# Purchasing Civilization

Ideas to Renew the Relationship between Citizen & State

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liberal insight

"I like to pay taxes.
It is purchasing civilization."

Oliver Wendell Holmes

liberal insight

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# Introduction

The last three decades have seen a vast change in the British economy. To some extent, this change has been imposed on nation states by the process of globalisation, & accelerated by a plethora of innovations in the way we communicate with each other. However, for the most part, the change has been a result of domestic policy & the fluctuating fortunes of the major parties at the ballot box.

The widespread financial reforms undertaken by successive Conservative governments under the leadership of Margaret Thatcher provoked a fundamental shift in the relationship between state & citizen. Nowhere was this more apparent than in the tax system. The emphasis placed on the concept of 'aspiration' both by Thatcher & by her New Labour successors (particularly Tony Blair), while in many ways conducive to innovation & personal responsibility, has also engendered, over time, a collective mentality that is suspicious of taxation in general & deeply cynical about the return achieved by public spending. Despite this mentality, though, the British electorate still values public services such as the NHS extremely highly – something that is readily apparent in the campaign tactics of political parties at election time. For example, David Cameron staked much of his party's effort in the 2010 general election to convince voters that he would 'cut the deficit, not the NHS'. A party that is seen as hostile to such cherished public institutions reaps a political whirlwind – as can be seen, at the time of writing, from the acrimonious Health & Social Care Bill.

Thus, at the heart of British politics, there lies a contradiction. Political parties must now convince voters at each election that they will make their tax burden lighter (or, at least no heavier than it is at present), while promising improvements to vital public services at the same time. This may arguably have been the cause of the Labour government's reliance on borrowing, particularly during a time of strong economic growth; with hindsight, it was an attempt to square the circle. This motivation may also have been behind the complicated nature of the reforms they did make, such as the oft-altered tax credits system.

This contradiction may persist despite the best efforts of politicians, but this paper makes several recommendations that, we believe, would help to restore the reputation of taxation somewhat in the eyes of the public. If we are to renew the relationship between the government & the governed, the importance of honesty, transparency & simplicity cannot be overstated. If all three are emphasised at once, taxpayers may legitimately feel that they are richer in social capital: in other words, they may truly know what it is to purchase civilization.

# Executive Summary

This paper sets out the broad sweep of our current thinking on the British tax system. In particular, it deals with the present topical debate over the possibility of a 'tax shift' from earnings to wealth. However, it also engages at a higher level with the underlying beliefs & messages that different tax policies send to voters, & counsels a change of approach in order to better establish a relationship between citizen & state that is characterised by trust, clarity & shared goals.

### We recommend a number of changes in the way governments & politicians speak & campaign on tax, including:

- Increased transparency about where public money is actually spent
- Honesty about the likely winners & losers resulting from changes to the tax system
- Integrity & restraint in campaigns condemning projected tax changes
- The end of tax avoidance practices in Whitehall & Westminster
- Consideration of the possibility that individual taxpayers may be given power to ear-mark a proportion of their money for specific services, especially locally
- Increased pre-legislative scrutiny of tax policy, including allowing an elected House of Lords to scrutinise & amend Finance Bills

### At the highest level & in the long-term, we advocate widespread reform & simplification of the overall personal tax structure by:

- Implementing at the earliest opportunity a national Land Value Tax which would substitute a large proportion of existing tax revenues
- Bringing capital gains into the Income Tax regime
- Prioritising the equalisation of National Insurance & Income Tax thresholds, with a view to merging the two systems
- Linking the personal income tax allowance (after equalisation with NI) to the same level as a full time (37.5 hours a week) minimum wage salary – or £11,856 at the time of writing
- Maintaining the current top rate of income tax, while raising the threshold at which the 40% rate is levied, & restoring the personal allowance to all taxpayers

### Finally, we advocate assisting businesses by:

- Exempting pre-revenue & loss-making small businesses from employment tax
- Changing the rules for tax returns to avoid the 'year-end rush'
- Making substantial improvements in HMRC's service delivery, accompanied by strong public government support

# The Selfish State

The British executive arguably wields more power over tax policy than in any other democratised nation. The process by which changes are made to the tax structure in the UK is, perhaps, unique in its lack of scrutiny. Tax policy proposals are initiated solely by the Treasury, & put to Parliament in the form of a Finance Bill (usually immediately following the Budget, perhaps the most important regular Parliamentary event after the Queen's Speech), which cannot be amended or blocked by the House of Lords. Additionally, the ability of the average backbench MP to scrutinise or suggest amendments to Finance Bills is puny when compared to the might of the Treasury, where there is a great deal of practical expertise both within the Department & from Her Majesty's Revenue & Customs (HMRC).

This would be bad enough without the further consideration that the Budget is not subject to the same pre-legislative scrutiny as the majority of other Bills, whether in Parliament or externally. Rather, any debate that takes place as to the nature of a forthcoming Budget is generally a matter for the Executive. At the time of writing, for example, this has certainly remained the case, with the main battleground (over what tax cuts should or should not be made) firmly established between Conservative & Lib Dem MPs, most of whom have jobs within government.

This power has unsurprisingly been the foremost method by which successive governments have sought to put their own unique stamp on the country they rule. In particular, the Treasury has been the main force first in the three governments led by Margaret Thatcher, & then in the three led by Tony Blair &, latterly, Gordon Brown. More than ever before, these three leaders used the Treasury not simply as a way to raise funds for public spending on goods & services. They used its policy-making power & pre-eminence as a branch of the Executive as the most important, most public & most publicised way of asserting their authority & implementing their democratic mandate. Gordon Brown, when Chancellor, explicitly viewed tax as a tool of social & economic policy.

This willingness to use tax as a way of sending highly-visible messages to the electorate was, for a time in the 1970s, the main battleground between parties seen by the public as embodying markedly different ideologies. But the reliance on attention-grabbing alterations to the tax structure is, we suggest, the main causal reason for some significant shifts in British social attitudes over the past three decades. Since 1979 the median voter has drifted to the economic right; he or she is less likely to agree that the government should redistribute income; & he or she is also more likely to distrust the government. The 26th report into British Social Attitudes by NatCen, published in January 2010, found that public support for increasing taxation & public spending had declined from 62% in 1997 to 39% - its lowest level since the early 1980s – although 50% held the view that spending & taxation levels should stay as they are.

There are competing theories as to whether the convergence of the main political parties on the question of marginal tax rates has been the cause of, or a reaction to, these shifts in voter behaviour & attitude. But it remains a fact that there has been a considerable decline in the number of voters who perceived substantial differences between the Conservative & Labour parties. From a peak of 88% in 1983, 2005 saw a low of just 13%, although in 2010 that figure increased to 23%.

We would suggest that this drift to the economic right, combined with a widespread distrust of politicians & the democratic process more generally, makes the possibility of significant reform of the taxation system very difficult, but at the same time a vital part of the renewal of the relationship between citizen & state. There is space in the political economy for a far-sighted, honest approach to taxation that emphasises simplicity, transparency & fairness. To some extent, this is the space that the Liberal Democrats have attempted to fill historically; one thinks of their very popular policy for 'a penny on income tax for education', or their flagship manifesto demand in 2010 (partially implemented by the Coalition government) for an increase in the personal income tax allowance to £10,000.

However, it is possible to do much more to address the decline in trust & the lack of enthusiasm for a genuinely fair tax system. We have set out in some detail the manner in which tax policy is hoarded by the Treasury to the detriment of transparency &, perhaps, quality; we therefore advocate a number of reforms to change the perception of a 'Selfish State'.

## Follow the Money

One of the biggest obstacles facing policy-makers in every area is the problem of communication. By this we mean that in such a centralised political system (where over 95% of tax is collected centrally), it is extremely difficult to maintain public understanding of processes & outcomes. The average taxpayer often knows exactly how much income tax & National Insurance he or she pays each month – it's on one's payslip, after all – but how far does he or she comprehend how that money is used? This is complicated yet further by the perceived demise of the contributory principle in practice, if not in theory; most people are realistic about the fact that although National Insurance & income tax remain separate systems, they are paying their money into a central pot & they have no real way of knowing what goes where.

The Coalition government has made excellent progress on the release of data relating to public expenditure & departmental contracts. However, merely releasing data is not equivalent to improving transparency. In fact, without a user-friendly system in place, an abundance of data has the opposite effect. It creates confusion & complexity, reducing understanding instead of enhancing it. By contrast, privately-made websites such as www.wheredoesmymoneygo.org are doing a much better job of distilling information into a readily-accessible form that truly educates the citizen about the role of government.

We also believe that in a purportedly liberal democracy, it must be right for people to be able to make contributions to specific areas of public expenditure. We therefore advocate further research into the possibility of ear-marking; that is, introducing into the taxation system the power for individual taxpayers to determine – at least to some extent – where they would like their money to be spent.

There is, of course, a balance to be struck between individual priorities & those of the governing party or parties, so this power would need to be clearly limited. However, it seems self-evident to us that giving this ability to citizens would help to foster a more coherent & collective approach. Implemented together with our recommendations on the right way to collect revenues, this could also have a strongly decentralising effect.

## Taxing the Political Mind

Politicians should also consider the wisdom of imposing unexpected policy changes upon an electorate that has already decided not to place its trust in them. Here, honesty is paramount: honesty prior to elections about likely tax changes, & honesty from government about the winners & losers from said changes. Too often, governments make snap policy decisions that rebound all too quickly when the details are studied.

A topical example is the Coalition government's disastrous announcement that child benefit would be cut for top-rate taxpayers. In isolation, this is a perfectly justifiable spending cut; when the policy was announced, the vast majority of people supported it as a necessary way of recouping public funds from the richest 15% in society. But it has since come under repeated attack from all sides for a number of reasons, chief among which is that it hits single-earner families unfairly.

This is precisely the kind of headline-grabbing, hastily-drafted policy that unravels almost as soon as it has been announced. In order to rescue governments from themselves, we recommend a revolution in the way that tax policy is drafted & enacted. No longer should the Budget remain an in-house plan, cooked up exclusively by the Executive & delivered to Parliament without genuine scrutiny or transparent outside consultation.

Instead, while we recognise that the financial outlook can change swiftly, we strongly recommend that governments attempt to bring the Budget (& the subsequent Finance Bills) broadly into line with other legislative processes. This could be done by producing Green &/or White Papers, & by allowing formal pre-legislative scrutiny either by Commons Select Committees or even by the publication of a draft bill to be scrutinised by a separate Parliamentary Committee.

Further, we recommend that once the proposed reform of the House of Lords is complete, governments should consider legislating to allow the House of Lords to scrutinise & amend Finance Bills. This should not alter the supremacy of the House of Commons, but especially given the haste with which Parliament is usually forced to consider the Budget, it would make much sense for the Upper House to add its own substantial expertise to the process of scrutiny.

Finally, on the subject of political campaigns, we urge caution on the part of those who craft the "messages" to which the electorate is subjected every few years. Too often, a political party employs a negative, attacking advertising strategy designed to encourage voters into a reaction of fear over another party's policy. An example of this was the ill-fated Liberal Democrat attempt, in 2010, to capitalise on the success of the Conservatives' 1992 campaign, 'Labour's Tax Bombshell'. The Lib Dems released a poster showing a 'Tory Vat Bombshell' in April 2010, claiming that 'You'd pay £389 more a year in VAT under the Conservatives'.

Less than three months later, the Liberal Democrats joined the Conservatives in a Coalition government that announced a rise in VAT to 20%. Of course, in a Coalition, the Lib Dems could not implement their planned budget in full – one that would not have required an increase in VAT – but the damage was done. All the campaign ultimately achieved was to create the impression in the public's mind that the Lib Dems would not raise VAT, only for them to do precisely that when in government.

The easiest way to avoid such mistakes in the future – for all parties – would be to concentrate on honest, clear statements on what will be prioritised. This tactical error looks even worse when one considers the success & popularity of the Lib Dems' main tax pledge: namely, the increase in the personal income tax allowance to £10,000. It would be a refreshing change if all parties, but particularly those who wish to retain a reputation for honesty & integrity, campaigned positively on their own policies, without leaving any hostages to fortune.

## Whiter than Whitehall

It is also essential for the restoration of trust that no one is seen to be above the law. The question of tax avoidance is a classic example of a situation where a new stated government initiative collides with what was seemingly standard practice, creating the effect in the public eye of rank hypocrisy. The Coalition government has taken a surprisingly strong line on tax avoidance, as they have on data & transparency, announcing several different ways in which they are attempting to tackle it.

This said, tax avoidance remains legal. Every individual & every business presumably attempts to minimise the amount they pay to HMRC in tax; we know of very few people who deliberately pay more than they are asked for. But government rhetoric seems to be attempting to conflate avoidance with evasion – that is, evading taxes by illegal means such as misrepresentation & concealment of true income or overstating deductions.

We agree with the government that there are too many examples, in particular, of large corporations & extremely wealthy individuals who have successfully paid a far lower rate of tax than they ought to. We are considerably more surprised by the recent stories involving public officials who have received salaries without deductions for tax or National Insurance. One such is the CEO of the Student Loans Company, Ed Lester, whose salary of £182,000 was transferred gross to his private service company. This deal was signed off by the Universities Minister & the Chief Secretary to the Treasury. Further reports have suggested that at least 25 senior staff in the Department of Health have similar arrangements, with the likely effect of reducing their tax bills.

We do not make any comment on the personal arrangements of these individuals, but it is clear that if the government intends to pursue an aggressive anti-avoidance policy –as may well be politically popular in the current climate of austerity – it should ensure that its own employees, both in Whitehall & elsewhere, subscribe to the same principles. As it is, the present situation reeks of hypocrisy & only damages the reputation of government yet further in the eyes of an already distrustful electorate.

# From Earnings to Wealth

## A Question of Priorities

Merely tinkering with the workings of government & the behaviour of politicians & civil servants is clearly not enough to make a substantial improvement to the British tax system, of course. As we approach the 2012 Budget, the central debates are, as ever, on tax: the right level of income tax, the right kind of tax cuts, and the right kind of wealth tax.

Broadly speaking, there is agreement among the Liberal Democrat wing of the Coalition that the priority should be to accelerate the implementation of the party's flagship tax policy: raising the personal income tax allowance to £10,000. This policy has also drawn support from several Conservative & Labour MPs, although it has also received criticism from some quarters. These reservations generally have to do with the fact that changes to income tax do not help those who are unemployed, but the peculiarly high marginal tax rate that affects some high earners when the allowance is phased out has also been criticised, particularly by *Independent* journalist John Rentoul.

Meanwhile, the majority of Conservative politicians & pundits have focused somewhat narrowly on the perceived injustice & inefficacy of the 50% tax rate introduced by the Labour government just before the 2010 election. The chief criticisms levelled at the 50% rate are that it hampers the international competitiveness of the British economy, & that it fails to raise enough revenue to be worthwhile – mainly due to the ability of high earners to avoid tax. Both criticisms are very difficult to prove or disprove, but it seems clear to us that neither is sufficient reason to abandon the 50% rate without further evidence. In particular, it seems very odd indeed to reward avoidance with a tax cut; the same journalists who call for a return to 40% are those who wish to punish so-called "scroungers" by cutting their benefits.

Senior Liberal Democrats have gone some way to address the concerns of their coalition partners, advocating further property taxes should the 50% rate be abolished. In particular, Dr Vince Cable, the Business Secretary, has long championed the so-called 'Mansion Tax', an additional levy on properties worth more than £2 million. This idea of a 'tax shift', from earnings to wealth, has had a mixed reception across the political spectrum, although there has long been a substantial grassroots movement in both the Lib Dem & Labour parties in favour of a land value tax.

## Levelling the Land

We do not believe that the mansion tax would raise the same revenue as the 50% tax rate. Although it is claimed that the policy could raise as much as £1.7bn, a new property tax would be costly to implement; in fact, some commentators suggest that it would not bring in any net revenue at all. By contrast, Treasury forecasts suggest the 50% rate will raise £3.1bn in 2011/2012 & £2.7bn in 2012/13. Moreover, the mansion tax is likely to concentrate property even more in the hands of the extremely wealthy than is currently the case. Most seriously, the mansion tax does not address the urgent need for land value taxation to tackle the most grotesque concentration of wealth in the UK: 69% of land is owned by just 0.3% of the population.

We do not believe, therefore, that the suggested deal – swapping the abolition of the 50% rate for the introduction of the mansion tax – is financially sensible or politically worthwhile. However, if the government does eventually decide to abolish the 50% rate, we would not wish to see the mansion tax in its place. We would rather see extra council tax bands based on a long overdue revaluation, which should be easier to implement & less likely to have unintended consequences. This policy is also less obstructive to the desired introduction of a fully-formed land value tax.

Instead, Liberal Insight recommends retaining the 50% rate, which was, in any case, a long-held Liberal Democrat policy, & focusing short-term efforts on making the income tax system fairer. Raising the personal allowance to £10,000 is one step in the right direction, but rhetoric along the lines that people are being 'taken out of the tax system' is misguided when National Insurance thresholds lag behind.

We therefore recommend as a first priority the equalisation of income tax & National Insurance thresholds. While the latter threshold is lower, the more progressive move is to raise it, rather than the income tax allowance. Once equalisation has been achieved, we should aim to raise the total tax-free allowance to the same level as a full-time, minimum waged job: £11,856 at present rates, assuming a 37.5 hour week. The idea of taxing a genuine 'minimum wage' is surely inherently risible.

However, we should not simply look at those on low incomes. It cannot be right that those earning between £100,000 & £112,000 currently pay an exceptional marginal rate of 64% due to the phased withdrawal of the personal allowance. We therefore recommend that the personal allowance is simply extended to every taxpayer & not withdrawn from high earners as at present. In order to pay for this, we suggest that the threshold at which the 50% rate is levied is lowered from £150,000 to £140,000. Depending on the amount of revenue raised from this measure, we would also be interested in the possibility of reversing the lowering of the 40% band.

In the medium term, we strongly urge the eventual merging of income tax & National Insurance, as has already been suggested by the Office of Tax Simplification & the Institute for Fiscal Studies. However, we believe there are other simplifications that can & should be undertaken. In particular, we do not see the need for a separate Capital Gains Tax. Therefore, we recommend that capital gains tax rates should be equalised with income tax rates, & then merged into the income tax system, although broadly preserving current reliefs.

All this can be accomplished in the short or medium term. We therefore recommend very strongly that alongside these reforms, a comprehensive study into the feasibility of a national Land Value Tax should be set in train. We envisage this tax as a long-term replacement for many of our existing taxes, also allowing income tax to be substantially reduced.

The six-stage plan put forward by the Coalition for Economic Justice is compelling, & we broadly support its arguments & general shape. However, in order for such a plan to be enacted, we again emphasise the need for a substantial shift in the way tax policy is discussed & enacted by politicians. Without this shift, essential & overdue reforms which would make our tax system more understandable & more equitable will indeed continue to fall victim to the 'tyranny of the status quo'.

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[1] Viewable at http://www.c4ej.com/cej-publications/an-implementation-plan-for-land-value-taxation

## Simplify, Simplify!

As with transparency & avoidance, the Coalition government has professed a strong commitment to simplicity in the tax system. It has set up the Office for Tax Simplification which has already advocated the radical measure of merging income tax & National Insurance, alongside many smaller tweaks to the way business & government communicate. In particular, their Small Business Tax Review contains a number of sound recommendations for simplification.

There are a number of further ways in which the government can help small businesses by making the tax burden lighter & the process of dealing with tax easier. Foremost among these is obvious: the HMRC has long been the cause of considerable anxiety & even fear among businesses & individual taxpayers alike, & although it has recently begun a process of improvement, there is much still to do.

A major step would be for the government to recognise the need to improve HMRC's levels of service, as they currently have a disproportionate impact on SMEs when private sector growth is paramount for the economic recovery. This would at the very least entail reversing the planned reduction in HMRC staff over the course of this Parliament, &, in all likelihood, giving HMRC additional resources to collect tax & support business, as the CEO of the Institute of Chartered Accountants in England & Wales has recently suggested.

On the basis of the well-known shortcomings in HMRC's performance, we strongly question the relatively recent appointment of Lin Homer, former head of the UK Border Agency, as its Chief Executive Officer. Homer's record at UKBA was appalling; she was also previously the head of the Immigration & Nationality Directorate in 2006, when it was found that over a thousand foreign criminals had been mistakenly released. It is questionable whether her appointment at HMRC was sensible, taking into account both the great need for improved performance & her track record.

Another way in which small businesses would be assisted would be to assess in depth the current system of deadlines for tax returns & accounts. At present, the 'year-end rush' in January is inimical to the smooth operation of businesses of all sizes, creating as it does enormous pressure on all participating in the process: business, tax advisers & accountants, & HMRC. A study into the possibility of changing year-ends or increasing the amount of time available, particularly for SMEs, would be welcome.

Finally, the government should consider reducing the burden on pre-revenue & loss-making small enterprises. This could be achieved by making employment tax off-settable against losses by small firms; to make this fiscally neutral, the further cuts in the corporation tax rate could be cancelled.

# Conclusions

Ultimately, there will always be people who hate the idea of paying tax. There will always be those who insist that all taxation is theft. We agree up to a point; it is almost always true that individuals, families & businesses know better how to spend their money than the government does. However, even those same people often value the social institutions set up to protect the weak & the infirm, & to ensure that everyone has a minimum standard of living – & will even go so far as to support organisations & political parties who aim to maintain & improve those services.

We have attempted to set out in this paper an overview of changes that ought to be made to Britain's tax system. But we placed the section on political approaches to tax reform above our actual tax proposals. There is good reason for this. Tax can no longer be seen as a tool with which to send messages or to acquire political cover. There is too much complexity, inequity & volatility in the present system for anything other than a long-term, considered & dispassionate approach to be taken. When the state has such power simply to sequester money that has often been earned by individuals with much effort & over a considerable length of time, the seriousness of getting the balance right should be readily apparent.

The Liberal Democrats, in 1995, produced a report called 'Being Honest About Taxation'. In it, they recommended policies such as earmarking cigarette & alcohol duties for special NHS projects, using National Insurance contributions to pay pensions, & so on. They called for each household to receive an annual breakdown of how its taxes were raised & spent.

If a minor political party could call for such detailed measures in 1995, why do our citizens, in an age of improved technology, still lack the information & the power to determine how best to purchase civilization?

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