How would you change the UK tax system to improve future employment prospects and drive the UK economy?

Any modern and dynamic economy requires the support of a flexible tax system, capable of responding to increased pressures on public finances and funding capital expenditure. This is particularly salient in the UK, given that the government currently records a budget deficit of almost £100 billion and faces the demographic challenges of an ageing population.

There is a now some political consensus that the “ability to pay” principle should underpin any credible tax system: those with the broadest shoulders should bear the greatest burden of tax. However, this invites an inevitable tension between constructing tax policy which is fair and transparent on the one hand, and which is competitive and offers sufficient incentives on the other.

The UK is currently experiencing the fastest rate of economic growth in the developed world. However, structural weaknesses threaten the precarious recovery. Fiscal reforms should respond directly to the underlying causes of these weaknesses, and not merely address symptoms.

On the supply-side, worker productivity in the UK has been persistently low - lagging behind the US, Germany and France by around 20%. A rational tax-benefit system should reward hard work, encourage industriousness and support businesses that invest in human capital. There can be no glass ceiling for people who want to work hard and get on.

Unemployment in the UK is falling fast. But many jobs are part time and low paid. The Exchequer has not seen the surge in income tax receipts one would usually expect. In fact, in the quarter April-June, revenues actually fell. The UK is fast becoming a nation of low taxpaying, low earning workers.

These domestic challenges must also be placed within the context of rapidly changing global circumstances. There hasn’t been a truly tax reforming Chancellor in the UK since the days of Nigel Lawson. But since then, labour and capital have become more internationally mobile, and penal rates of taxation not only harm incentives, they also drive wealth from within a nation’s borders. As the French government has painfully discovered, the Laffer curve is not just a back-of-the-envelope calculation. There are limits to the effectiveness of taxes on earnings.

The UK should have a competitive tax regime; it should not become a tax haven. Reducing the burden of taxation, which weighs heavy on the aspirations of individuals and the expansive potential of businesses, should be at the centre of any reforms. The proposals outlined in this paper aim both to encourage fairness, in the sense that no particular income group should be needlessly disadvantaged or discriminated against, and also seek to construct a tax system fit for the 21st century.
**Income tax**

Currently in the UK, the tax-benefit system supports individuals moving from benefits and into work. This is hardly surprising: there are political pressures to reduce headline unemployment figures, and getting people off JSA reduces liabilities for the Exchequer. But by vigorously pursuing this end, successive governments have paid scant attention to the nature of the jobs being created, and how, when people gain rightful employment, they can be encouraged to work hard and aspire to progress in their respective industry.

Under the current framework, tax relief is targeted at earners on the periphery, in particular part-time workers and people on the minimum wage. Meanwhile, the “squeezed middle” earners face high marginal tax rates and diminishing incentives as they progress up the career ladder.

**The Personal Tax Free Allowance**

A flagship policy of the Coalition government has been the changes to the tax free allowance. For a basic rate taxpayer, the reforms equate to a windfall of £571 per year and around 2.4 million low earners have been taken out of tax altogether.

However, there are significant risks with this strategy. Apart from the £12 billion it costs the Treasury in lost revenues, there is a danger of fostering a ‘low income trap.’ Individuals moving to full time hours, or who gain a pay rise which takes them over the tax free allowance, now face high effective marginal tax rates. The Institute for Economic Affairs estimate that a single earner married couple would face a marginal rate of tax (including benefit withdrawal) of over 60 per cent across the income range £10,000-£39,407.

Where workers face a marginal tax rate of 60%, the financial incentive to progress in their chosen career is undermined, and upskilling has a low and diminishing pay off. Businesses are also deterred from engaging in capital accumulation, thus, reducing worker productivity.

This paper proposes that increases to the personal allowance should be closely accompanied by adjustments to tax thresholds higher up the income scale in order to offset high marginal tax rates.

**Income Tax Thresholds**

In recent years, “fiscal drag” has led to a real terms increase in income tax for millions of workers and undermined incentives. The higher rate of income tax (currently 40% in the UK) was initially reserved for wealthy individuals. However, 1.4 million more people are paying the “higher rate” than in 2010 and estimates from the IEA suggest that even if the upper tax threshold increases to £50,000 in 2020, 900,000 more earners will be dragged into the 40% band in the next five years.

Failing to adjust thresholds in accordance with wage growth is no different to imposing tax hikes through the back door. This paper supports the proposals of the Institute of Directors for a ‘triple lock’ on income tax thresholds. Pensioners are guaranteed increases to their incomes of RPI inflation, wage growth or 2.5%, and so too workers should enjoy protection from inflation.
**The Laffer Curve**

There is clear evidence that a system of progressive income tax is the most desirable model of redistribution, not least because it is perceived by the public as the most fair.

But national prosperity rests on the innovation and dynamism of wealth creators. The tax free allowance does not currently apply to earners whose income exceeds £100,000, which means that individuals with annual earnings between £100,000 and £120,000 face marginal income tax rates of 60%. This is a crippling disincentive on workers in this income bracket.

The highest paid 3000 people in the UK pay more tax than the lowest paid 9 million. So the notion high earners don’t contribute in taxation stands up to little scrutiny. The tax free allowance should be extended to all earners in order to mitigate high marginal taxes.

This paper also proposes reductions to the upper rate of income tax. The CEBR have estimated that the 45p rate is already above a revenue maximising rate, which they suggest is likely to be less than 40p. Furthermore, HMRC figures show that in 2011/12 the amount collected from top income taxpayers was £41.3 billion under the 50p rate before jumping to £49.4 billion in 2013/14, when the top rate was cut to 45p. Some of this effect was no doubt due to the impact of forestalling, but at the very least the ease with which individuals were able to change their tax affairs suggests that high income individuals are highly responsive to tax rates.

**The Incentive Function**

A rational tax-benefit system should take into account what we know about individuals’ responsiveness to incentives. This should determine the direction of relief, not the level of income. Research suggests that women with working-aged children and people around retirement age (55 to 70 years old) respond proportionately well to worker incentives.

In the case of the latter, reducing the age at which employee and self-employed National Insurance contributions stop being payable from state pension age to age 55, or reducing the age at which a higher tax-free personal allowance is available from 65 to 55, would provide a stimulant effect to worker participation and expand the productive capacity of the economy.
**Simplification**

Simplifying the tax system should be at the core of any future reforms. A more coherent tax system would reduce administration costs, drive efficiency and increase transparency.

A first step would be to merge income tax with National Insurance Contributions (NICs). For workers, the latter is effectively a tax on income. It represents a deduction from their pay packet each month and NI is, in the eyes of most people, almost entirely detached from the benefit system to which it supposedly contributes.

Merging the two rates would also allow a realignment of the National Insurance and income tax thresholds. Figure 1 illustrates the idiosyncrasies that arise from the current system of taxation on income, by combining NI and income tax. The 62% tax rates arise because the tax free allowance does not apply on incomes over £100,000, and the 12% rate arises because income tax and National Insurance thresholds are not properly aligned.

The tax system in the UK is littered with complexities and unnecessary exemptions which creates fiscal distortions and undermines worker incentives.

| £0 – 7,228 | 0 % |
| £7,228 – 7,475 | 12 % |
| £7,475 – 42,475 | 32 % |
| £42,475 – 42,484 | 22 % |
| £42,484 –100,000 | 42 % |
| £100,000 – 107,475 | 62 % |
| £107,475 – 140,000 | 42 % |
| £140,000 – 147,475 | 62 % |
| £147,475 – 150,000 | 42 % |
| £150,000 + | 52 % |

**Figure 1**: Combined income tax and National Insurance

Public finance theory also suggests that there is no long-term difference between the impact of employees’ and employers’ NICs – both drive a wedge between the cost of employment for the employer and the wage the employee receives (Bell et al 2002.) Reducing NICs would ease the burden of employing workers for businesses, thus providing a boost for employment. It would also increase real wages and provide a cash stimulant as an incentive for individuals to enter the job market.
**Encouraging Business Investment**

Long-term, sustainable economic growth will be underpinned by business investment; both in capital stock and labour resources. This paper argues for a tax system which encourages SMEs, promotes the UK’s world leading industries and supports the government’s apprenticeship scheme.

**Human Capital**

Ensuring that UK labour markets are skilled and dynamic is central if the country is to compete, and ultimately succeed, in the “global race.” The creation of one million apprenticeships since 2010 represents an important milestone to this end. But youth unemployment still remains an intractable problem – in July there were 737,000 young people out of work.

Apprenticeship schemes increase worker participation, especially among young people, and provide an additional source of skilled labour to the UK engineering and manufacturing industry. In November 2012, for instance, Rolls-Royce opened a new, state-of-the-art Apprentice Academy in Derby. The facility enables the company to increase the number of apprentices it trains, beyond its own requirements.

This paper seeks to establish a more explicit link between businesses that invest in human capital and the rates they pay in taxation. This would allow the government to route financial support for apprenticeships directly through employers. Offering tax relief through the PAYE income tax system would provide an explicit incentive for businesses, like Rolls-Royce, to develop apprenticeship schemes.

**The Cluster-effect**

There is clear evidence to suggest that business collaboration improves efficiency. Half of respondents to a recent survey by KPMG said that partnerships, rather than in-house R&D, would be key to future innovation activity. In sectors of the economy where the UK enjoys a comparative advantage, including technology clusters – such as ‘Silicon Fen’ in Cambridge or the Tech Roundabout in East London – tax relief should be made available against local business rates.

The renaissance currently being witnessed in business start-ups should be underpinned by a facilitating tax regime. These industries are a furnace for quality job creation and boost exports. For instance, offering tax relief, or even exemption, on dividends derived from investments in SMEs would increase the flow of capital into small businesses, which are currently cash-starved by a dysfunctional banking sector.

**Business Rates**

The UK currently has the highest business rates in the EU. This is a barrier to commercial expansion and capital investment. General Motors pay ten times more in rates for UK operations than for its next highest plant in Europe. The company’s director complains that "our plant and machinery is counted towards our hypothetical rental value, so when we invest in our plant and machinery to improve productivity... our business rates go up."
Business rates are biased against investment in physical space. This is wrong in itself, but in an internet age it is also anachronistic. Reducing the burden of rates, especially for small businesses, stimulates capital investment which may otherwise have been made in Europe. Of the 1.7 million premises taxed in the UK, 1 million are owned by small businesses. But they contribute just 6% of total revenues. Therefore, rate relief for SMEs would help small businesses expand and invest, while having only a limited effect on revenues.

Value Added Tax

Currently the Exchequer raises around half of total revenues from direct taxation. VAT, meanwhile, represents around 18% of the total. This imbalance represents an unnecessary bias against working households. While indirect taxes are mildly regressive in nature, they invite an element of choice for the taxpayer, unlike taxes on income.

The current application of VAT is uncomprehensive. Unlike most other developed countries, the UK applies a zero rate across a wide selection of essential goods such as food, water and transport, which comes at a cost to the Treasury of £40 billion. There is, therefore, some scope to broaden the base of VAT, so as to make its impact more neutral.

Consumption taxes affect all types of household income – capital, labour income and transfers - while labour taxes only affect workers. Abolishing zero-rate VAT would spread the burden of taxation more evenly. It would also transfer some of the burden from workers to consumers, thus, boosting incentives and driving economic growth. Poorer working households, who would be disproportionately affected by the changes, would be compensated by falling taxes on income.

Gains in tax revenues are likely to be substantial too. Consumption taxes attract far less effort to avoid and evade than taxes on wealth. Therefore, if as estimates suggest, the UK’s black economy is very large then even a small reduction in avoidance should provide the Treasury with a considerable windfall.

Collecting Taxes

Property prices have risen rapidly in recent years, and are currently exhibiting the features of a bubble. Governments have long relied on the vibrant housing market as a source of tax revenues. But somewhere along the way they have forgotten that the central aim of the tax system is to build resilience. Tax reforms are required to address the fundamental cause of the UK’s dysfunctional market for housing: a lack of supply.

This paper suggests that the much needed spur to housing development could be achieved by devolving more fiscal responsibility to the localities. This would take the heat out of the property market and simultaneously provide an economic boost through infrastructure spending.
The relationship between local and central government

The UK currently has one of the most centralised tax systems in the world. As of 2011, the most recent financial year in which figures are available, the proportion of tax collected at local or regional level was 2.5% of GDP in the UK. This compares to 15.3% in Canada and 10.9% in Germany.

The case of London is most striking. The Mayor has highlighted that the capital “currently spend[s] about 7% of all the taxes that are raised in London, compared to 50% in New York, [and] 77% in Tokyo”

There is clear evidence that taxes raised and spent locally are more effectively deployed to encourage economic activity. If councils were able to retain a large degree of their revenues – business rates for instance – then they would have a vested interest to enlarge their tax base. They would be more likely to grant planning permission for local housing developments and business investments if the tax benefits accumulated in their own coffers. Fiscal autonomy would stimulate infrastructure projects and prevent local resistance undermining the national interest: which is to build more houses.

Research by KPMG has also indicated that devolving greater fiscal responsibilities to the great Northern cities – Manchester, Leeds and Birmingham – would assist in closing the ‘North-South’ divide. Local governments would have the resources to deliver critical infrastructure, such as improved roads and rail services, which would link together urban centres and create a ‘Northern powerhouse.’

Economic Stability

The corporate tax system should lay the foundations for a stable and resilient economy. But under current rules, corporations enjoy tax advantages for funding their investments with debt, thus discriminating against innovative growth firms. Public revenues are also undermined as companies develop more hybrid financial models to reduce their tax liabilities.

The UK still lives with the effects of 2008 and the tax system should support financial stability. At the absolute least, similar tax incentives should be made available for equity-based returns. This could involve, for example, granting firms a deduction for the normal return on equity equal to the rate of government bonds.

There is also a case for introducing an Allowance for Corporate Equity (ACE) modelled on the Belgian example. An annual allowance against taxable profits, equal to a risk-free interest rate, would mean that investments yielding a normal rate of return would go untaxed; and only profits in excess of the normal rate would be taxed.

In an open economy, the case for this reform is greater still because corporate investment and capital can move abroad in search of better returns. Lower capital stock per worker results in lower labour productivity and in the long run, will be reflected in lower real wages.
Some Conclusions

In an era of larger government, taxes should be introduced in such a way that the productive capacity of the economy is placed under minimal strain.

Since the 1980s, the UK has relied on deriving revenues from the flourishing financial service sector and sapping the energy from the seemingly inexorable rise in property prices. The 2008 recession reminds of the need to build a resilient tax system, fit for the 21st century and braced for the increasingly volatile global economic environment.

This paper proposes a tax system which encourages businesses that invest in their human capital and provides incentives for a more industrious workforce. It is underpinned by the dual principles that the UK’s tax regime should be *competitive* but it should also be *fair*.

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