone around, who is going to be the one to start collecting money to give to said company? And who will be willing to pay? The free-rider incentive will of course be immense, and thus, in the view of some, the justification for government intervention is overwhelming. Just as government should tax negative externalities, it should also support positive externalities.

Basically the whole justification for government can be said to rest on the existence of positive externalities stemming from certain activities. The production of *pure public goods*, such as defence and rule of law are in fact nothing but activities that have such great positive externalities that we deem that it would be impossible to produce them in the private sector. Again, the anarcho-capitalists would argue, that even such vital things as these pure public goods could and should be left to the private sector²⁷. But, leaving this argument aside, it is generally accepted that pure public goods, those goods with extreme positive externalities, can only be produced if paid for by the government.

It is worth emphasising, that government *paying* for a good is not necessarily the same as government *producing* that good. In the case of defence, justice, and law and order there is much to be said against private production, but in other cases, such as education, there is not. Milton Friedman²⁸, among others, has sensibly argued for governments to pay for education through a voucher system, while leaving it to the market to actually supply the education. However, until such a reform has been instituted, it is clear that any money spent in the private sector in the production and consumption of education should be exempt from taxation. And so too should money spent on other goods in competition with the government, such as health or pensions, otherwise the competition with

²⁷ E.g. Murray N Rothbard: "For a New Liberty", 1973.

²⁸ Milton Friedman: "The essence of Friedman", 1984

government would become much too unfair. One cannot, however, carry the "public good" or "positive externality" arguments too far, blindly subsidising, and exempting from tax any and all activities that have positive side-effects on the rest of society.

Claiming that one's activities have positive externalities is one of the easiest things to do, and not one of the simplest claim to refute. This is because, in effect, almost *all economic activities in the free market have positive externalities*. What is *the invisible hand* of the market, if not one giant positive externality of economic activity within this market? Once the possibility of getting activities subsidised or exempt from taxation on the grounds of positive externalities has been established, everyone will try to secure government funding for their pet project on the grounds of some positive externality this activity might have. Again, established interest groups and large corporations will be in the most favourable positions to secure this economic rent, while normal citizens will loose out by not having their activity subsidised and at the same time having to pay for the subsidies to others. Furthermore, the ensuing complexity will be costly for taxpayers and damaging to the economy.

But there is an even more basic flaw to the arguments in favour of subsidising positive externalities. If *one* activity is subsidised because of positive externalities, then every other activity must be taxed all the more heavily to pay for this subsidy. And the most commonly, if not most heavily, taxed activity is normally *labour*. Not many would claim that labour has *any* negative externalities at all, in fact, most of us would probably agree that labour has substantial positive externalities. But, since all subsidies to activities with claimed positive externalities are explicitly or implicitly funded through taxes on labour, or other beneficial economic activity, it is nevertheless implicitly suggested that labour has negative externalities.

Until taxes on income and other economic activities, have all been removed, activity claiming to produce positive externalities should be compared with the positive effects of the activities being taxed. And only if the claimed positive externalities arguably are greater than the positive externalities of other tax objects, should they be subsidised in any way. Since government will *always* need some income from taxes, be it from on labour, interest, investments, etc., this should leave only the private or governmental production of *pure public goods* to be subsidised, because *only* such goods can clearly be said to have positive externalities greater than normal economic activity. On the other hand it should lead to a much lower taxation on labour and other economic activity. The long term economic growth rate will be the only true indicator of whether this cost-benefit analysis of government intervention has been done correctly.

To sum up the discussion on externalities, it is clear that government and taxation have a role to play, but that this role should be confined to the taxation of negative externalities. And even here it should be more limited and less complex than it is today. Only where the market option of defining property rights has failed or is arguably not going to work effectively, should government take over the protection of property use and violations. And the goal should

then be property protection, *not revenue*, with transparent taxes reflecting only the damage done, and their revenue being spent only on rectifying this damage.

In the case of positive externalities there is practically no role for taxation, since any activity exempt from taxation should arguably have better externalities than any other activity being taxed. Putting all activities to this test will undoubtedly remove some of the complexity of the current tax system, by severely limiting, if not altogether eliminating, the possibility of exempting one's activities from taxation – at least on grounds of positive externalities. However, until the production of certain public goods such as education, health and pensions, have been removed from the government's grasp, there must be a tax-exemption for the private production and consumption of these goods.

In any case there is little or no justification for the current misuse of externality-taxes and tax-exemptions by the British government. The extent to, and manner in which, the excuse of externalities is being used is neither justified by economic theory, nor by economic efficiency. The system is complex, confusing and counterproductive, harming the citizens by harming the economy - and it only benefits a few powerful interest groups and the egos of government bureaucrats.

5. The opacity exposed

Thus far the following arguments have been made against the opacity and complexity of the current British tax system.

- It is morally unjustifiable because the opacity hides from the taxpayers exactly how much they are paying for their government and the services it provides.
- A complex tax system is a cost-inefficient way of raising the money needed for the production of public goods.
- For these reasons and others, the British tax system inevitably increases government interference with the economy, thereby curbing economic growth to the disadvantage of all.

In the previous chapter it was further shown that while externalities do provide arguments in favour of government intervention and such government intervention necessarily must complicate the tax system somewhat, the current impact of externalities on the tax system is more a testimony to government failure rather than to government success.

The call is thus for a simpler and more transparent tax system that will give taxpayers a better control over a smaller government. However, before lining up the considerations that should guide such a tax reform it is important to have a quick glance at the workings of the tax system as it is. As was the case with externalities, many and large books have been written on this subject alone and it is not within the confines of this paper to cover every aspect of the subject. This chapter will attempt to expose the opacity of the current British tax system and the degree to which it is dominated by stealth taxation, before confronting it with the challenges of the future.

Who pays today's taxes? – and who will pay tomorrow's?

Traditionally, tax theory makes a distinction between the formal and effective incidence of taxes, that is, between who the taxes are *formally* levied on and who *effectively* pays them. While the formal incidences of most taxes are easily identified, the effective incidence is often much harder to determine for certainty. No matter where and on whom a tax is formally levied, the initial taxpayer will,

by changing his economic behaviour, share the tax payment to a varying degree with everyone else that he interacts with in the market. They again pass some of their costs on to others so that, in the end, the part of the original tax paid by each reflects the degree to which they were able, or unable, to pass on their costs to each other. Someone whose activities everyone is highly dependent on will be able to pass on most, if not all, of any tax imposed, while others, highly dependent on the activities of those around them, will bear the brunt of the taxes imposed.

One thing is, however, perfectly certain: *only people pay taxes*, companies do not. This is a little understood point, but crucial to the understanding of how the tax system works and how it should be working. The Times recently, in a comment on how to calculate the size of the increase in the British tax burden, criticised both the figures presented by William Hague *and* the figures presented by PricewaterhouseCoopers, saying²⁹:

“Mr Brown would protest, accurately [*sic*], that this conclusion includes changes which exclusively affect business and are therefore utterly irrelevant to the tax burden of individuals.”

Wrong. Business taxes are *not* irrelevant to individuals. Any tax imposed on a company *must* be paid by the customers, employees or shareholders of that company. Since nobody *wants* to pay any taxes, it is more a question of to what extents each of these three groups are able to avoid the tax. If all three groups are highly mobile, the company will be forced to leave the market and neither will the tax be paid, nor will the economy as a whole any longer benefit from the wealth-creation of the company.

This tax year the British government will have collected around £330 billion from the British economy, which is roughly 40 percent of the Net National Income, the entire amount of wealth created by the British people³⁰. Yet only about one third of this total tax bill will have been presented *directly* to the citizens in the form of Income tax, National Insurance contributions, and Council Tax. The remaining two thirds will have been collected either as the citizen's wealth was being spent, through VAT and other taxes and duties on consumption³¹, or as their wealth was being created in the economy, through the host of taxes levied on companies and investments. There are other taxes, but these are the three main categories each making up about a third of the Public sector receipts.

What it all boils down to is that out of every five pounds of wealth created by the citizens in the British economy today, the government will tax away the two, but only about 60 pence will be taken directly out of our personal incomes and

²⁹ “Caesar unto Caesar – How to read the various numbers in the great tax debate”, The Times, March 15, 2000.

³⁰ For a discussion of the various ways to calculate the tax burden, see the Tax Freedom Day website: www.taxfreedomday.co.uk.

³¹ It might be argued that taxes on consumption are presented *directly* to citizens, but only individually. How many people keep track of their payments and can say with any accuracy how much they paid in total consumption taxes last year?

wealth. Arguably, were the government to raise the current tax burden from only personal income³², the average and marginal tax rates on income would be so overwhelmingly high that there would be an outcry from taxpayers all over the country, maybe revolt, and possibly mass migration. Nevertheless, such is the size of the tax burden, which today is hidden out of view of the taxpayers.

The most obviously counterproductive case of stealth taxation is probably the National Insurance Contributions or NIC. A great fuss is made of the division of NIC between the employee and the employer, when in fact it makes no difference. For the employer, the *total* NIC contribution as well as any compliance costs are added to the cost of labour. Only for the first couple of years will any changes to NIC contributions have an impact on real wages. Very quickly prices and wages will restore the marked equilibrium, only at a higher cost, adding the cost of complexity. Thus the top marginal tax on labour in Britain is not 40 percent, but rather 52, adding the 12 percent employer's NIC.

It might be suggested that the opacity of the tax system is the necessary price one must pay to avoid the civil unrest of simplicity. Ignoring for a moment the moral implications of such an authoritarian view, as well as the economic fact that a revealed but simple tax structure would be less costly than a hidden but opaque one, there still remains the inescapable question of the government's *capability* to tax. Will the government be able to carry on its present course, shifting the tax burden away from direct taxes and onto indirect stealth taxes on wealth creation and spending? Since Labour came into office in 1997, in excess of 2000 new regulations have been implemented, increasing the annual cost to businesses by more than £5 billion³³ and increasing small business bankruptcy by 14 percent in the first half of 1999³⁴, a year when the British economy was booming.

If politics is the art of the possible, then the indirect ways of taxing the citizens that characterise the current system look more and more like a political impossibility. Companies, capital, and now even, with the growth of the Internet, spending have all become increasingly mobile and defiant of national boundaries. As this trend continues, the impossibility of taxing these factors will become increasingly clear to national governments, who in turn will be forced to shift the burden of taxation back towards direct taxes on personal incomes and wealth – and here too, the increasing mobility of labour will become ever clearer.

Some fear that this trend will create a *race to the bottom* between competing governments as they slash tax rates to attract capital, companies, spending, and, in time, labour. Oddly, this objection normally comes from the same persons who have no objections to private companies competing to provide the best services at the lowest price for their customers. Again, government is seen as something *different*: but it is not. The sooner the British government faces up to the fact that the taxpayers of the future will increasingly be able to avoid indirect taxation, the sooner will it be able to adjust the tax system accordingly.

³² Assuming that today's personal tax system is left unchanged.

³³ The Institute of Directors: Reg. Alert, July 1999.

³⁴ David Franklin: "RIP – SME", in *Economic Affairs*, vol. 20, no 1, March 2000.

The points made here do not run counter to the arguments on the immorality of stealth taxation. Future taxpayers will not avoid taxes because they have all taken a sudden interest in economics, uncloaked the hidden taxes and found them too high. They will avoid them because the price mechanism tells them to do so. Governments often miss this point entirely. In fact, that is why they shifted to stealth taxation in the first place: they thought that by hiding taxes, they could make people pay them. This line of thought may have held some sway in the days when information was not widely available, when foreign countries were something mysterious and dangerous, and when the factors of production were mostly immobile. In short, when government had a *de facto* if not *de jure* monopoly on its citizens and their wealth. Back then it was only a small elite who was able to see beyond national boundaries, and normally this same elite was also in power of the political system and so made sure it was all arranged to their own benefit.

But these days are long gone. There is a whole generation growing up for whom surfing the Internet is second nature. And they will buy their next Walkman, place their next bet, or invest their first million, wherever the price is right, not caring whether it is two streets away, or a few thousand miles. It is just one click with the mouse-button anyway. Whether the government likes it or not, it will in the very near future be forced to compete for the taxes of its own citizens. Ironically, if nothing is done, it will be the *least* mobile citizen, and certainly not the rich, well-educated, and mobile elite, who will have to pay for government activities.

Redefining the concept of tax

The increasing competition for taxpayers between national governments will entail nothing short of a *redefinition of the concept of tax*. The former Chancellor, Hugh Dalton, most accurately coined the *traditional* definition of tax in the following sentence³⁵:

"A tax is a compulsory contribution imposed by a public authority, irrespective of the exact amount of service rendered to the taxpayer in return, and not imposed as a penalty for any legal offence"

In the future this definition will not do. Tax competition will force governments to levy taxes which closely correspond to the quantity and quality of public goods and services demanded by, and supplied to, those whom the taxes are to be levied upon. Over time many tax reforms have been proposed, which advocate systems that are entirely different from the current, and which could arguably work more effectively too. Mainly because they are simpler and therefore have lower tax rates. Their implementation into the real world is, however, often impossible because they still rest on the assumption that tax can

³⁵ Hugh Dalton: "Principles of Public Finance", 1930.

be levied *without any link to the benefits received by the taxpayer*, and thus they ignore the tax competition of the future.

But there are other arguments against advocating the total restructuring of taxation on entirely new principles. Firstly, such proposals seldom take into account *the power of the status quo* within politics. The electorate and politicians alike all know what they have and not what they might have. Nor do they take into account the economic cost of changing from one tax system to another entirely different one. It is certain that such a change will be very costly in terms of administration, and it will almost certainly have some unanticipated effects on the economy. Furthermore, since current prices in the economy reflect the workings of the *current* tax system, the change to a very different tax system will benefit and punish people at random, which is morally questionable as well as being economically inefficient.

To avoid the dangers of doing more harm than good, the reform advocated here starts in the current tax structure, while it tries to put it through a test of effectiveness and simplicity, as sketched out in the previous chapters. First of all, it is asked how well the different taxes will be able to deal with the tax competition of the future. Secondly it is proposed how they can be changed so to meet this challenge, while following a path towards simplicity and transparency. If the British tax system is put to such a test, only a few taxes will remain, the majority being direct taxes on income and property. There could still remain some taxes on wealth creation and spending, but only to the extent that they were justified by the public services enjoyed by wealth creators and spenders. Or, in the case of negative externality taxes, to the extent they reflected the cost imposed on the rest of us by the activities of the said spenders and wealth creators.

The reform advocated here for the *lowering and simplification* of indirect taxes will undoubtedly boost economic growth, thereby paying back some or all of the tax revenue lost due to the initial lowering of tax rates. In 1990 the collection costs of UK income tax alone absorbed around 2 percent of the income tax collected. This figure excluded the administrative burden on individual taxpayers and their employers, the inclusion of which was estimated to bring the total administrative and compliance costs of income tax and NIC to between 4 and 6 percent of the tax collected³⁶. To the extent that these figures still hold today this would mean a cost of around £4-5 billion per year, on top of which comes the costs of administering and complying with the *indirect* taxes, such as VAT and corporation tax. In 1986/87 these costs were estimated at respectively almost 5 and almost 3 percent of tax revenues, adding another £3-4 billion to the total cost of maintaining the current opacity³⁷. And this figure of some *£8 billion wasted each year* excludes the damaging economic side effects of complexity, which are almost impossible to quantify.

³⁶ John A Kay and M A King: "The British Tax System", 1990. These figures are consistent with the ones found for the tax year 1986-87 in the thorough examination by Cedric Sandford et al. (See the following footnote).

³⁷ Cedric Sandford et al: "Administrative and compliance costs of taxation", 1989.

But not necessarily all the tax revenue lost from the reform advocated here will be recovered directly through lower costs and increased economic activity. If government wishes to keep spending at an unchanged level, save for administrative savings, it must increase the taxes imposed directly on citizens. It should be remembered, however, that lowering indirect taxes will increase both the *nominal* and the *real* values of the wages paid to employees and the dividends paid to shareholders. So, although tax *rates* may rise, the actual tax *burden* will be lower, leaving people better off in absolute terms.

6. Reforming the tax system – indirect taxes

This chapter examines the two main types of indirect taxes levied in today's Britain: taxes on companies and taxes on personal spending. It explores how the predicted redefinition of the concept of taxation will have an impact on each, and how they must be reformed to meet the challenge of the future tax competition between nations. Throughout, the aim is for simplicity and transparency, but at the same time the necessary complications which follow from our discussion on externalities cannot be ignored. Thus, there must be extra taxes on activities that unavoidably harm common property, and there must be tax exemptions for private activities supplied in competition with government.

Taxing companies

Today, companies are taxed in a variety of ways, the two main taxes being the *Corporation Tax* (CT) and the employers' *National Insurance Contribution* (NIC), each accounting for around £30 billion of the roughly £80 billion raised from taxes on companies. The last £20 billion accrues from the *Petroleum Revenue Tax* (PRT), and other business taxes. The tax legislation pertaining to companies is a highly complicated matter, with tax rates fluctuating according to profits and a host of tax deductions and exemptions, different schemes and plans. And, on top of this, companies are expected to administer many of the taxes levied on their employees.

As already stated, companies as such cannot pay any taxes, but are forced to pass the bill onto investors, customers, or employees, depending on the mobility of these three factors. It does not matter where or on whom the tax is actually levied, very quickly the prices will adjust to reflect the relative “strength” of the three groups involved. Capital is already very mobile and with the spending-power of consumers becoming increasingly mobile as well, the only group left to foot the bill of taxes on companies in the future will be the employees. If the employees cannot be made to pay either, perhaps because of minimum wage requirements, the company must either relocate abroad or leave the market to other companies.

It is very important to stress these facts, especially to those *not* in favour of shifting the tax burden away from corporations. With increasing trading across national boundaries, the prices of most goods and services, as well as the returns on investments, will in the future be set by the global market. And, as is the case with all market prices, they will tend to converge. Why would anyone buy a CD

in their local shop, if they can get it for less on-line? And likewise, why would anyone invest in a domestic company offering a lower return than a foreign company with the same risk-profile? In order to stay competitive British companies *must* give as good a return to shareholders as their competitors, and increasingly they *must* also sell their goods at similar prices as well. If the British companies are faced with taxes that their competitors do not face, they must pass the cost of these taxes on to *the weakest link in the chain*, the employees. This is true regardless of where the tax is actually levied, e.g. regardless of it being tax on company profits, such as CT, it must be borne by lowering the wage pool paid to employees.

This does not mean that shareholders and consumers cannot be made to pay *any* share of the various taxes on corporations, but only that if too high taxes are levied on either of these groups, they will inevitably be passed onto employees. The tax burden that will remain to be paid by customers and shareholders will reflect the advantage to these groups for undertaking their economic activity inside the boundaries of the taxing body. Thus the share of CT paid by British consumers and British-based companies respectively will in the future reflect the advantage they each get from the security, stability, and law and order provided by the British government. It is therefore more honest if the tax rates are set to actually reflect this advantage, rather than just being a hollow token of how much we all think business ought to be paying.

It is difficult to say exactly how low the tax rate on company profits should be set to reflect this, or whether there should be one at all. Only time will tell whether future competition for companies between countries will lower the rates so much that it will be cheaper to abolish CT altogether. Remember that a zero-rate will only reflect the fact that companies do more good than harm to the economy. Until that day, however, there are a few things that should be done in the short to medium term. First of all the rates should be gradually lowered to around 10 percent or lower, and secondly, the tax system should be dramatically simplified by phasing out the many tax exemptions that today relieve companies of almost a quarter of their taxable potential³⁸. Most companies will undoubtedly welcome an across-the-board removal of exemptions in exchange for a simpler tax structure with lower rates, *and so will the economy*. Private companies producing public goods in competition with government should of course be exempt from CT, following the arguments presented earlier in the discussion of externalities.

Further simplification could be achieved by removing the arbitrary distinction between a company's running expenses and long term investments. Instead they could be treated equally by allowing companies a 100 percent write-off the year in which they acquire either, and then allowing them to carry forward losses from one year to be set off against future profits³⁹. There is a lot of folklore about

³⁸ Maurice Saatchi and Peter Warburton ("The War of Independence - A Declaration", 1999) estimate the notional taxation of companies to be around £106 billion (1997-8), but tax reliefs reduce this to roughly £80 billion. The removals of these tax reliefs will thus not only save administration, but will directly help "pay" any reduction in corporation tax.

³⁹ How such a reform could benefit the economy by simplifying and standardising company taxation is described by Robert E Hall and A Rabushka: "The flat tax", 1985.

the 100 percent first year write-off and some discussion as to whether it is in fact an uneconomic distortion rather than a simplification. One thing is, however, certain: the lower the CT, the less important any write-off rules become, and with no corporation tax at all, companies could be free to arrange their accounts in any way they see fit, as long as shareholders or owners were satisfied.

Lower and simpler corporation taxes will boost the economy by attracting investments and companies from abroad, as well as by stimulating the creation of new companies through the lowering of fixed costs of entry, especially for smaller companies. On top of this comes the positive economic impact of the highly educated workforce of accountants and tax lawyers, publicly and privately employed with corporation tax assessment and speculation, now free to do more productive work. It is not unlikely that the broadening of the company tax base along with the increased economic activity from such a reform, especially in the longer run, will generate enough jobs and wealth to entirely make up for the revenue lost through lower tax rates. To the extent that this is not the case, the lost revenue must be covered either by lowering public spending or by increasing the revenue from other taxes such as taxes on spending or income taxes. But, since the money saved by companies must be passed on to someone, lower CT will also increase the incomes of employees and lower the prices on goods and services.

Another aspect of corporate taxation that should be simplified, although clearly not abolished, is the taxation of the negative externalities that production inevitably inflicts on common property, such as the environment. Where there are genuine negative externalities present, it does not pay for countries to compete against each other by exempting companies from paying externality taxes. This is because the negative externalities from production (such as pollution) reflect actual costs, which someone must pay at some point. Thus, it is economically efficient for the externality costs to be paid at the moment they are inflicted, by those who inflict them. To the degree to which the externalities are avoidable, they will be avoided; to the degree to which they are not, those demanding the goods or services, even at an increased price, will have to endure the externality costs.

If a country collect *less* than is needed to cover externality costs, in order to attract companies from abroad, then other taxpayers in that country, present or future, will at some point have to pay the rest. At the same time, people in other countries will be able to buy the cheap goods *without* having to pay the cost. Therefore, no British businesses should be exempt from paying negative externality taxes on the grounds of export advantages since such a policy will only benefit the customers abroad offered lower priced goods, while punishing the British taxpayers left with the bill of rectifying the cost of production. Even though the removal of all exemptions from negative externality taxes may hurt some British businesses in the short term, the long-term benefits to the British economy and public will be greater.

The exact sizes of the different externality taxes to be levied on production are not within the confines of this paper to assess. This is a task for professionals

and one can only hope that the government employs competent ones. However, to avoid the risks of stealth taxation through the government increasing externality taxes beyond what is justifiable by the cost of the externalities, the revenues from each of these taxes should be kept on separate accounts, and then only be used to reduce what was arguably the negative externality that justified the tax in the first place. It will still be tempting for the government to modify externality taxes to redistribute wealth between different groups, rewarding their preferred industry at the expense of others for example. Citizens should always watch out for such abuse and try to erect constitutional measures to prevent it; remembering that any such political action is ultimately a negative-sum game from which the citizens themselves must eventually bear the costs.

Taxing personal spending

Personal spending is today taxed in various ways depending on the character of the good or service bought. A little more than half of the roughly £100 million currently raised from the taxation of spending, is levied through the Value Added Tax, or VAT. VAT works like a sales tax, only it is levied gradually as a good passes through the economy, rather than at the last stage only⁴⁰. Although more costly in administration, VAT insures that some tax will be paid, even if part of the tax should be avoided at the last stage the good passes through. Logically, the higher the sales tax, the greater the reward for avoiding it and the stronger is the argument for changing to VAT.

The standard rate of VAT is currently 17.5 percent, but there are several exceptions from this rate. Some items, such as some financial services, education, and funerals, are exempt from VAT, while other goods, such as children's clothing and footwear, some foods, and some water and sewerage services, are zero-rated⁴¹, and still others again, such as domestic fuels, are subject to reduced rates⁴². These lower rates and exemptions somewhat reflect the political desirability of the commodity traded, much along the traditional arguments presented in the discussion of positive externalities.

The future challenges facing any sales tax in many ways mirror those facing the taxation of companies. As the competition between companies become global, the global market will increasingly set the prices of goods and it will be very hard for any company to differ from these prices. Thus, any sales tax imposed

⁴⁰ A sales tax is levied only as the good is sold to the consumer, no matter how many links it has passed through, e.g. a sales tax of 10% on a good sold for £100 would come to £10, a total of £110. VAT is levied along the way as the good is passed through the economy, but in the end amounts to the same. E.g. with a VAT of 10% a shopkeeper will pay his supplier £60 for a good plus £6 in VAT. He will then sell on the good to the consumer for £100 plus £10 in VAT. He can then deduct the VAT already paid (£6) against the VAT received (£10), bringing the total VAT received by government to £10 (£6+£4), all eventually paid by the consumer.

⁴¹ Zero-rated is not the same as exempt from VAT, since the VAT paid on inputs can still be reclaimed (in the first instance), hence being zero-rated is better than being exempt.

⁴² For a full description of the VAT liability of various goods and services, visit the HM Customs and Excise's web-site: www.hmce.gov.uk.

on British consumers that could be avoided by buying from abroad must be borne by the company selling the good, rather than by the consumer. As noted above, companies must either go out of business or pass this bill to someone, and so, again, it will be the employees who lose out. Consumers will only be left with the price for the benefit of trading within the protection of the British government and legal system.

Some argue that this bleak picture for the future of sales taxes should be modified on a couple of points. Firstly, some goods and services will *never* be subject to global competition because of the cost or time it takes to transport them from producer to consumer. Secondly, government can *fight* this global competition by imposing taxes on imports, which is made somewhat easier by Britain's geographical position. What should be noted to both of these arguments is, however, that it will be highly arbitrary which goods can be taxed and which goods cannot. Big bulky object such as refrigerators will be expensive to transport and hard to get through customs, just as perishables like most groceries would not survive such a trip. CDs on the other hand, and electronic goods such as virtual services via the internet, are cheaply and almost risk free delivered to another country.

One possible solution would be to set up a governmental Department of Sales Taxes, which would judge not only the political *desirability*, but also the realistic *probability*, of successfully taxing each and every different kind of good and service available in Britain. A tax could then be levied reflecting both these judgements, open to periodical reviews. Not only would this be a very costly solution, it will also open up even more possibilities for government activities to be influenced by powerful interest groups, wasting resources to capture the massive amounts of economic rent made available by government. Levying many and different sales taxes on various goods and services at different stages of production is already administratively difficult and expensive, both for companies and the government, who also have to monitor imports. Furthermore, varying taxes on different goods and services is economically inefficient because it obscures the relative prices and thus lead to a sub-optimal spending pattern, e.g. inducing people to buy far too many CDs and far too few refrigerators.

Instead the same solution is proposed as for taxes on companies, that is, a systematic reduction of tax rates and simplification of tax structure. One low standard rate of sales tax, reflecting roughly the consumer's advantage from trading in Britain, should be levied on all goods and services except those produced in competition with government. Today, around one third of the potential VAT revenue is given back through exemptions and zero rates. Some of this, although it is hard to say exactly how much, would be taxed under the rigid application of the above distinction and would thus pay for some of the rate reduction. Those favouring continued exemptions or lower ratings for "essentials" such as food, should remember that this entails a huge bureaucracy to define what are "essentials" and define the border between, for instance, bread and cakes.

Since the sales tax, like the tax on corporations, must ultimately be set in competition with other countries, it is not clear whether it too in time will prove more cost-efficient to abolish altogether. At first it could be set at around 5 percent. With such a low rate of sales tax, it would become more cost efficient to abolish the VAT principle and levy it as a single-stage wholesale tax instead. When the reverse happened in Britain in the beginning of the 1970s, the number of tax collectors increased more than six fold and the number of VAT-taxpayers rose by an astounding 19 times⁴³. These persons would all be freed to do more productive work instead of collecting taxes. A rate as low as 5 percent would also ensure that everyone, even those spending a large part of their income on zero rated items today, will be better off.

A sales tax of 5 percent would boost the British economy by keeping domestic companies from fleeing, attracting foreign companies, and stimulating the creation of new companies and jobs. Whether the combined positive economic effects of such a sales tax reform: lower rates and reduced administration, would in fact make up for all the revenue initially lost is not certain. And so again, to the extent that government spending is not lowered, the lost revenue must come from increased taxation of other factors, such as personal incomes.

As with taxes on companies, the other great exception to the rule of simpler taxes arises from the existence of negative externalities to some consumption. The total revenue from these taxes is today around £45 billion, with half of this stemming from fuel duties and the second largest part being the combined duties on spirits, wine, beer, and cigarettes, totalling some £12 billion. Unlike taxes on negative externalities from production, taxes on consumption are hard to levy by the governmental body that has to endure the costs imposed. A tank of petrol, for example, can be bought in a neighbouring country but used in Britain, thereby passing the cost of pollution to Britain, while the tax collected and the revenue of the filling station remain abroad.

In regards to petrol, the fossil fuel most easily transported across borders, it should firstly be noted that most of the negative externalities, such as forest damage and any global warming, reach beyond the national boundaries of Britain, and so are better handled at a trans-national level through international agreements. If such agreements imposed costs on governments according to the amounts of fossil fuels sold in each country respectively, it would become economically inefficient for any country to undercut the tax-market for the same reasons as for taxes on production externalities described above⁴⁴. Secondly, it should be noted that the more local negative externalities from petrol, such as particle pollution in big cities, are more easily dealt with at a more local level, through such things as road pricing.

⁴³ John A Kay and M A King: "The British Tax System", 1990.

⁴⁴ If, for example, EU countries had to pay, say, 60 pence per litre of gasoline sold in each country respectively, then any country levying a fuel tax of less than 60 pence would run a "fuel tax deficit" - to be paid by other taxes on its citizens.

Apart from perhaps the fuel duty, the taxes on cars and driving levied today are arguably not economically efficient if the aim is to reduce pollution and congestion, the two often-cited negative externalities from cars⁴⁵. Taxes, such as Vehicle Excise Duty for example, only increase the *fixed* costs of having a car, but, increasing the *fixed* costs of driving only benefits those who drive a lot at the expense of those who drive less. It does so by reducing the tax per mile for the former group while increasing it for the latter, and modifying the tax to incorporate the fuel efficiency of different cars does *not* alter this point. It only benefits those in fuel-efficient cars who drive frequently, and thus pollute a lot, at the expense of those in perhaps less fuel efficient cars who drive only occasionally and thus actually pollute far less. It is proposed that the same revenue as today should be collected in the most economically efficient way, that is, only through local road pricing and fuel duties set in agreement with neighbouring countries to reflect any harm to the environment.

Moving on to the duties on alcohol and cigarettes we find the same cross border considerations as with fuel duties, except that the externality costs imposed by their consumption, namely raising the cost of NHS, are all strictly confined to Britain and do not cross national boundaries⁴⁶. With duties on alcohol and cigarettes it has been argued that the externality arguments are often one-sided, not including the public *savings* arising from the earlier deaths of smokers and drinkers. But this whole discussion overlooks the real problem: the cost-free provision of health. If health care were private, smokers and drinkers, along with any others leading unhealthy lives, would themselves have to pay to the extent that their consumption imposed a health risk.

However, as long as health remains free at the point of consumption, the duties on both tobacco and alcohol should at least be lowered to reflect more truly the cost to society. Secondly the duties on alcohol should be standardised to reflect the amount of alcohol rather than any redistributive preferences of the government. Today higher tax is levied on the alcohol in spirits than on the alcohol in beer, reflecting the assumption that richer people drink spirits, while poorer people prefer beer. The question is not whether this assumption is right, nor whether it is morally justifiable for government to discriminate in this way. Rather the question is whether it is economically efficient to do so.

Recent studies have shown that lowering and standardising the duties on spirits, wine, and beer at £10 per litre of pure alcohol would make the initial loss of tax revenue minimal, while having positive effects on the British economy⁴⁷. Likewise, experience from other countries has shown that very high taxes on tobacco and cigarettes (and Britain has tobacco taxes more than twice the size of the EU average) do not markedly reduce smoking, and thus the costs to society, nor do they increase tax revenues. Rather they induce smuggling and increase the revenues of organised crime at the expense of the chancellor and the legal

⁴⁵ For a thorough examination, see: Peter Mumford: "The Road from Inequity: Fairer ways of paying the true costs of road use", Adam Smith Institute, 2000.

⁴⁶ Only in the relative few instances where people migrate.

⁴⁷ Paul Heines: "Freedom and Whisky Gangs Together", Adam Smith Institute, 1999.

economy as a whole. The market penetration of smuggled cigarettes ranges between 14 to 48 percent across the UK and last year cost the government an estimated £2.5 billion in lost revenue⁴⁸. One can only wonder why, in the face of this, the chancellor chose to raise the duty on cigarettes even further in the 2000 budget.

The aim of the reforms proposed to both company taxes and the taxes on personal spending is to reduce these taxes to the sizes justified by the benefits to companies and consumers, or, in the case of externality taxes, to make them reflect more closely the cost imposed by companies and consumers. The effects would be to free up the economy, inducing economic growth, while not running down the environment. Furthermore it would leave the bulk of the tax burden to be levied through direct taxes on the ones who actually end up paying all of it: the citizens.

⁴⁸ These were the findings of the Tobacco Manufacturers' Association in their (pre)comment to "The Chancellors Budget 2000", 9 February 2000.

7. Reforming the tax system – direct taxes

This chapter will concentrate on the direct taxes paid in Britain today: taxes on personal incomes and taxes on property. As previously argued, these two tax bases are considerably less mobile than corporations and consumption, and the government will therefore have to shift the tax burden towards them if it wants to maintain tax revenues in the future. It is not so much a question of whether one welcomes the shift towards more direct taxes, because it will take place *irrespective* of government action. Only, if nothing is done, the shift will be hidden and therefore come at a somewhat higher cost to taxpayers, adding the cost of complexity.

Today, taxes on incomes are levied in almost as complex a manner as the indirect taxes. The distinction between what is taxable income and what is not is extremely blurred, including for example some capital gains but not all. There are literally hundreds of different tax allowances, deductions, and exemptions. The income tax is levied, along with the National Insurance Contributions (NICs) and Capital Gains Tax (CGT) in a manner that makes the average and marginal tax rates dance all over the place, discriminating arbitrarily between different types of incomes. The result is certainly not equality, either in the sense of equal treatment or in the sense of equal end-results. Rather the result is frustration and extra work for taxpayers, higher than necessary marginal tax rates, and an army of tax assessors and tax collectors to harass us and then demand a pay cheque for their efforts. All in all: weaker incentives for taxpayers to work and make an effort, and higher incentives for them to be idle or to move into the black economy. With the future prospect of even more of the tax burden being shifted onto wage earners, there is an increasing need for simplifying the personal income tax structure and for making it as cost-efficient as possible.

The last part of the chapter will focus on taxation of property, the most immobile tax base of all. In this context we shall also look at the *division* of the tax burden between central and local government and the possible advantages of stimulating competition between local governments within Britain.

Defining personal income

The first problem when taxing personal income is determining what it is, most importantly distinguishing it from capital gains. Some will find such a distinction impossible and even unwanted, believing that any capital gain should be taxed as income. To those it could be argued that:

- There is a big difference between income and capital gains, and
- While the former is easily identified and taxed, the latter is not.

The difference between income and capital gains is, in theory, clear enough: an income is a certain payment at a certain date, subject to a formal or informal contract, while a capital gain is uncertain and *not guaranteed to be positive*. Thus work wages or interests on bank deposits are clearly incomes, while increases in house prices or shares are clearly capital gains. The former are certain and guaranteed by contracts, while the latter are uncertain and could just as well be negative. Dr. Barry Bracewell-Milnes described the difference thus⁴⁹:

“It is rather like the difference between night and day. Certainly there is a dusky time in the evening where it is difficult to say confidently whether night has fallen or not. But at most moments within any 24-hour period, everyone is perfectly well aware whether it is night or day... If the otherwise insignificant boundary becomes important in some context, then we set an arbitrary cut-off point – as we do with “lighting up time”, a convention to prevent people driving unsafely while the night is still deepening”

But what about these borderline cases? Clearly the problem of separating income from capital gains, and the possibility of transforming the first to the latter, have been the main driving forces behind treating capital gains as personal incomes subject to taxation. The problem overlooked by those who find the border between the two hard to police is, however, that the inclusion of capital gains as an income opens up a host of other boundaries to be policed.

To what extent should capital *losses* be deductible, if at all? Should all capital losses in one’s entire lifetime be deductible from any capital gains, or only those from within the same year as any gains? What about inflation in that period? To what extent should running investments in physical capital, or the opposite as the case might be, be included in calculations of capital gains? If a house is sold after 20 years of decay for the same price as it was bought, indexed for inflation, then surely some capital gain must have been materialised along the way by the owner. Should this gain be taxed? How is it calculated? If the same house is sold for twice the original price after being vigorously kept and refurbished, should this investment not be deductible? What if the bottom has gone out of the housing market and the house, despite investments, is still only worth the original price? Should the investments still be deductible?

The list of questions is never-ending, and I shall not attempt to answer any of them. Neither shall I attempt to answer the other question faced when including capital gains as taxable incomes: which capital gains should be taxed and which should not. If policing the boundary between income and capital gains is difficult, this new boundary is even more so. As interns or trainees, many young people work for low wages in the anticipation that their *value* as workers will rise from the experience, and other young people spend years in universities hoping

⁴⁹ Barry Bracewell-Milnes: “Captive Capital – How Lower Gains Taxes Unlock Wealth”, Adam Smith Institute, 1995.

the same. Clearly these increases in “personal” values are capital gains, but neither are taxed. Only the part of personal values actually materialised as income (if any) is being taxed. The capital gain itself is not, and trainees and interns are free to leave the country with it – even students are free to leave with the capital gains from an education largely paid for by other taxpayers. Only if they *choose* to stay and earn an income from their gains will they be taxed – on their incomes.

The same clear and logical distinction is easily applied to other capital gains. In fact, most capital investments can be compared with the above examples, where young people choose between materialising *some* of their future value now, as trainees, or risking it all for an even higher value in the future, as students. Likewise with bonds and shares where you can have little or none of any gains materialised as dividend or interest, and the rest as a *possible* capital gain⁵⁰. Here again we see the clear distinction between the *certainty of income* and the *uncertainty of gains*. The first should be taxed, the latter not.

This distinction between taxable incomes and non-taxable gains also has implication for other taxes, most notably the *insurance premium tax* and *betting and gaming duties*. In essence, insurance and betting are the same: money invested in the possibility that something specific might happen. The more certain the investment is to materialise, either because the chance of the event happening is great, or the same investment is made continuously, the less will the total return be if the event happens. And if you are investing in several events, it is likely that you will end up paying more than you receive. The profitability of both casinos and insurance companies is a clear testimony to this fact. Any positive economic returns from gambling or from insurance are thus nothing but capital gains, and should therefore *not* be taxed. As with shares and bonds, and houses and education, it is the *uncertainty* of any profits and the *impossibility* of taxing consistently that logically points to this conclusion. Should all bets made in one’s lifetime be deductible from any winnings, or maybe only the bets made this season? Those who think that betting should be taxed simply because it is “bad” are not only being paternalistic, they are also forgetting that on-line betting overseas is a growing business. Exempting domestic betting from taxation will at least keep the jobs and profits involved inside Britain.

There are also more *pragmatic* reasons for not taxing capital gains, including betting and insurance. Like other indirect taxes, they are very cost-inefficient with capital gains taxes (CGT) being undoubtedly the most complex part of the personal tax system, as anyone who has attempted to read through the Inland Revenue’s “introduction” to the tax will know⁵¹. Yet, *including* insurance premium tax, and betting and gaming duties, the taxes on capital gains only account for about *one and a half percent* of the total tax receipts in Britain, while the negative effects are much greater. The taxation of capital gains, along with

⁵⁰ The nominal capital gains from selling bonds are of course certain. What you take a chance on is whether the gains will be positive or negative in real terms.

⁵¹ “An Introduction to CGT” and other information about the capital gains tax are available on Inland Revenue’s web-site: www.Inlandrevenue.gov.uk.

the complex manner in which these taxes are levied, tempt people to invest abroad rather than inside the British economy. With the mobility of capital and the growing possibility of on-line investment, this becomes a threat not only to tax revenues but to the British economy as well, which will see investments drop in face of foreign competition. This trend cannot be reversed, and only fought at a very high cost to taxpayers and the economy. It is therefore much more forward-looking to prepare Britain by abolishing the taxation of *all* capital gains⁵².

The last gains that should clearly be distinguished from taxable incomes are inheritance. Inheritance tax today yields only a little over *half a percent* of the total British tax receipt, while its damaging effects on the economy are disproportionately greater. Some estimates of the total administrative costs are more than 10 percent of revenue, and the destabilising effects on the economy are such that abolishing inheritance tax would probably *increase* total tax revenues rather than the opposite⁵³. Furthermore, the abolition would promote personal ownership instead of penalising unquoted companies and other owner-managed family firms, forcing them to move abroad in order to stay alive.

Taxing personal income

Having clearly *identified* personal income and separated it from other *non-taxable* gains we are still left with the question of how to tax it. There are countless theories on how a *just* taxation of income is levied, ranging from *poll taxes* through *proportional taxation* to *progressive taxation*. It is not within the confines of this paper to go into this discussion and we shall just settle on the fact that it is generally accepted that income taxes should be progressive, taxing higher incomes relatively harder than lower incomes.

Today this progression is achieved through a system of increasingly higher tax rates applied along the way as personal incomes rise. Since the first parts of all incomes are taxed at the lower rates, the tax rate on the last parts of higher incomes must be substantially greater in order to make the overall result progressive. This entails very high marginal rates on higher incomes earners, *reducing* their work incentives by reducing the take-home income from any extra effort. Furthermore, like varying VAT rates, the different marginal tax rates obscure the natural relationship between the costs of different kinds of labour⁵⁴. Following the *theory of second best*⁵⁵ the entailing sub-optimal labour demand is only avoided by levying the same marginal tax rate on all income, that is, by having a proportional income tax structure.

⁵² Dr Barry Bracewell-Milnes: "Captive Capital – How Lower Gains Taxes Unlock Wealth", Adam Smith Institute, 1995.

⁵³ Dr Barry Bracewell-Milnes: "Free Wills: Inheritance Without Taxation", Adam Smith Institute, 1995.

⁵⁴ Making the cost of labour depend on the *previous incomes* of those supplying the labour.

⁵⁵ *First best* being that no tax should be levied, the *theory of second best* implies that if a tax must be levied it should apply equally to all income as this will distort the first best equilibrium least.

The challenge is to resolve the problem of increasing, and thus varying, marginal taxes *without* abandoning the goal of progression; remembering that the goal of progressive taxation is *not* to make people with higher incomes pay high *marginal* taxes, but to make them pay high *average* taxes. The simplest way to accommodate both concerns is by having fairly high personal tax allowances combined with a flat or proportional tax on all income above these tax allowances. The tax-free allowances will insure that, even though the *marginal* tax rate stays the same, the *average* tax rate rises gradually with income. The higher the tax allowances, the higher tax rates will be needed on income above the threshold and the more progressive will the overall tax structure be. Off course, there will still be a difference in marginal taxes between the few people earning incomes below the tax threshold and everyone else, but the positive effects of this difference will far outweigh the negative.

Firstly, high personal tax allowances provide people without any incomes with an easy entrance to the labour market because it allows them to sell their labour more cheaply than the people already in the labour market. Secondly, if the personal tax allowance is substantially high, it will clearly separate the people *receiving* transfer incomes from the people *paying* taxes, by making sure that these groups do not overlap. In Britain, separating these two groups would end the needless transfer of some 30 to 40 billion pounds in and out of the same households every year. Furthermore it will remove the extreme disincentives now associated with the move from unemployment to paid employment because of the *simultaneous* withdrawal of benefits *and* increase in tax liabilities. Together, these two effects can today raise effective marginal tax rates for people entering the workforce to more than 100 percent, leaving some people no better off, *or even worse off*, by taking a job⁵⁶. However, since higher tax allowances also narrow the tax base, their positive effect should be set off against the negative effects of the necessarily higher tax rates they entail.

Part of this negative effect can be countered by letting the higher personal tax allowances replace the many different tax deductions and exemptions, without which the tax revenue from today's direct taxes on income would be approximately 70 percent higher than it is. Contrary to belief and, maybe, intention these deductions and exemptions have been proven to benefit *wealthier* individuals who can arrange their financial affairs to take advantage of the system rather than poorer individuals not able to do so⁵⁷. Most people would undoubtedly welcome an across-the-board abolishment of deductions and exemptions in exchange for higher personal tax allowances. It would be administratively cheaper, and it would remove the opacity and complications that today make people worry more about avoiding the taxman than they do about working. A personal tax allowance of £7,500 per year for every adult in Britain would be substantially higher than the current tax allowances to ensure that the only ones *worse off* in terms of tax-free incomes would be the people who are now exploiting the system. At the same time, the almost 8 *million taxpayers* who have yearly incomes below £7,500 *and* receive means-tested benefits from

⁵⁶ Maurice Saatchi and P. Warburton: "The War of Independence – A Declaration", 1999.

⁵⁷ Ibid.

the government (thus both paying and receiving at the same time), would be left better off on their own incomes, now tax-free, leaving them with *reduced needs for benefits*.

Personal tax allowances are based on the *individual* as the tax unit, rather than the household or family, but some argue that different kinds of households should be treated differently: encouraging nuclear families, helping single mothers, etc. To allow individual households the greatest freedom to arrange their lives according to preferences, they could be allowed to "pool together" the personal tax allowances of individual household members, so that a household of two adults, for example, would not have to pay any taxes on the first £15,000. At the same time, child benefits could be changed into additional tax allowances of, say, £2,000 per year⁵⁸ for the first two children. Allocating high universal personal tax allowances while allowing households, whatever their type, to pool these tax allowances together, would be the fairest and simplest way of treating all individuals alike, while still taking into account the different kind of family or other relationship arrangements people might prefer to live in.

The tax and allowance reforms advocated here do have some further implications for the tax and welfare systems, and a few points should be made. Firstly, the personal tax allowances should be the *only* tax allowances available, save of course for the necessary tax exemptions for money spent on private health, education, and pensions, *as long as they are produced in competition with government*. Secondly, the implication of the above allowance-reform is that no household earning incomes above their "pooled" allowances should be receiving any government benefits whatsoever. Since only very particular circumstances would entail that households with incomes above their allowances should be in any grave financial need⁵⁹, these rare instances could be handled much more effectively by private charities. Lastly, the social benefits to household earning less than their pooled allowances should be paid as a *negative tax*, that is, as a fixed percentage of the allowance not used⁶⁰. The size of this negative tax rate could still vary according to circumstances, but it would ensure that *no household ever faced an effective marginal tax rate above 100 percent when moving from benefits to work*.

With current levels of incomes and the proposed allowance reform⁶¹ it would require a flat tax of something like 29 percent (17 percent excluding employer's NIC) on personal income *excluding* capital gains, etc. to levy the roughly £155

⁵⁸ To allow children gradually to develop their personal finances, the child allowance could be gradually increased from around the age of 14 or so.

⁵⁹ Remember also that goods and services will become less expensive when indirect taxes are lowered, thus *reducing the need for income subsidies*.

⁶⁰ It would work like this: today, unemployment benefit, for example, is around £2,700 a year, which is exactly 36 percent of £7,500, the proposed personal allowance. Under a *negative tax system*, a household with an unemployed would receive 36 percent of their "pooled" allowances not used. A household with 2 adults earning a total of £12,000 would thus be entitled to £1080 per year (36 percent of £15,000 - £12,000), with an extra £720 (36 percent of £2,000) for each of their first two children. For more on negative tax, see e.g. Milton Friedman: "The Case for Negative Tax", in "The Essence of Friedman", 1984.

⁶¹ Not including the child allowance reform and the effect of "pooling" together allowances.

billion (including all NICs) currently levied on incomes and capital gains, etc. Slashing CT to 10 percent and introducing the 5 percent sales tax instead of VAT will require the flat tax rate to be raised to around 39 percent (27 percent excluding employer's NIC). And entirely abolishing both these indirect taxes will raise the required flat tax rate to 43 percent (or 31 percent excluding employer's NIC)⁶². At first glance these tax rates look quite scary, but they cannot be directly compared with today's tax rates. They include *all* NICs, including employer's NIC of 12 percent, and it should also be remembered that shifting the tax burden from indirect to direct taxes *does not* imply that the tax burden has *changed* in any way, only that it has been brought into the open. More importantly, the rates do not take into account the *positive dynamic economic effects*, which one could expect from such a reform, as outlined in earlier chapters.

To capture these economic effects, the proposed tax reform was put through the *Liverpool econometric model*⁶³, whose predictions indicate that the proposed tax simplifications would both *increase* economic growth and *reduce* unemployment. Whether or not the reform was accompanied by any shift from indirect to direct taxes, the predicted cumulative GDP gain would be in the region of 1 percent over the next 4 years, while the reduction in unemployment (benefit count) would be around 100,000 over the same period. These simulations exclude the positive effects that can be expected from the lowering of marginal taxes, especially for higher earners. Lowering the marginal tax from 52 to 39 percent, for example, increases the marginal wage for higher earners by approximately 27 percent (from 48 to 61 pence in the pound). Given an expected labour supply elasticity in the order of unity for higher earners⁶⁴, this translates into a similar rise (27 percent or so) in the labour supply of this group. Using the somewhat cautious assumption that higher earners represent one tenth of the income tax base, this again should increase the latter by 2 - 3 percent.

Although the simulations are only rough estimates, they nevertheless clearly indicate that, *even without lowering the tax burden*, there are economic gains to be achieved by tax simplification alone. Along with other positive effect to be expected⁶⁵, these economic gains should increase government surplus, thus making scope for substantial tax cuts within the next couple of years. If, however, some or all of the *already expected* surplus were used towards tax cuts in order to ease this transition, the flat tax rate could be lowered by as much as 9 percentage points⁶⁶. Such a tax cut would in itself boost GDP by another half

⁶² The tax rates presuppose that "saved" employer's NIC will be paid as increased incomes to employees. The two latter tax rates further presuppose that all CT "savings" are passed on to employees and shareholders. On the other hand it is presupposed that lower consumption taxes *only* affect prices and not incomes.

⁶³ I thank Professor Patrick Minford his assistance. The *Liverpool econometric model* has been successfully predicting economic performance for over 20 years, see e.g. Patrick Minford and A Haldenby: "The Price of Fairness", Centre for Policy Studies, 1999.

⁶⁴ This was the finding of Patrick Minford and P Ashton: "The Poverty Trap and the Laffer Curve - what can the GHS tell us?", in Oxford Economics Papers, 43, 1991.

⁶⁵ Such as the effects of reduced compliance and administrative costs.

⁶⁶ Without any reforms, the expected public sector surplus by 2003/4 is 3.5 percent of GDP. A tax cut of 9 percentage points would keep the debt / GDP ratio steady by running a deficit of 1.5 percent of GDP.

percent p.a., while reducing unemployment by a further 130,000 over the next 4 years - thus helping to pay for itself.

Taxes on property – local taxes

Although the economic argument for transforming indirect taxes into direct taxes on income may thus seem strong, it can be argued that, like other traditional tax bases, income will become increasingly harder to tax, especially as the Internet expands. People could be working on-line in a low tax country, getting paid offshore, maybe even in virtual currencies⁶⁷, while still benefiting from living in Britain, perhaps even receiving income support. This would be criminal and, as with all other criminal acts, the government should try to stop it and bring to justice the criminals. However, as in the black economy today, the *incentives* to avoid taxes as well as the social indignation attached to doing so will be highly dependent on the tax rate. It can therefore be argued that some of the tax burden should be moved away from income and onto even more direct forms of taxation such as taxes on property. And it is almost certain that in the future, such a shift will take place.

People who own property clearly benefit from the public services provided by the state wherein they have that property, and part of the tax burden could be levied to reflect this benefit *and* to help reduce the tax rate needed on income. Two questions then remain: how should the property tax be levied, and by whom should it be levied? Today, there are three kinds of property taxes in Britain: council taxes, business rates, and stamp duties. Council taxes are set and levied by local councils, business rates are set by the government but levied by the councils, and the stamp duties is set and levied by the government. Stamp duties is a particularly inefficient tax because it is basically a tax on mobility, levied as property is transferred in the economy, thus raising the price of mobility - a factor so crucial to economic growth. Furthermore, all three property taxes share the economic problem that they are levied on the *value* of property, thus *reducing* incentives to reinvest in property because such reinvestments are later taxed.

Some argue that taxing *only the land value* of property and *not* the value of any buildings or other improvements on that property could solve these problems⁶⁸. The distinction would ensure that an increase in property value stemming from one's own action, such as a new roof or cultivation of bare land, would *not* be taxed, while any increase not stemming from your own action would. These latter "external" benefits include lower crime rates, cleaner streets, and even improved traffic conditions, all of which will increase the value of properties in a certain area. The problems are accurately distinguishing the land value from the whole property value *and* determining how severely this land value should be

⁶⁷ For a greater insight into the impact of the Internet on taxation and other government activities, see IEA's Economic Affairs, Vol. 20, No 1, March 2000.

⁶⁸ The Henry George Foundation has for years praised the benefits of land value taxation. See e.g. their web-site: www.HenryGeorgeUK.cjb.net.

taxed. If government were benevolent and all-knowing these hurdles could be easily overcome, but since this is *not* the case, taxes on property and land, like other taxes before them, can prove to be a very powerful weapon in the hands of governments. Especially since the *immobility* of property makes tax resistance very difficult.

The problems involved with the taxation of land and other property can, however, be somewhat overcome by the help of that most powerful of market forces: competition. Many of the above mentioned "public" benefits to property owners are very local in nature, wherefore much could be said in favour of letting *local* governments levy all property taxes of any kind. By *locally* setting both the tax base (property value, land value, etc.) and the tax rate, the ensuing *competition* for property owners would help ensure that not only the best property tax base was found, but also that property tax rates were kept at economically sound levels. Of course, central government would have to legislate to ensure that local governments did not tax their populations in any way that could be seen as discriminatory or arbitrary, but that they followed sound principles of equal treatment. But, within such legislative boundaries, local taxes could be levied in any way local governments saw fit. There could even be an extra flat tax on income or an extra sales tax, as in the US. Since citizens only have to move on the *margin* to be a threat to the tax revenue of a local government, their mobility would ensure that no local government could levy a tax that it could not properly enforce and which was not accepted by its citizens and businesses.

To allow the competition between local governments to be as effective and fair as possible, there should also be a reform of the way public spending is *divided* between local and central government. People in general, and governments in particular, have no respect for other people's money, and thus there is an incentive for local and central government to make each other pay for public services. A clear division is needed instead of mixing together the economies of local and central governments as it is done today. If a service is guaranteed by the national government, the tax to pay for it should be levied by the national government. If the service is guaranteed by a local government, the tax should be levied by that local government. Today, local government's share of spending is roughly £65 billions. If this amount was entirely to be collected through local property taxes, as opposed to the £35 billions levied on property today, the flat income tax rate could be lowered by a further 5 percentage points.

8. Summary and conclusions

The 6 central chapters (2 - 7) of this publication can be roughly divided into three parts: a theoretical part, a pragmatic part, and a practical part. In the first of these were presented the various *theoretical* arguments against the complexity of the current British tax system and in favour of simplification. The moral argument being that only a simple and transparent tax system can allow citizens to value the services of their government against the costs of that government. And the economic arguments being that a simpler tax system would be cheaper, fairer and encourage economic growth to the benefit of all. These conclusions are not new, but reflected the centuries-old wisdom of liberal enlightenment philosophers, such as Adam Smith himself. Knowledge sadly forgotten in the 20th century's worship of the all-powerful state.

The more pragmatic part of this publication focused firstly on the flawed *externality arguments* that have so often been at the core of political arguments in favour of complicating the tax system. It was concluded that some externalities *do* prove a case for government intervention, but nowhere near as extensively as they are used today. Secondly, the opacity and complexity of the current British tax system was exposed and set against the *competition for taxpayers* between countries, which we have only begun to see the impact of. It was concluded that while the British government taxes away 40 percent of the wealth created by the British people, less than one third of this tax bill is directly presented to those very same citizens.

With the bulk of the British tax burden thus effectively being levied via complicated stealth taxes, the British tax system is neither morally and economically justifiable, nor is it ready to compete with foreign governments for the future tax revenue of British taxpayers.

In the last part of the publication it was therefore sketched out how to transform the British tax system, so as to make it morally justifiable in the eyes of its citizens, economically efficient, and able to stand the challenges of the 21st century. To achieve all this, it was firstly argued that the tax burden must be shifted away from indirect and hidden stealth taxes onto direct taxes on personal incomes and property. Partly, this shift is already taking place via the price mechanism, but bringing it out into the open is not only fairer, it is also simpler and thus cheaper. In recognition of the fact that *companies cannot pay any taxes* and the prospect of consumption taxes being increasingly avoided through the Internet, it was proposed to *slash corporation taxes to 10 percent and replace the*

various VAT rates with a flat rate sales tax of 5 percent. In the longer run, however, it was recommended that both these indirect taxes be abolished altogether.

If the government wants to keep public spending at its current level, the revenue lost from lowering indirect taxes will of course have to be raised from direct taxes, which could thus be feared to become dangerously high indeed. The immediate effects from lowering indirect taxes will, however, counter this in a number of ways. Firstly, as the money saved in indirect taxes finds its way to citizens through lower prices on goods and services as well as increased salaries and dividends. And secondly, as the many public and private resources currently tied up in the administration of indirect taxes are freed to do productive work. The combined effects would be to lower public spending (subsidies are linked to prices) and administrative costs while at the same time broadening the tax base by increasing incomes.

In order to further enhance these positive effects it was also proposed to reform the British system of *direct taxes*, introducing a *flat tax system* with a proportional tax rate levied on all personal incomes over personal tax allowances, proposed to be increased to £7,500. It was argued that such a flat tax system with personal allowances of this magnitude most effectively accommodates the many aspects, which make a good tax system. It ends the needless transfers to and from the tens of millions of households currently *both* paying taxes *and* receiving means-tested benefits, while also keeping marginal taxes as low as possible. Importantly, the flat tax system does *not* abandon the principle of progressive taxation, as the value of personal allowances diminish with rising incomes. Along with this reform, there should be a clear separation of capital gains from personal incomes, with the abolition of *capital gains tax*, *inheritance tax* and other minor taxes, such as *insurance premium tax* and *betting and gaming duties*.

Without allowing for any dynamic effects from the proposed tax reforms, the flat tax needed on personal incomes above £7,500 would be 39 percent (27 percent *without* employer's NIC). Economic simulations, however, suggest that such a tax reform would stimulate economic growth, widen the tax base, and slash unemployment, on top of which comes the other positive effects of simplification that are impossible to quantify. Within a few years time, the positive effects of the tax reform advocated should thus make room for substantial tax cuts, including the abolition of CT and sales taxes altogether. In order to help the reform along, it was therefore recommended to use the *already* expected government surplus to *immediately* cut the flat income tax rate to 30 percent (again, *without* employer's NIC, this rate would be 18 percent). The effects of such a substantial tax cut would be to further enhance the effects already predicted: boosting economic growth further, slashing unemployment even more, and extending the effects of lower marginal taxes.

Lastly, a reform of *property taxes* was proposed along with a *local government tax reform*. This reform should *clearly* separate the economies of central and local government, making each collect the tax revenue needed for their own expenses. At the same time the power to tax property should be taken wholly out of the

hands of central government, thus encouraging competition between local governments to find the best property tax base and -rate.

Beyond Tax simplification

As was made clear already in the introduction, the *primary* aim of this publication was not to advocate tax *cuts*, but rather to advocate tax *simplification*. As shown, such simplification will in itself lower taxes somewhat by cutting administration, boosting economic output and lowering unemployment. But most importantly, the advocated tax reforms will help show the British public how much they are in fact paying for the services of their government, and hopefully this knowledge will convince the public that they are at the moment getting poor value for their money.

The hope is that this recognition would make people demand more, or, as it is, *less* from their government. *Less* in the sense that many of the problems pertaining to government production and services are inherent: *they can only be solved if taken out of the hand of government*. The system, as it is now, is built on a century-long tradition of growing discrepancy between what is *expected* from government and what government is *actually* capable of delivering. Tax simplification is not the last step in the process of reversing this worrying trend, increasingly undermining public confidence in western democracies - but it is certainly the first. Until plainly shown, citizens cannot be expected to take the consequences of the fact that government is not the end-all and be-all of problem solving. And the most convincing way of showing this is via the price mechanism.

However, as it was also made perfectly clear, simplifying the British tax structure will still leave citizens with a flawed price mechanism when dealing with their government. We will still be inclined to ask for more public services as voters, than we are afterwards willing to pay for as taxpayers. Tax simplification will, however, make the cost of this discrepancy more clear, and it will hopefully help pave the way for other political reforms that could help further reduce this political dilemma.

9. Recommendations

This publication calls for the simplification of the British tax system. Further, it suggests that the economic gains from simplification be used towards the lowering of the overall tax burden. More precisely, this publication recommends the British government to:

- Abolish Capital Gains Tax, Inheritance Tax, Insurance Premium Tax, and Betting and Gaming Duties. Together these taxes account for less than 2 percent of total tax revenues, and are unjustifiable as well as economically damaging.
- Reduce Corporation Tax to 10 percent in preparation for later abolition, and remove most deductions and exemptions. This will reduce administration, attract foreign capital, and increase personal incomes.
- Replace VAT with a 5 percent Sales Tax on all consumption, in preparation for later abolition. This will reduce administration, lower prices and keep business in Britain.
- Replace Stamp Duties, Business Rates, and Council Tax with local property taxes, set in competition with one another.
- Abolish Vehicle Excise Duty and allow for local road charges in urban areas, thereby taxing the use of cars, not the ownership.
- Replace Duties on Spirits, Wine, and Beer with one standard Alcohol Duty of £10 per litre of pure alcohol. Lower Tobacco Duties to EU-average to reduce smuggling.
- Replace the various personal tax allowances, exemptions, and deductions with one standard personal tax allowance of £7,500 for every adult. Allow couples living together to combine their allowances to £15,000, adding another £2000 per child for the first two children.
- Replace the various tax rates and NIC contributions with one flat tax rate of 18 percent (+ employer's NIC of 12 percent) on all income above the allowances.

Economic theory, strongly supported by economic simulations, predict that the economic effects of these reforms will be positive, increasing economic growth and reducing unemployment. Part of this improvement is a direct consequence of the simplification of the tax system, and part of it is the dynamic effect of the subsequent lowering of the overall tax burden.

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