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WHAT'S WRONG WITH 50p?

UNFAIR, COMPLEX, UNCERTAIN, INEFFICIENT AND DAMAGING

JILL KIRBY AND IAIN GRIFFITHS

SUMMARY

- Adam Smith set out four principles of taxation: fairness, simplicity, certainty and efficiency. The proposed new 50p income tax rate meets none of these criteria.
- The accompanying withdrawal of personal allowances will lead to widely variable marginal rates, reaching 61.5% for those earning between £100,000 and £112,000, while those earning more will face a lower rate. This will result in unfairness and complexity.
- The departure from a 30 year trend towards flatter taxation, accompanied by the Chancellor's hints of worse to come, will result in uncertainty about future taxation.
- The new rate is unlikely to raise revenue. Aggregating the microeconomic impact of the new rate and its associated changes shows that both participation and wealth effects will result in much lower revenue than the Chancellor claims.
- Even if the Treasury's optimistic assumptions are accepted, its estimated revenue of £2.4 billion is nugatory in comparison with current government borrowing requirements of £175 billion.
- The new rate is the highest in the G8 and will therefore put the UK at the bottom of the international competitiveness league for high earners.
- The negative impact of the 50p rate far outweighs its ability to reduce the national debt. Moreover, it threatens the UK's ability to rebuild enterprise and restore its battered economy.

INTRODUCTION

Public anger at bankers' bonuses provided the Chancellor of the Exchequer with the perfect backdrop for his Budget announcement of a new 50p rate of income tax on higher earners, to take effect in 2010 – shortly before the likely date of the next general election. Presented as a measure to shore up public finances, it has also been seen as a political manoeuvre designed to wrong foot the Conservative opposition. The Conservatives have refused to take the bait and so the case against the new rate has not been widely made.

Adam Smith's four principles of taxation – fairness, administrative simplicity, certainty and efficiency – provide an enduring test against which to assess income taxation.[1] This paper analyses the new rate according to these principles and also considers both the immediate and long term implications for the international competitiveness of the UK economy.

FAIR?

Advocates of a flat tax argue that everyone should hand over the same proportion of income in tax, since the wealthy will provide a larger share of total revenue. Progressives say that fairness requires a stronger element of redistribution so that the better off relinquish a larger proportion of income on the grounds that they can afford to do so. The budget proposals fail on both counts.

The personal allowance (the amount of income that is tax free) is to be phased out for those whose income is above £100,000. This will result in an effective marginal tax rate of 61.5% for anyone earning between £100,000 and £112,950. Those earning slightly more, however, will be able to keep an additional 20% of any rise, and face an effective marginal tax rate of 41.5%. An individual earning £150,000 will face an effective marginal tax rate of 51.5%, halfway between the two (see graph opposite).

The richest 1% of people in the UK already provide 24% of all government revenue from income taxation. Indeed, the richest 10% of the population account for over half of government revenue. The existing 40% regime is already highly redistributive.

Share of Total Tax for Percentile Groups

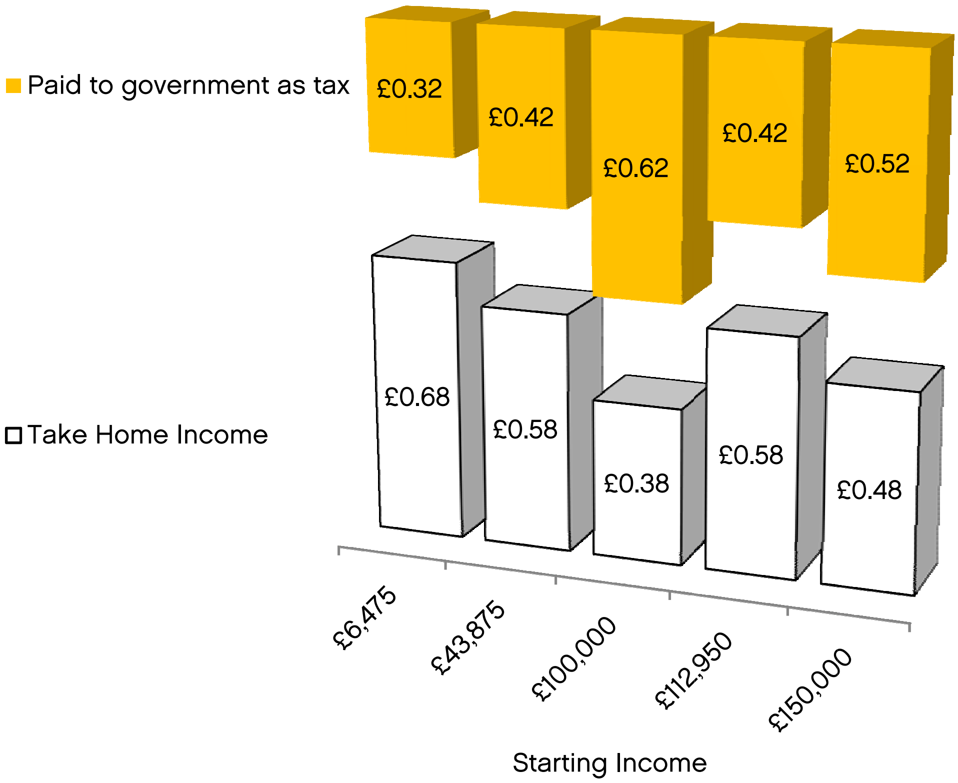
Year	Top 1%	Top 5%	Top 10%	Top 25%
1999-00	21.3%	39.6%	50.3%	69.5%
2008-09	23.9%	43.0%	53.6%	71.2%

Source: ONS, *Survey of Personal Incomes*, May 2009.

Finally, the notion of horizontal equity holds that all people in the same circumstances should face the same income tax rate. As the incentive to avoid taxation increases, however, the capacity of different individuals to reduce their tax burden will inevitably vary. The Chancellor of the Exchequer told the Treasury Select Committee that, "It is perfectly legitimate for people to tax-plan. They are only obliged to render unto Caesar what is due to Caesar." As such tax avoidance activities become more prevalent, the disparity between individuals on high incomes will inevitably increase. For example, a number of football clubs are reported to be considering converting salaries into interest-free loans. The highest earners with the most creative advisors will be able to protect a larger portion of their earnings from the taxman than others in the same tax bracket. This surely fails the fairness test.

[1] A Smith, A*n Inquiry into the Nature and Causes of the Wealth of Nations*, 1776

What happens to every pound in your pay rise



Source: Finance Bill 2009

ADMINISTRATIVELY SIMPLE?

The deadweight cost to both the taxpayer and HM Revenue & Customs of assessing, collecting and paying taxes is substantial. Administrative costs increase with the complexity of the tax system and the amount of information that is needed for it to operate. Adam Smith recognised the need to maximise the convenience of taxation; clearly the Chancellor does not.

Before the introduction of the 50p tax rate for those earning over £150,000, the complexity of the tax system was already resulting in high administrative and compliance costs. The 2008 Tolley's Tax Handbook was the longest yet, reaching 10,134 pages over four volumes, rivalling India's as the longest in the world. It is no surprise that 56% of the 8.8 million self-assessment taxpayers now use tax consultants.[2] Indeed, as his expenses claims revealed, the Chancellor is unable to complete his own tax return without professional advice.

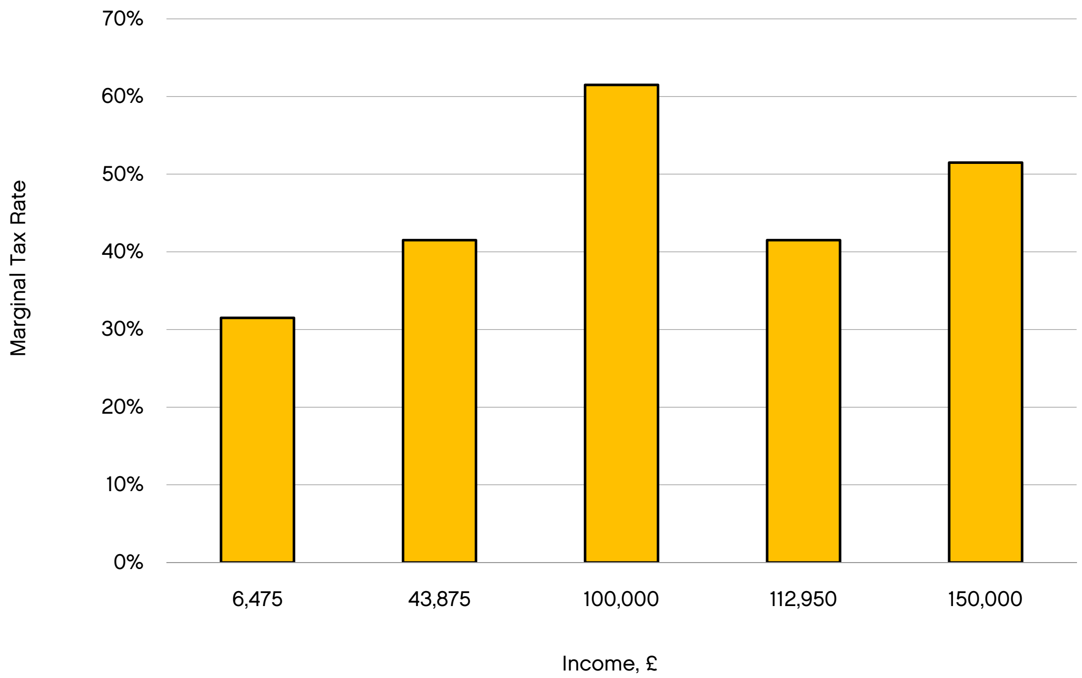
As a consequence of the Finance Bill 2009, there will be 16 different personal tax rates in the UK (including rates levied on trusts and dividend income) and a top marginal tax rate of more than 60%.

Complexity causes errors. Two million PAYE coding errors already occur each year, and one in four such codes are calculated incorrectly.[3] The Government's decision to remove the 10% starting rate of income tax was at least a step in the right direction for more simplification. Adding a new tax band for the highest earners will have the opposite effect. It will raise the cost of administration and compliance, and increase further the cost of this tax to the economy.

[2] HMRC, *Review of HMRC Online Service*, March 2006.

[3] House of Commons Public Accounts Committee, *Filing of Income Tax Self-Assessment Returns*, January 2006.

Effective Marginal Income Tax Rates - April 2010



Source: Finance Bill 2009

CERTAIN?

Closely overlapping with the issue of administrative simplicity is the principle that the tax burden faced by an individual must be easily known to them. The 50p rate demonstrates the uncertainty caused by the unintended consequences of changes to the tax system, in addition to the perplexing number of marginal rates.

Accountants at Saffery Champness have shown that consequences of the new rate could include a marginal rate as high as 138% for top-rate payers, making an increase in pay result in a lower post-tax income.[4] Whilst this rate would apply under a limited set of circumstances, the calculations highlight the additional uncertainty that will be introduced into the tax system.

In addition, the principle of certainty implies that individuals are able to anticipate the taxes they will face. However, as both the 2009 Budget and the 2008 Pre-Budget Report have shown, large-scale changes have been introduced with little warning. This uncertainty serves to make the UK a less attractive base for business.

EFFICIENT?

Tax theory tells us that where a tax system is made more efficient, it increases GDP. This results from the removal of distorting factors that affect decisions to work, save and invest. Consequently, behavioural and financial distortions must be minimised in order to maximise the efficiency of income taxation.

The most harmful distortions relate to the extent to which they reduce participation in the labour market. As a result of the so-called 'substitution effect', any increase in income tax means that the relative benefit of working is reduced – individuals receive less money for each hour worked. In some cases this may be offset by the 'income effect', whereby a reduction in total income could motivate people to undertake additional work in order to maintain their take-home pay.

[4] As reported on www.citywire.co.uk, 13 May 2009. An individual earning £169,000, and paying £131,600 of this income into a pension, will receive £26,320 from HMRC as tax relief. If this person then received a £32,000 annual bonus, he would lose the £26,320 tax relief and face a further £17,900 of income tax. These calculations have been confirmed as accurate by HM Revenue & Customs.

The overall impact is the sum of these two effects. Those on higher incomes are least likely to be sensitive to the income effect, making the benefit of less time working the overriding factor. As such, a higher income tax rate can lead to reduced labour participation.

The impact of a reduction in labour supply by those on high incomes is liable to have a particularly damaging effect on the economy, since this group includes entrepreneurs who deliver multiple spillover benefits to the economy and to growth. In explaining this it is important to recall the basic principle that if something is taxed, you have less of it: the result of taxing entrepreneurs and wealth creators is a reduction in entrepreneurship and wealth creation. The 50p rate therefore hurts not only the pockets of the very rich, but also the economy as a whole.

The political consensus over the past 30 years in the UK has supported a move towards lower, flatter taxation on high income, based on the arguments outlined above. The top rate has fallen from 85% in 1979 to 40% in 1988, a period which saw significant growth in the economy and in tax revenues. The introduction of a 50p top rate in 2010 represents the first definitive step away from this policy in 30 years.

IT WON'T RAISE REVENUE

The Chancellor has stated that: "No-one wants to put up taxes. And I am fully aware of the need to keep our corporate and personal tax rates competitive. But it is right to do it in a way that those most able to bear the burden make the greatest contribution."[5] Adam Smith recognised over two hundred years ago that a responsible government must balance its budget, and so far as this is the imperative, there might a case for the new rate in the short-term (notwithstanding the longer term damage to growth and competitiveness). The Chancellor's approach is, however, self-defeating.

The deadweight loss on 50p tax is evident. An aggregation of the actions that will result from its perverse incentives it creates makes the Treasury's claim that it will raise £2.4 billion in 2012 highly optimistic. And even if this is accurate, it is nugatory compared to the £175 billion the Government plans to borrow this year.

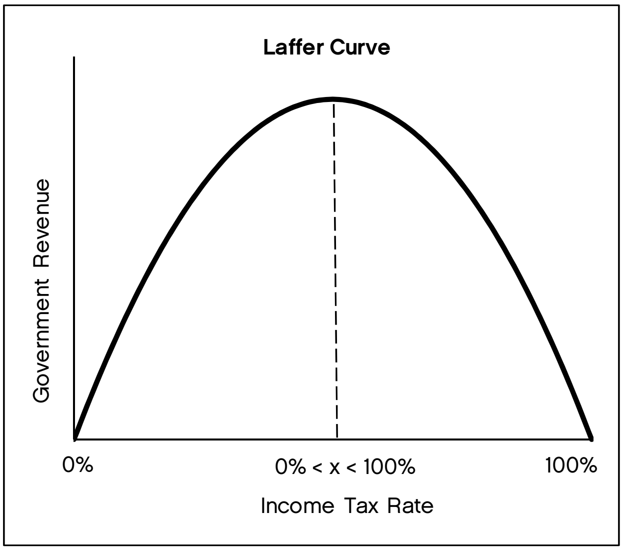
The Laffer Curve illustrates the principle that higher taxation does not always increase revenue. It demonstrates that no revenue is created when the income tax is 0%, which is self-evident, but also when it is 100% (by removing all incentive to work). The Curve reveals that the disincentive effect of increases in income taxation does, at some point, result in the accrual of less revenue to HM Revenue & Customs.

When the economy is on the downward-sloping section of the curve, any increase in the income tax rate will reduce the revenue the government receives as a consequence of the behavioural changes it induces. Conversely, a tax decrease can increase government revenue.

Furthermore, even where the economy is on the upward-sloping part of the Laffer curve, any increase in taxation will not result in a proportional increase in revenue. Behavioural impacts mean that such increases are diluted.

[5] Mansion House Speech, 17 June 2009.

While there is much debate about the point at which government revenue begins to decline, the 50p rate looks set to provide at best a minimal increase in government revenue. To put the incentive to avoid in context, the increase in the top rate of tax represents a 25% increase in taxation for all earnings above £150,000. This explains why even the Treasury's behavioural assumptions indicate that 69% of those affected by the increase will avoid it.



The Treasury's estimates of £2.4 billion increase are implausible for other reasons. Firstly, as the Institute for Fiscal Studies has calculated, the 45p rate, announced in the 2008 Pre-Budget Report, would not raise the anticipated revenue.[6] Using different measures of taxable income elasticity (that is how responsive people's behaviour is to changes in income tax), the IFS shows that the government would lose money under certain assumptions. This also applies to the 50p rate.

Second, while government forecasts do include behavioural changes that cover how much a person might choose to work in the UK (based on the income and substitution effects discussed earlier), there are additional factors resulting from lower disposable income levels that are not accounted for. For example, lower after tax incomes will result in reduced consumption. This will result in a loss in VAT revenue which would increase the probability of the government losing money as a result of these changes.

In this context, it is not surprising that there is such widespread concern about the decision-making process, of which the Chancellor said, "There is no science behind it, it is just simply my judgment that I thought that figure was an appropriate figure. It is the top 1%, as it happens, of earners in this country and I decided that that was the right level at which to pitch it."[7]

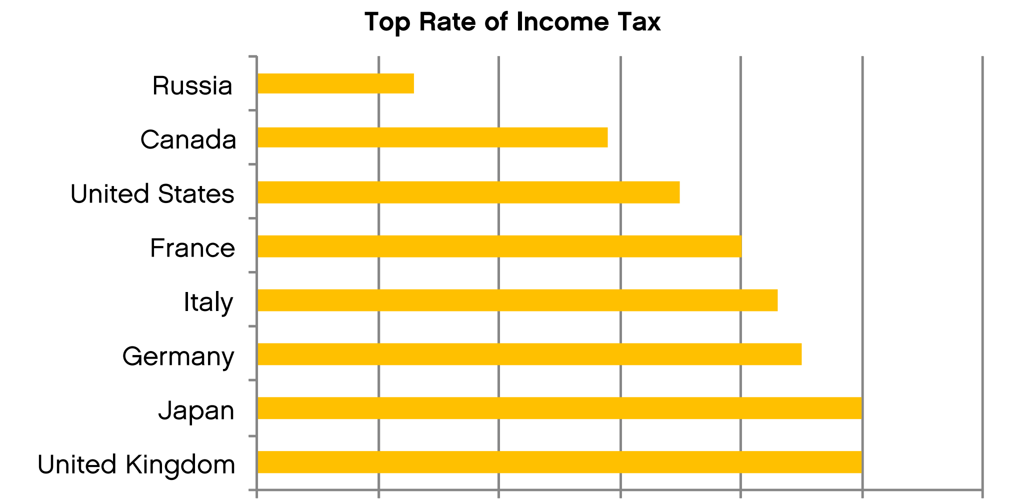
DAMAGING TO COMPETITIVENESS

In evidence presented to the Treasury Select Committee, a number of potential avoidance techniques were discussed, including outward migration from the UK, deterrence of high earners from coming to the UK, and movement of income to capital growth (which would be taxed at the lower rate of 18%). The issue of migration demonstrates the potential adverse effects on UK competitiveness as a result of businesses and entrepreneurs moving abroad.

International tax competition has been discussed widely in relation to corporation tax. A number of multi-national corporations have moved tax location, as a result of both high corporate tax rates and crackdowns on tax havens, exemplified by British

[6] M Brewer and J Browne, *Can More Revenue be Raised by Increasing Income Tax Rates for the Very Rich?,* IFS, 2009.

[7] House of Commons Treasury Committee, *Eighth Report of Session 2008-09*.



Source: KPMG, "Individual Income Tax Rate Survey 2008"; Finance Bill 2009

companies, including WPP and Shire, moving to Ireland in recent years. As Britain moves to tax its most highly paid and mobile workers at an internationally uncompetitive level, it is very likely that many of them will also choose to relocate.

High tax rates will affect where these individuals choose to work, spend their income and establish firms. Internationally, the average top rate of income tax has fallen from 31.3% in 2003 to 28.8% in 2008. The steepest decline has been observed in Europe, from 41.5% to 36.4%. It is therefore important to note that the new 50p top rate in the UK is, with Japan, the highest of all G8 countries.

While the relative attractiveness of the UK as a place for business is not purely based on its tax code, it is important to note that many of the factors that would once have drawn people to the UK are now in decline. Increasing levels of regulation, combined with low standards in healthcare, education and training and lack of an effective modern transport system make the UK less internationally attractive. A report by PricewaterhouseCoopers has also warned of the increased costs to overseas employers assigning employees to the UK.[8]

Already some emigration by wealthy non-domiciled workers and UK citizens is underway. A survey by Knight Frank shows that, since October 2007, 7% of non-domiciled and 2% of high net worth individuals (HNWI) have moved out of the UK. 25% of HNWIs are reportedly planning or thinking about leaving the UK in the future.

The fact that the UK is one of the first countries to raise its top rate of income taxation is likely to compound such concerns. The richest and most mobile members of the British population have far greater incentives to move abroad. The loss to the UK economy will be vastly amplified.

Even if other economies adopt a similarly stifling top rate of income tax, as the Chancellor has predicted, a report in 2008 by KPMG notes that, “It is common to hear the comment from foreign workers that once families have become accustomed to the huge increase in spending and saving power that low tax rates provide, it can be very difficult indeed to justify going home.”

Given the propensity of such emigration to become permanent, the harm to the economy could persist even if the new rate is later withdrawn. The UK could lose out on growth and jobs, not only due to the inherent flaws in the policy, but also because the UK is the first country to announce such a large increase.

8 PricewaterhouseCoopers, *Global Watch*, 2009.

The UK's tax regime is already less competitive than it was ten years ago. The Tax Reform Commission's business survey in 2006 saw 66% of 600 businesses agreeing that "the UK tax system is having a negative impact on the UK's international competitiveness".[9] These latest changes will only serve to compound the harm already being done to the British economy.

CONCLUSION

The new 50p rate fails all the tests for effective income taxation. By portraying it as a measure to reduce government debt, the Chancellor is painting the illusion that the government's profligacy will be paid for only by the richest members of society. But even on the Chancellor's own numbers it will make a tiny inroad into the mounting debt, so that further tax increases, or major spending cuts, or both, will be required. The long term damage for the economy will be significant as business and individuals move abroad, while the benefit in reduced debt will be minimal. The removal of this top rate is essential to making the British economy competitive again.

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[9] Tax Reform Commission, *Tax Matters: Reforming the Tax System*, 2006.

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The CPS believes in regulation that does not inhibit the growth of business; taxes that do not act as a disincentive to work or to investment in the UK; and a leaner more effective state that avoids unnecessary intervention in the economy. Recent publications have both analysed the mistakes of the past, and have laid out an agenda for future economic reform: how to rebuild UK economic competitiveness whilst improving our regulatory regime.

The feeble state of the public finances was examined in *The Price of Irresponsibility* by Brooks Newmark MP and *Uh-Oh, We're in Trouble* by Charlie Elphicke, long before the Government's own predictions revealed just how bad things have become. The causes of the financial and economic crises were analysed on *From Boom to Bust* by Howard Flight and *What Killed Capitalism?* by Andrew Lilico. These papers set out both what should have been done then and what should be done now to restore the free market, and revive the economy. And the long-term damage done to British competitiveness was exposed in John Littlewood's *Labour and the Stock Market*. One of the results of this is that the London Stock Market has now fallen by 26% in real terms since 1 May 1997 – the worst performance of all of the major stock markets in the world (with the exception of Japan).

Maurice Saatchi made the case for never again allowing the UK to become entranced by the quest for low inflation in *The Myth of Inflation Targeting*. The Bank of England should target not only inflation, but also to support the government in achieving sustainable economic growth. Sir Martin Jacomb attributed the failure of the Bank of England and the FSA to the Tripartite Arrangements established by Gordon Brown in 1997 and set out proposals for how the regulaotry structure should be reformed in *Re-empower the Bank of England*.

There is an alternative to greater regulation, higher taxes, declining competitiveness and economic decline. The Centre is committed to advocating the policies which will lead once again to an economy that is competitive, productive and innovative.

THE AUTHORS

Jill Kirby is Director of the Centre for Policy Studies. A writer and policy analyst, her publications include *Choosing to be Different: women, work and the family* (CPS, 2003); *The Price of Parenthood* (CPS, 2005); *The Nationalisation of Childhood* (CPS, 2006) and *Who Do They Think We Are?* (CPS 2008). From 2005 to 2006, Jill served on the Tax Reform Commission, appointed by Shadow Chancellor of the Exchequer George Osborne to advise the Conservative Party on the case for a flatter, fairer tax system.

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