fair tax:

towards a modern tax system

Edited by Chris Wales

THE SMITH INSTITUTE

THE SMITH INSTITUTE

fair tax:

towards a modern tax system

Edited by Chris Wales

Published by the Smith Institute

ISBN 1 905370 34 2

Contents

Preface
Wilf Stevenson, Director of the Smith Institute 3

Introduction
Chris Wales, Managing Director of Lucida plc 5

Chapter 1: Issues in personal tax design
Robert Chote, Director of the Institute for Fiscal Studies 10

Chapter 2: Business taxes
Philip Broadley, Executive Director, Prudential plc, and John Whiting, Tax Partner, PricewaterhouseCoopers LLP 18

Chapter 3: Fairness in the taxation of small businesses
Professor Francis Chittenden, ACCA Professor of Small Business Finance at Manchester Business School, and Hilary Foster, Visiting Researcher at Manchester Business School 28

Chapter 4: Taxation and local government
Chris Wales 42

Chapter 5: Capital, wealth and inheritance taxes
Dr Irwin Stelzer, Senior Fellow and Director of Economic Policy Studies at the Hudson Institute 54

Chapter 6: Environmental and behavioural taxes
Professor Paul Ekins, Professor of Energy and Environment Policy at King's College London and Director of the Green Fiscal Commission 64

Chapter 7: User charges – a reassessment
Dr Jonathan Leape, Senior Lecturer in Economics at the London School of Economics & Political Science 74

Chapter 8: Is tax avoidance "fair"?
Professor Judith Freedman, KPMG Professor of Taxation Law at the University of Oxford 86

Preface
Wilf Stevenson, Director of the Smith Institute

The Smith Institute is an independent think tank set up to undertake research and education in issues that flow from the changing relationship between social values and economic imperatives. In recent years the institute has centred its work on the policy implications arising from the interactions of equality, enterprise and equity.

The issue of fairness in the tax system is complex, with many competing voices and interests. For Adam Smith, the central tenant of a fair tax system was that the "subjects … contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state". This rings true today; those who enjoy wealth do so to some extent only because of what the state offers, be it through providing security and infrastructure, or so that there is a healthy and skilled workforce.

Yet the level at which taxation is levied, and the selection of those who are levied, is always going to be a political decision, and hotly contested. In a global age where capital is highly mobile, Britain has to ensure that it attracts inward investment and that its tax system does not act as a disincentive to risk taking and hard work. Balanced against this is the attractiveness of Britain because of the amount of revenue raised and invested in human capital and infrastructure. Alongside this, the complexity of taxation can often mean the system is judged as unfair – hindering efficiency and creating burdensome administrative costs, especially for smaller businesses. But without complexity, there is a danger that a simplified tax structure will be too crude and unfair to many citizens.

Beyond the purely economic arguments, taxation also has a social function, defining the kind of community we live in. From One Nation conservatism to the social democratic left, taxation is seen as a way of redistributing wealth to create a fairer, more cohesive society. Thus, a fair tax regime is about both the revenue raised and how this is shared through expenditure. Increasingly, tax is also seen as a way of redressing market failures such as the impact of economic growth on the environment, while arguments about devolution are intimately linked with the tax-raising powers of local and central government.

This collection of essays opens up the debate about the strengths and weaknesses of the present British tax system. The authors cover a wide range of issues and seek to solve some of the inherent complexities and tensions that all tax regimes face. Set against the new landscape of globalisation and climate change, the contributors offer their thoughts on how Britain can have a fairer, more modern tax system.

The Smith Institute thanks Chris Wales (managing director of Lucida) for agreeing to edit this collection of essays and gratefully acknowledges the support of Prudential plc and the Association of Chartered Certified Accountants (ACCA) for this publication and the associated seminar series.

Introduction
Chris Wales, Managing Director of Lucida plc

The taxation system is at the heart of the modern state and its relationships with individuals, households and businesses. It is the necessary accompaniment to a government that is engaged in the welfare of its people. It affects the business climate, and the quality of the contribution that individuals make to companies. It increasingly defines national boundaries in a globalised world.

The UK tax system has evolved over many generations and is now used for purposes that go well beyond its historical function of raising revenue. It has been an economic tool to promote efficiency, a political tool to achieve redistribution of income and wealth, and a social tool to encourage welfare and development. Today society demands that it delivers fairness among our people and a competitive framework for our businesses. The system is necessarily complex and the interaction between different parts of it can be difficult to model. Change takes time. Complexity brings inertia.

Real opportunities for informed debate about taxation choices are limited. In principle, the people consent to a given level of taxation at the time of a general election. In practice, there is little constructive debate even then about the level of tax, and even less about the way in which it is levied. This makes it difficult for any party to claim consensus, either for the taxation system as it stands or for a particular reshaping of it.

Within parliament, taxation policy tends to be dealt with either at a high level of generality in economic policy debates or in minute detail during the committee stage of a finance bill. Strategic policy options are rarely debated. Few MPs are tax policy experts with the ability and experience to engage in such debates without professional support from economists and lawyers. And parliament itself has no structure through which to provide that support. Information and data are hard to access. The result is that there is almost no examination of the architecture of the tax system as a whole. But it is the design of the tax system, arguably more than the overall level of taxation, which shapes the economy, affects our livelihood and drives our behaviour.

Shifts of emphasis between different forms of taxation can give rise to significant behavioural change. They can affect investment and consumption and our attitudes towards our social obligations. They can reflect our views on the kind of society in which we want to live. Should we expect the tax system to reflect a particular political philosophy, and to change as society changes? Or should it simply represent an economically rational and efficient approach to raising the revenue that the government of the day requires to meet its spending programme? Whatever view is taken, it is clear that there is a debate to be had about taxation choices.

Later this year, under the auspices of the Institute for Fiscal Studies, Professor Sir James Mirrlees will produce what promises to be one of the most wide-ranging reviews of the architecture of the tax system, drawing on the experience and knowledge of economists and lawyers from around the world. It is important that, alongside his work, we debate the political philosophy of the tax system, discusssing how it might be modernised and under what influences it should be reshaped.

In this monograph we explore, through a number of thoughtful contributions, some of the key issues of the UK tax system: its development, its weaknesses and the influences that can and perhaps should shape it. One of the themes that recur in a number of the essays is the need for policy makers to look at the effects of the tax system as a whole rather than on a tax-by-tax basis.

Robert Chote comments, "When discussing how fair or efficient the tax system is, we should really look at the tax, tax credit and benefit systems in their entirety rather than at any tax or set of taxes in isolation … It is the impact of the overall mix that matters." Philip Broadley and John Whiting, writing in relation to business taxes, say, "The system needs to be looked at in its entirety …".

One of the weaknesses of the policy-making process today is that it is all too often carried out with little regard to the shape and impact of the tax system as a whole. The result is a lack of coherence in the system, difficulty in identifying consistent principles underlying it and the sub-optimisation of economic outcomes.

Another recurring theme is the need for a better process in the development of tax policy. Broadley and Whiting emphasise the importance of consultation, while recognising that there have been significant improvements in this area under the present government. Professor Judith Freedman addresses the importance of consent on a more philosophical level:

The libertarian position tells us only that redistribution requires justification and not that it should not take place. The question then becomes the way in which it is decided and *conveyed to the taxpayer that tax is to be levied on his property or earnings. If that is done in a proper democratic fashion, any complaints should be dealt with through the political process and not by an argument that taxation is a form of expropriation, since once it is legitimately decided that tax is due, this part of the relevant property is no longer the taxpayer's "own" ...*

But Professor Paul Ekins highlights the risk that simply asking people for their opinion, and then acting on it, may not lead to popular policy. Opinion polls, he comments, "generally show public support for the green tax shift that is the central element of green fiscal reform, but much less backing for the individual taxes, such as those on energy or road transport, that are essential components of such a shift".

Through this monograph and the related seminar series, the Smith Institute is providing an opportunity to explore the shape and balance of the tax system away from the day-to-day debate on the minutiae of the legislation: how to tax income, how to tax capital in the type of society that we seek to create and preserve, how and whether to use taxation instruments to achieve environmental objectives; and within each of those frameworks, at the level of the individual taxes, how to ensure that the system can be accepted as fair and can be a better reflection of the values in our society today.

I am grateful to all the contributors, to those who have supported this venture, and, not least, to the Smith Institute for recognising the importance of stimulating a wider debate on all these issues.

Chapter 1

Issues in personal tax design

Robert Chote, Director of the Institute for Fiscal Studies

Issues in personal tax design

This chapter briefly discusses a few of the many questions that policy makers need to ask themselves when deciding how to tax household income and spending. After some introductory comments on how we should assess fairness and efficiency in the tax system in general, it focuses on selected design features of income tax, national insurance, transfer payments (benefits and tax credits), value-added tax and excise duties.

The chapter focuses on issues that are being considered by the Mirrlees review, currently taking place under the auspices of the Institute for Fiscal Studies.[1] Indeed, it draws primarily upon preliminary contributions prepared for the review. As the conclusions of the individual studies and the overview that will make up the final report have yet to be published, this chapter necessarily poses broad questions rather than giving precise answers.

Some general observations on assessing the tax system

When discussing how fair or efficient the tax system is, we should really look at the tax, tax credit and benefit systems in their entirety rather than at any particular tax or set of taxes in isolation. Governments have a number of (frequently conflicting) objectives for the tax system, including raising revenue, redistributing income and influencing behaviour. Different taxes perform well on different criteria and very few (if any) perform well on all of them. It is the impact of the overall mix that matters.

Take redistribution as an example. Pay As You Earn (PAYE) and the growth of the welfare state mean that many households pay taxes *and* receive benefits. So in judging whether the state redistributes fairly we need to look at the net effect of the whole system: what the state takes with one hand and gives back with the other. Therefore, for example, we should be wary when some politicians say that it is "unfair" that the poorest fifth of the population pay a higher proportion of their gross income in direct and indirect taxes than the richest fifth. This ignores the fact that the poorest fifth receive much of their gross income from other taxpayers via the benefit system.

The tax and benefit system unequivocally narrows the gap between the rich and the poor – but it is benefits, and not taxes, that do most of the work. To put some numbers on that assertion: the wages and other private incomes of the richest fifth of the population in the UK are about 16 times bigger than those of the poorest fifth on average. But once you

1 www.ifs.org.uk/mirrleesreview

include income from benefits, the gap between the richest and poorest falls to seven times. Take off direct taxes (like income tax) and the gap falls again to five times. But then take off indirect taxes (like VAT and excise duties), which together tend to be regressive – at least relative to annual income, which is not necessarily a good guide to lifetime income – and the gap rises again to seven times. If we include benefits in kind (such as social housing, the NHS and education), the gap shrinks again to four times. You need the full picture to judge how much redistribution the state is undertaking, let alone to make any value judgment about how fairly it redistributes.

It is also important to remember that this comparison only includes taxes that are formally paid by specific households. It excludes taxes that are formally paid by businesses, the impact of which will eventually be felt by individuals in their capacity as shareholders, employees, customers or suppliers of those businesses. When asked about a change in the overall burden of tax, a Treasury spokesman recently responded: "The numbers quoted can only be reached if you add in taxes not paid by families, such as corporation tax and VAT paid by businesses. As such, we do not consider that this represents the real world." In the real world that most people inhabit, all taxes are ultimately incident on individuals and not abstract legal forms.

That said, we now turn to some features of direct and indirect tax design.

Direct taxes

Taxes on earnings from employment and other income are the biggest sources of revenue for the government. The Treasury expects to raise a little over £160 billion from income tax and a little over £100 billion from national insurance contributions in 2008/09, compared with total government receipts for the year expected at around £580 billion.

Merging income tax and national insurance

Income tax and national insurance were introduced at different times and for different purposes. They have steadily converged and now look quite similar in structure, although with some important remaining differences. For example: national insurance remains a "contributory" system, although the link between contributions and benefits is weak; income tax is formally charged on individuals, while national insurance formally charges both employers and employees (a distinction with administrative significance, but little economic impact); and there remain significant differences in the bases of the two taxes (their definitions of earnings, the period of assessment, and the treatment of multiple jobs, self-employment, savings and pensions).

The convergence of income tax and national insurance poses an obvious question: why not go the whole hog and merge them? This would have significant potential gains in terms of greater transparency and reduced administration and compliance costs. Integration would create a natural opportunity to rationalise the system and make it fundamentally fairer and more efficient. Policy makers may believe that it is important to retain some of the differences between the two taxes, and most of them could indeed be retained in a merged system (although at the expense of making the final system more complicated). Significant reform would also entail big transition costs, but it is certainly worth considering, and the Mirrlees review will do so.

Work incentives in the tax and transfer system

The 2007 Budget contained a controversial but welcome simplification of the combined schedule of income tax and national insurance rates, including the abolition of the 10p starting rate of income tax on non-savings income and the alignment of the upper earnings limit for national insurance contributions with the higher rate threshold for income tax. But there is certainly more to be done in looking at the structure of tax rates on household income and asking whether they make sense in the light of what we think we know about how people's decisions to work and save respond to them. To think sensibly about the rate structure, we need to look at the withdrawal rates of benefits and tax credits as well as the rates of income tax and national insurance.

Contributors to the Mirrlees review suggest four important problems with the existing system:

- The amount of income lost in tax and withdrawn transfer payments (benefits and tax credits) when people move into work on low incomes appears uncomfortably high. This "unemployment trap" discourages people from moving into paid work.
- Many low to moderate earners get to keep barely a quarter of every extra pound they earn because of the withdrawal of tax credits. This discourages them from working longer hours or seeking better-paid work.
- Housing benefit has an extremely high withdrawal rate, which can mean that recipients see almost no gain from working longer or seeking a higher-paid job. It is a powerful disincentive to advancement in the labour market for some people who seem particularly responsive to it.
- Tax credits, council tax benefit and housing benefit are burdensome for claimants, expensive for the government and less well-targeted on the people they are supposed to help than they could be.

An important challenge is to try to address these problems in the face of what we think we know about how people respond to the incentives in the tax, tax credit and benefit systems. Among the factors to take into account are:

- For some groups, such as second earners and the less well-qualified, the tax and transfer system has more influence on whether they decide to work in the first place than on whether they decide to work a little harder or a little more.
- Most people do not respond much to incentives in the tax system when deciding how many hours to work, although they may be more responsive in making other choices that determine how much they earn.
- For the very top earners, taxable income may be quite responsive to tax rates even if hours of work are not.

This points to a number of features of the tax and transfer system that deserve attention and which the Mirrlees review will be thinking about, among them: the size of earnings disregards (the amount you can earn before having benefits withdrawn); the relative generosity of in-work tax credits and out-of-work benefits; the speed with which tax credits are withdrawn as people's incomes rise; and the treatment of second earners. Contributors will also consider what scope there is to reduce administration and compliance costs in integrating different transfer payments.

Indirect taxes

Indirect taxes raise about a quarter of government revenue. Since 1978/79 the share of total revenue raised from VAT has risen from around 8% to 15%, while the share raised from other indirect taxes (notably excise duties) has fallen from around 17% to 10%. This rise in the importance of VAT has been the single most striking change in the composition of UK tax revenues in the last three decades.

Policy makers have long thought it sensible to have direct and indirect taxes running in parallel. In his 1861 Budget speech, William Gladstone famously likened them to two attractive sisters: "I cannot conceive any reason why there should be unfriendly rivalry between the admirers of these two damsels. I have always thought it not only allowable, but even an act of duty, to pay my addresses to them both."

One powerful reason to do so is that this spreads the risk of enforcement problems. Another is that we may feel it attractive to tax purchases of different goods and services at different rates. We focus on this latter justification in these remarks.

VAT

The UK's 17.5% standard rate for VAT is in line with the average for the Organisation for Economic Co-operation & Development countries, but its coverage is relatively narrow by international standards. Zero rating (notably of food, children's clothes and residential construction) removes about 12% of consumer spending from the VAT base. A number of items are subject to a reduced rate of 5%, including domestic power and energy, contraceptives, certain energy-saving products and children's car seats. Together with exemptions, this means that VAT raises barely 45% of what it would raise if the standard rate were applied to all consumer spending. This is one of the narrowest VAT bases in the industrial world, primarily because of the range of goods subject to zero rating.

We should not distort people's decisions about what to buy and consume without good reason. Some complications in the rate structure (such as the zero rating of children's clothes and the reduced rate for domestic fuel) have been justified on distributional grounds, because the less well-off spend a higher proportion of their weekly budget on these items than better-off households. But differential VAT rates are a blunt instrument with which to achieve distributional objectives – and certainly blunter than those available through the income tax, tax credit and benefit systems.

Poorer households may spend relatively more on the lower-taxed goods and services, but richer households spend more in absolute terms and therefore receive more of the tax break. It is worth examining reforms that would make VAT rates more uniform, while using some of the revenue to compensate poorer households.

If it is possible to make VAT less distorting, without unacceptable distributional consequences, it is interesting to ask why this has not been done already. Is it that politicians find it hard to convince people that the poor will be compensated adequately? Do people prefer the appearance of helping the less well-off by cutting their tax bill rather than by giving them more benefit income, even if the net outcome is the same? Do governments naturally fight shy of reforms that increase the churning of money between citizens and the state, because it increases both revenue and spending as a share of national income? We cannot be sure, but it is certainly important to think about how one might sell such an apparently desirable reform.

In addition to equity, people make two related arguments for differential VAT rates on efficiency grounds. One argument is that it makes sense to impose higher VAT rates on goods for which demand is relatively inelastic, in other words where higher prices are less likely to discourage people from buying them. A second argument is that we should differentiate VAT rates in an attempt to offset the damaging impact of taxing employment earnings on work incentives. This could be done, for example, by having reduced rates on work-related items such as childcare costs, commuting and work-related clothing, and higher rates on goods and services associated with leisure, to make that less attractive. Taken to its extreme, this could imply a highly differentiated structure for VAT with lots of different rates on lots of different goods and services. One has to judge when the benefit of differentiating VAT rates outweighs the costs.

Excise duties

Like all other EU countries, the UK charges excise duty (a single-stage sales tax) on motor fuels, tobacco products and alcoholic drinks. We focus here on the last two and leave consideration of fuel duty to the discussion of environmental taxation elsewhere in this volume. Excise duties on tobacco and alcohol both raise about £8 billion a year and the rates imposed are towards the top of the EU league table.

Economists have traditionally taken the view that even if tobacco and alcohol are to some extent addictive, people understand the risks when they consume them, and there is no prima facie case for imposing high taxes on those products just to protect people from the consequences of their own decisions to consume them. Additional taxation of these products is more often justified on the grounds that one person's decision to drink or smoke imposes external costs on others.

This is a complicated issue, as the external costs (and benefits) are hard to quantify. Simplifying enormously, one could argue that smoking tends to impose high internal costs on the smokers themselves (by killing them early), but that it saves the taxpayer money in the process by reducing the amount that has to be spent on their pensions and care in old age. On the basis of the external costs alone, one might find it hard to justify the relatively high excise duty on tobacco in the UK. But some behavioural economists argue that high excise duties on tobacco can be justified as a way to help people (especially young people) act in their own interest when they lack self-control.

While duties on tobacco are much higher than the external costs of smoking might seem to justify, those on alcohol appear much lower than might be justified by the external costs of drinking (arising from drink-driving and crime). One important difference is that each cigarette smoked causes roughly the same amount of additional damage, whereas alcohol consumption does not have a big external impact on people until it becomes abusive. Imposing a duty on alcohol high enough to reduce the external costs of abusive drinking would create big (and perhaps politically unacceptable) welfare losses on the majority of moderate drinkers. This raises the question of whether it would be possible to target (tax or other) policy more closely on problem drinking.

Conclusion

Taxes on household income and spending are the biggest sources of revenue for the Treasury. They are also visible and comprehensible by the standards of some other taxes. So it is not surprising that they have such political resonance.

With the caveat that we should judge the fairness and efficiency of the tax system at a holistic rather than partial level, there is plenty of scope to consider reform of the individual elements of the personal tax system. To take some of the examples discussed here, as regards direct taxes we might wish to reconsider the need for separate income tax and national insurance systems, and we might wish to re-examine the profile of marginal tax rates implied by the interaction of the income tax, national insurance, tax credit and social security benefit systems. As for indirect taxes, we might wish to consider whether there is a better way to achieve distributional objectives than to have an unusually narrow VAT base, and whether the current levels of taxation for alcohol and tobacco are justified by the costs to those who consume them and to others.

All tax reform proposals are easier to suggest in abstract than to implement in practice, in part because the losers tend to be more aggrieved than the winners are grateful. One need only look at the derision heaped upon those who have been brave or foolhardy enough to suggest widening the VAT base from time to time.

It may be that the chances of useful tax reform are greatest either when the public finances appear unexpectedly strong and the government thinks it has money to spare, thus allowing it to buy off the losers, or when the public finances are unexpectedly weak and the government has no choice but to inflict some pain. Which of those alternatives looks more likely over the next few years is a story for another occasion.

Chapter 2

Business taxes

Philip Broadley, Executive Director, Prudential plc, and
John Whiting, Tax Partner, PricewaterhouseCoopers LLP

Business taxes

Business contributes a very significant amount of the tax revenues collected on behalf of HM Treasury. On some definitions, well over 90% of government revenues are derived from business in one way or another. It is clearly of great interest to all those involved – business and tax gatherers – that the system of taxation, as it applies to businesses, should work well.

This chapter will deal with business taxation; particularly, but not exclusively, for those businesses with large-scale operations. (Smaller businesses are considered elsewhere in this monograph.) It will not attempt a design for a new tax system, but instead derive some principles (many of which will apply not just to business situations) and discuss how the system is doing at present.

Some background matters

In common with many aspects of the UK's taxation system, the business tax regime has evolved rather than been designed. Corporation tax adapts good, old-fashioned income tax to the corporate world, carrying over such principles as the schedular system, which is still with us. Corporation tax is only one of more than 20 taxes that affect businesses in the UK.[1] This immediately highlights two desirable features of a modern business tax system:

- The system needs to be looked at in its entirety, taking into account all the taxes that impact on business, not just corporation tax (as with pensions policy, addressing only one aspect inevitably makes the system more complex).
- The administrative side of tax matters a great deal – this paper is not concerned with arguments for a given tax rate, but with the overall tax system. That means taking into consideration the administrative burden the tax system creates.

It does need to be acknowledged that, under economic theory, companies do not bear taxation; rather, the burden of taxes is passed on to customers (for sales taxes), employees (for labour taxes) or investors (for profit taxes). However, the fact is that companies are used in the UK, and in virtually every other territory in the world, as a convenient taxing point. They are expected to gather and pay taxes, and are generally left to sort out how, if at all, the taxes are reflected in prices, wages or distributions. That means that

1 The Total Tax Contribution surveys undertaken for the Hundred Group of Finance Directors by PricewaterhouseCoopers have consistently shown that for every £1 of corporation tax paid, Hundred Group members bear another £1 or close to £1 of other UK business taxes – and, indeed, collect well over £3 more in UK taxes that don't have an impact on the profit and loss account.

companies have a valid interest in the tax system.

International principles

Business today is increasingly international. Businesses of any size will soon find themselves dealing with more than one country and, as well as problems of language and regulation, will encounter local tax systems. As business does not conduct its transactions on a neat and tidy, country-by-country basis, with obvious and clearly defined amounts of turnover and profit accruing in each country, it means returns on income in differing countries are often an additional burden, carried out purely for tax purposes.

It is inevitable that countries will develop their tax system in the way that suits them and meets their needs. But that will lead to differing taxes and systems. This, in turn, runs the risk of tax systems hindering international activities because of the way these systems interact (or, often, do not interact), increasing burdens for business from both a compliance and a cash point of view.

This all causes tax to be a significant factor in how businesses plan their affairs internationally. A great proportion of that planning is simply reflecting the business's need to monitor the taxes that it pays, ensuring compliance and avoiding doubling up on charges. One principle, therefore, of a modern tax system should be to require that tax authorities clearly show how they manage the interface between their tax systems. That management should be measured in terms of how easily and smoothly the systems interact, how clearly guidance is given to businesses, and a commitment to smoothing out anomalies and difficulties that emerge. Inevitably, there will be disputes: countries will not necessarily agree how many of the goose's feathers each should take. But the decision on that should come through co-operation between authorities, not simply by each grabbing feathers and leaving the poor goose to point out that, overall, it has been plucked twice in the same area.

- *The system should have regard to interactions with tax systems of other countries and the authorities should work to ease the burdens placed on business by those interactions.*

Location, location

Taxes are often seen by businesses as costs that they need to manage, "management" meaning both the actual cost of the taxes and their administrative burden.[2] Business will

2 The 2007 Total Tax Contribution survey highlighted something of this administrative burden, showing that Hundred Group members incurred a total of some £66 million on UK tax compliance alone.

naturally have regard to the impact of taxes when considering where to locate their operations. Taxation is unlikely ever to be the only factor in deciding where to locate, but it will always feature prominently on the list. It can tip the balance towards or against a particular location. A current example within the insurance industry is the move of some businesses to Bermuda, significantly influenced by the very favourable tax regime offered.

The principle is that a modern tax system has to give serious consideration to the impact on global competitiveness. The need to keep the UK's tax system competitive internationally is particularly important given the global reach of the UK economy. The financial services industry is internationally focused, with considerable scope for moving some of its operations to other countries (offshoring).

This need seems increasingly well understood and acknowledged by both the current and former Chancellors. However, it does not necessarily mean that tax rates have to be cut significantly to maintain the UK's competitive position. As noted already, tax is only one of a number of factors that businesses will consider.[3]

But tax rates are an obvious indicator and, in a sense, the "shop window" of the country. The Republic of Ireland is an example of a country that has used a tax cut to its advantage, in this case to its corporate tax rate. A number of Eastern European members of the EU look set to follow Ireland's lead in setting a low rate of corporate tax.

What a modern tax system should do is develop in the context that it will have an impact well beyond the country's immediate reach. In tax terms the UK is no longer an island.

- *Changes to the tax system should always have regard to the impact on the UK's international competitiveness and, as far as possible, the aim should be to make changes that improve, or at least do not damage, the UK's competitive position.*

Design principles

Having noted some general principles, the next stage is to look at more detailed principles of a modern tax system. Many are not just issues for business taxation, but they have particular resonance in that field.

3 See, for example the Global Financial Centres Index, published by the City of London in March 2007, which assessed the various centres on 14 different factors, two of which were tax-based: total tax rate on business and an employee's effective tax rate.

The tax system should be **coherent.** It needs to fit together well, with as few gaps or overlaps as possible. Transactions should be taxed once, under a clear principle. Normal business transactions should not suffer unexpected tax consequences. The assumption should be that if a business incurs expenditure then it has a valid business purpose for so doing. Arguably, the famous "wholly and exclusively" rule in corporation tax is somewhat outmoded. There should not be the phenomenon of the "tax nothings" that cause there to be no deduction, or VAT recovery, for something the business sees as a perfectly valid activity. This is particularly the case for some things that rank as capital expenditure under what are, in effect, 19th-century principles. Nor should businesses have to worry about items that rank for income tax and PAYE when given to employees but do not attract national insurance contributions (or vice versa).

Business values **certainty** – knowing the consequences of actions. The increasingly imprecise nature of the tax system has led to rising uncertainty. So, as far as possible, a modern tax system should give certainty and let businesses know where they stand. Settling whether the VAT status of a product or service is standard or zero-rated can make a crucial commercial difference but, as demonstrated by recent case law, can take many years to resolve.

Leading on from certainty is **consistency.** Sudden change to a tax system can cause businesses particular problems when they have planned on a medium- or long-term basis taking into account a particular tax treatment. This is not to say that a tax system cannot change, just that change needs to be brought in with proper regard to the consequences. Unfortunately, given the complex nature of the UK system, tax changes frequently have unforeseen consequences. Consider the recently announced changes to capital gains tax, or the phasing out of capital allowances on industrial and other buildings. A number of project finance arrangements set up in the expectation that tax allowances would be given for the hotel or factory in question suddenly had to be renegotiated, or left those involved with very different tax consequences compared with what most would argue was their reasonable expectation over the lifecycle of a major capital investment project.

Certainty and consistency are part of building **confidence** in a tax system. Whilst the government has to have the power to change and generally manage a tax system, one that appears changeable on a political whim is not going to encourage long-term business planning.

A major part of the solution to the certainty/consistency/confidence thread is that there should be effective **consultation.** Tax changes need to be developed as something of a joint venture between those running the system and those affected by it, with commitment from both sides. Government has to raise revenues and business needs to play its part in agreeing how those revenues should be raised. The goose, in other words, should accept that some feathers will be removed and should be involved in suggesting which would be the least painful to take.

Consultation can take place at many stages of a proposal's development. In many ways the key is to allow proper time. For anything significant, consultation should ideally conform to the following broad guidelines:

- Budget announcement on the principle of change;
- consultation on the principles;
- pre-Budget report announcement of the decision on the direction of the change;
- consultation on the detail of the change;
- Budget announcement on the exact direction; and
- publication and debate on the Finance Bill, including final detailed discussions.

This implies a time scale of at least 15 months for any significant change. If that seems excessive, it is relatively modest when compared with the time that business spends developing major initiatives. Indeed, a longer-term framework for planning and developing tax changes would be welcome and perfectly possible, whilst not constraining the ability of a government to take anti-avoidance or revenue-raising action. But, in a modern tax system, such precipitate action must be the exception, not the rule.

It is true that there has been a significant increase over the past few years in the number of issues on which consultation takes place. One must concede that government is less likely to consult stakeholders in areas where it wishes to plug what it considers to be tax avoidance, as it will want to act very swiftly. However, where the government is looking to modernise or simplify tax legislation, it does appear willing to undertake consultation even where there are anti-avoidance measures included in the tax legislation. An example of this is the present discussion and consultation on the taxation of foreign profits. This has started with a discussion document and we are awaiting the consultation document.

One of the benefits of good consultation is that **collateral damage** will be minimised. With change, the law of unintended consequences is always a risk, so officials need to ensure that measures are carefully targeted. The changes to the share schemes rules in 2003 are a case in point. Although no doubt well-intentioned, the impact of these (primarily) anti-avoidance measures on university spin-outs was damaging and, of course, led to a need to make further changes. While recognising HMRC's reasonable concern with minimising the risk of tax avoidance during a consultation period, those concerns should not be allowed to stand in the way of developing sound measures to achieve the desired goal.

One way of avoiding collateral damage is to avoid, as far as possible, unnecessary **complexity** within the tax system. Arguably, complexity feeds on itself. Bringing in complex rules tends to create anomalies, which then have to be dealt with. Introducing enhanced relief for research and development expenditure has in many ways been a good idea. It has, however, led to extra complexity in the tax system and there is evidence that some of those who could claim the relief have been put off by the administrative effort required to establish a claim. Concerns over complexity are accompanied by the ongoing issue of the sheer volume of tax legislation in the UK.

Finally, whilst change is inevitable within a tax system, there is a dichotomy in that it needs to be both guarded against (so it is not over-frequent) but at the same time promoted (so there is an ethos of improving the system). Business continually reviews how it operates and tries to improve. Although the tax system does not have the discipline of the market and a need to maintain market share, it is sensible to have a commitment to a **continuous review** of the tax system in order to keep it up to date, make sure it is modern and fit for purpose, and provide a mechanism to feed in ideas for improvement.

That will require resources, but it would be an investment that would pay back a good dividend. The investment might lead to recognition that the system needs to be modernised in a particular area (has the 19th-century regime for stamp duty really been adapted for the 21st century?) or that a detailed point needs updating (the £8,000 allowance for moving expenditure needs substantially increasing or simply abolishing). And changes should be the subject of "post-implementation review". Has the change worked as intended? Is it operating sensibly and efficiently (from the point of view of HMRC and business)?

It will be observed that the letter C crops up regularly in this survey of design features of a modern tax system:

- *coherent design;*
- *certainty of treatments;*

- *consistency of the system;*
- *confidence in the system;*
- *consultation;*
- *collateral damage minimised;*
- *complexity attacked;*
- *change minimised; and*
- *continuous review and improvement.*

Evaluating the current system

In setting out the principles, some examples have been noted. Taking a wider view adds to the mixed picture.

The UK's business tax system has been the subject of extensive and virtually continuous change in recent years. The volume of additional legislation has been huge. At the same time there have been significant procedural changes. Not all of this is bad, by any means. The development of a modern regime for taxing interest and financial instruments in recent years has, in many ways, been a good example of how the system should evolve, particularly with the regime's general foundation in "following the accounts".

The way the tax system is operated is also a significant factor in evaluating a tax system. The UK is fortunate in having a tax authority that has the highest standards of probity and professionalism, but that has not stopped there being a distinct shift in the way that HMRC has viewed big business in recent years, mostly for the worse. This might have been caused by the merger of the Inland Revenue and HM Customs & Excise, and by the pressure to increase tax revenues. The tax authority has become notably more aggressive, even bullying, in the way it pursues business, and attempts by business to reduce tax bills have been demonised. A modern tax system has to operate on the basis of trust, co-operation and mutual respect. In this era of self-assessment, the tax system cannot operate without the considerable efforts that are put in by businesses to manage efficiently their tax affairs.

The establishment of the Varney review was an acknowledgement of the problems that have been alluded to in this chapter. Many of the recommendations within the most recent report are sensible and appropriate in pushing the UK towards a modern tax system. Examples include:

- focusing HMRC's efforts through risk assessment, and communicating and discussing this work with the businesses concerned;

- trying to settle disputes more quickly – avoiding seemingly endless arguments over transfer pricing, for example, though that in turn will require HMRC to be better able to understand how business operates internationally; and
- increased training and professionalism within HMRC – business may have a part to play in assisting with that process, given that the taxman is often criticised for not having a better understanding of business.

The crux of the Varney review will be its implementation. Whilst we have heard positive statements of intent, the pressure on HMRC to reduce head count, and the loss of many experienced inspectors following the merger of the Inland Revenue and HM Customs & Excise, is worrying.

The changes to the tax system announced in 2007 give a distinctly mixed picture. Cutting the rate of corporation tax from 2008 is naturally welcome, but paying for it by cutting capital allowances is less so. Whatever the pressure to maintain tax revenues, the loss of capital allowances on buildings, with minimal transition, does not encourage a long-term view of investment by business. Added to this were the changes announced in the 2007 pre-Budget report, which have prompted further focus, especially within the financial services sector, on how a modern tax system should be developed. It is worth looking at two of the major changes:

(i) Residence and domicile

Most experts had assumed that things were being left as they were. Instead, a sudden announcement comes that major changes are to take place, without proper consultation on the potential consequences. Where is the proper review of the key terms of residence and domicile? Where are the precise definitions that will enable business to operate PAYE and national insurance contributions accurately and easily for people coming to work here? Why does the UK need an effective 90-day test of residence, which is surely just going to generate endless treaty-based arguments with other countries? Why was an extra charge proposed for levying on taxpayers without first considering whether it was creditable under double tax treaties? Has proper regard been given to the damage the new system will do to the attractiveness of the City of London and, in particular, the impression given of likely further increases in taxation on the non-domiciled? Fundamentally, why were questions such as these not addressed during proper consultation instead of only emerging after political commitment to make what seems to be a set package of changes?

(ii) Capital gains tax

Of course, the capital gains tax changes are aimed at individuals and therefore have no impact on business – or that appeared to be the Treasury's message and perhaps their genuine conclusion. But, taking just one aspect of the changes, there was a lack of thorough consultation to consider the overall effects on saving and investment. Instead of having a tax regime that rewarded long-term share ownership over other forms of saving, the playing field is suddenly tipped dramatically because of the capital gains tax changes. Day trading is now to be treated in the same way for capital gains tax as long-term share ownership. Capital gains on buy-to-let properties are suddenly much more tax-efficient. A government always has the option to make significant changes to the tax system, but in order to develop a modern tax system such changes should be implemented in line with the principles outlined in this chapter. Investors, whether companies or individuals, should be able to plan for the long term.

To put something on the credit side, the simplification commitments are welcome. Whilst there is undoubtedly a long way to go, the tone and stance coming from the Chancellor in this area are welcome and the studies being undertaken are promising. However, in order to simplify, one must take a holistic approach to an already over-complex system and recognise what the unintended consequences might be.

Conclusion

This chapter has set out some principles that should be met by a modern tax system. Although this has not been a rigorous evaluation, it will be apparent that the UK has a far from perfect score. In particular, more recent events do seem to have indicated something of a backward step, with changes in 2007 failing to meet the principles of consistency, consultation, collateral and coherence.

But it is also salutary to put the UK into a wider context. The recent World Bank/PricewaterhouseCoopers report *Paying Taxes: The Global Picture*, looks at the tax regimes of 175 territories and puts the UK in a high position. We are in many ways relatively well-off. But, as any business knows, a good position can very quickly deteriorate, not least when one's competitors are striving to improve their offerings and absorb one's ideas. The UK economy depends crucially on its attractiveness against an international backdrop, and the business tax system is a significant component. Coherent, explicit and, above all, consistent commitment to the principles outlined in this chapter is needed to ensure that the UK maintains and even improves its position. We do not yet have a fully modern business tax system in this country.

Chapter 3

Fairness in the taxation of small businesses

Professor Francis Chittenden, ACCA Professor of Small Business Finance at Manchester Business School, and Hilary Foster, Visiting Researcher at Manchester Business School

Fairness in the taxation of small businesses

This chapter explores the interplay between notions of fair taxation and the impact of taxes on small businesses.

First we examine the views around fairness: why it is difficult to define and why it is important for a tax system to be regarded as fair by citizens. Later we review the nature of the small-business sector and discuss the aspects of fair taxation likely to be relevant. At the time of writing, the outcome of the announced[1] government review of small-business taxation has yet to be made public.[2]

Fairness

What constitutes a "fair tax" has been the subject of debate since Adam Smith proposed his four canons of taxation in *The Wealth of Nations* in 1776:

- Equity: a tax should be seen to be fair in its impact on all individuals.
- Certainty: taxes should not be arbitrary; the taxpayer should know his or her liability and when and where to pay it.
- Convenience: it should be easy for taxpayers to pay what they owe.
- Efficiency: the tax system should not have an impact on the allocation of resources and it should be cheap to administer.[3]

It seems that everyone is agreed that tax should be fair; the problem is reaching agreement on a definition of fairness. In order to express an opinion on what makes a tax system fair, it is essential to understand the purpose of such a system.

In his former role as Chancellor of the Exchequer, Gordon Brown was quoted as saying:

It is essential that tax policy is based on clear principles. These are to encourage work, savings and investment, and fairness. Fairness by ensuring that everyone bears their fair share of taxation and pays the correct amount and which is seen to be fair by vigorous pursuit of tax avoidance and evasion.[4]

1 HM Treasury *Pre-Budget Report* (December 2004)
2 Sweetman, S "Whatever Happened to the Review of Small Business Taxation?" in *Accounting Web* (6 January 2008)
3 Adapted from Lymer, A and Oats, L *Taxation Policy & Practice* (Fiscal Publications, 2007/08)
4 *Financial Statement & Budget Report July 1997*, quoted in Hurwich, D "A Joint Conference of the Chartered Institute of Taxation, the Inland Revenue and HM Customs & Excise 29–30 June 2001" in *Tax Adviser* (September 2001)

The evolutionary nature of taxation policy

The tax system in advanced democracies at the beginning of the 21st century is very different in structure and purpose from the system in place a century ago, when the tax take was typically less than 10% of GDP. Tax policy ideas in advanced economies during the 20th century developed as a result of political and social changes;[5] for instance, in the UK, additional funding was needed to pay for two major conflicts and social changes such as the introduction of the old age pension and the national health service, two institutions that are the subject of considerable debate today. The introduction of PAYE tax proved advantageous to government both in terms of improved cash flow during the tax year, and employers becoming collection agents; a system that was quite efficient when most people worked for large public- or private-sector organisations. Additionally, the electorate became used to the idea of paying tax as a deduction from salary.

Over the same period, political ideas changed, moving from the use of tax policy as a means of economic redistribution through to Keynesian economic views that governments should use tax policy as an instrument of social and economic management. In the 1980s opinion shifted towards allowing the market to determine economic outcomes with a reduced level of intervention by government.

The difficulty with the constantly changing economic and social environment is that tax systems may lag changes and so contribute to uncertainty (see below). It is interesting to note proposals[6] for a fifth desirable quality in a tax structure: that of flexibility – the ability to "cope with changing economic circumstances over time without requiring substantive changes".

Against this backdrop, governments have persisted with the notion that tax policy can be used to influence the behaviour of citizens, thereby encouraging what are viewed at the time as desirable activities. In reality this may amount to a distortion of the market, and too often the well-intentioned relief misses the intended target of, for example, supporting the genuine entrepreneur, instead becoming a tax avoidance vehicle for those with access to sophisticated tax advice.[7]

5 Steinmo, S "The Evolution of Policy Ideas: Tax Policy in the 20th Century" in *The British Journal of Politics & International Relations* vol 5, no 2 (May 2003), pp206-236
6 Lymer and Oats, op cit
7 Truman, M "Slowing the Machine" (Institute of Chartered Accountants in England & Wales' Tax Faculty's Hardman Memorial Lecture) in *Taxation* (22 November 2007)

Debates around fairness

Certainty is seen to be of great importance: "a very considerable degree of inequality … is not near so great an evil as a very small degree of uncertainty"[8].

Transparency and complexity are also seen as having a significant bearing on certainty. It might be argued that legislation in the UK has now reached such a degree of complexity that it appears both tax officials and tax advisers struggle to interpret the position, and so ordinary taxpayers have little hope of finding clarity on their own, as noted by an accounting/tax practitioner serving small firms: "If trained people on both sides (HMRC and tax advisers) don't understand how to interpret the legislation, then there is a problem."[9]

Following on from this point, it is also suggested that the tax implications of a transaction should be capable of being understood before the transaction is undertaken.[10] Tax planning activities – the legitimate organising of a taxpayer's affairs in order to minimise the tax due – have been regarded as perfectly legal. However, an example of HMRC itself contributing to uncertainty is the recent case of *Jones v Garnett (Arctic Systems)*.

HMRC pursued the case all the way through the English legal process over a number of years, resulting in a great deal of uncertainty over the area of small and medium-sized enterprise tax planning during that time. The legislation was apparently unclear to both tax officials and tax advisers, and even though the House of Lords eventually found in the taxpayer's favour,[11] views continued to differ with regard to certainty because HMRC announced that it would change the law as a result. Discussions continue as to whether this response is fair given that the taxpayer simply arranged his affairs by choosing, out of two legitimate options, the one that would result in a lower tax bill.

A major debate relates to the issue of equity and how this should be defined. A number of writers agree on the need for two basic forms of equity in the tax system:[12]

8 Adam Smith, quoted in Davidson, S *A Flat Tax for Australia?* (Association of Chartered Certified Accountants, 2006), p5
9 Chittenden, F and Foster, H *Perspectives on Fair Tax* – Association of Chartered Certified Accountants research monograph (ACCA, March 2008)
10 Lymer and Oats, op cit, p49
11 The Special Commissioners and the High Court found in favour of HM Revenue & Customs, on the basis that there was a "settlement" (as defined by section 620 of the Income Tax (Trading & Other Income) Act 2005) and that the exemption in section 626 did not apply. This was overturned by the Court of Appeal, which decided in favour of the taxpayer on the basis that there was no settlement and therefore the settlements legislation could not apply. Finally, in the House of Lords (July 2007), all five judges agreed that the case should be decided in the taxpayer's favour and although all but one took the view that there was a settlement, they were unanimous that the exemption in section 626 applied.
12 Lymer and Oats, op cit, p44

- horizontal equity – where taxpayers with equal taxable capacity bear the same burden; and
- vertical equity – where those whose need is greatest suffer the least tax.

However, closer inspection reveals that both of these are difficult to define.[13, 14]

Other writers argue against traditional tax analysis, suggesting that taxation should be viewed in the context of the whole pattern of government income and expenditure:

What matters is not whether taxes – considered in themselves – are justly imposed, but rather whether the totality of government's treatment of its subjects, its expenditures along with its taxes, is just.[15]

Public attitudes and perceptions

A number of writers suggest that taxpayer acceptance is important for the workability of the tax system.[16] However, there are difficulties with assessing the level of acceptance, because those surveys that have attempted to measure public attitudes and perceptions may be misleading as a result of the following:

- Issues around the understanding of the technical terms and concepts – when subjects' views on tax were tested using a mix of abstract and concrete questions, it became apparent that there was a lack of public understanding of the concept of a progressive tax and how it operates.[17]
- Differences between attitudes and behaviour[18] – taxpayers may agree with a concept, but may feel differently when faced by the prospect of parting with their own hard-earned cash.

13 For a discussion of tax equity in distributive justice, see Musgrave, RA "Horizontal Equity, Once More" in *National Tax Journal* vol 43, no 2 (June 1990)
14 For a discussion of the history and principles of approaches to tax equity, see Musgrave, RA "Progressive Taxation, Equity, and Tax Design: Tax Progressivity and Income Inequality" in Slemrod, J (ed) *Tax Progressivity & Income Inequality* (Cambridge University Press, 1996)
15 Murphy, L and Nagel, T *The Myth of Ownership: Taxes & Justice* (Oxford University Press, 2002), p25
16 Musgrave, op cit (1996); Song, Y and Yarbrough, TE "Tax Ethics and Taxpayer Attitudes: A Survey" in *Public Administration Review* vol 38, no 5 (Sept-Oct 1978); and Rawlings, G "Cultural Narratives of Taxation and Citizenship: Fairness, Groups and Globalisation" in *Australian Journal of Social Issues* vol 38 (2003)
17 Roberts, ML, Hite, PA and Bradley, CF "Understanding Attitudes Toward Progressive Taxation" in *Public Opinion Quarterly* vol 58, no 2 (Summer 1994)
18 Seidl, C and Traub, S "Taxpayers' Attitudes, Behaviour and Perception of Fairness" in *Pacific Economic Review* vol 6, issue 2 (June 2001)

- Preferences potentially having been heavily influenced by the structure and level of tax rates in force at the time the survey was taken.[19]
- Perception of other taxpayers' behaviour – where taxpayers perceive that others, particularly high-wealth individuals, are not paying their fair share, this may lead to a breakdown of trust in the system and views that the wealthy should pay more.[20]

The issue is encapsulated as follows:

... fairness as process and fair in outcome are deeply subjective concepts of expected behaviour and action concerning the fulfilment of mutually agreed upon or expected obligations and bargains concerning resource distribution. In practice, however, fairness is dynamic, fluid and contingent.[21]

Increasing complexity, lack of certainty that others are contributing their fair share and a tax system that lags behind the pace of economic change: all may contribute to a breakdown of trust and ultimately threaten the legitimacy of the tax system. The danger to the state is that as trust in the tax system decreases, levels of compliance fall and tax in effect becomes voluntary – a matter of increasing importance as the number of self-employed in the UK rises.

From a slightly different perspective, another study presents evidence that citizens tend to be more compliant when they have a positive view of the state,[22] finding its constitution and laws fair and feeling that they are treated with respect by the authorities. Additionally, this work with the Swiss cantons showed that where citizens felt they had a higher level of direct political control, their tax ethics were higher and they were more likely to comply with the tax system.[23]

The implication for government is that in setting tax policy the state should strive to be seen as neutral in its dealings with citizens[24] in order to promote feelings of fairness and procedural justice.

19 Sheffrin, MS "Perceptions of Fairness in the Crucible of Tax Policy" in Slemrod, op cit
20 Rawlings, G "Cultural Narratives of Taxation and Citizenship: Fairness, Groups and Globalisation" in *Australian Journal of Social Issues* vol 38 (2003)
21 Ibid, p279
22 Frey, BS "A Constitution for Knaves Crowds Out Civic Virtues" in *The Economic Journal* vol 107, no 443 (1997): see particularly pp1,050-1,052
23 For a discussion of theories of tax evasion and Frey's later work, see: Heard, V *The Philosophy of Tax* (KPMG Tax Business School, 2005)
24 Rawlings quotes: Murphy, T "Procedural Justice and Tax Compliance" in *Australian Journal of Social Issues* vol 38, no 3 (2003)

The nature of small business

This section examines the heterogeneous nature of small businesses, their characteristics, and the context in which they operate, and then evaluates their importance to the economy. It also assesses those aspects of fair taxation likely to be relevant to the smaller business and whether there is a case for treating these businesses differently.

Small firms come in a variety of shapes, sizes and legal forms. There are a number of quantitative definitions to be found: in tax law, company law, Enterprise Directorate[25] data and European Union statistics, to name some sources. The variety and overlap serve to illustrate the difficulty in arriving at a clear and concise definition

From a qualitative perspective, Wynarczyk et al[26] argued that there are three core differences that distinguish small firms from large firms: uncertainty, innovation and evolution. Uncertainty was seen as key, comprising both external and internal environmental factors; its three aspects were identified as: being a price taker; having a limited customer and product base; and the much greater diversity of objectives of owners of small firms compared with large firms. Evidence of these uncertainties may be seen in the high attrition rate experienced by young and small firms:

The broad pattern which emerges is that the young are more likely to fail than the old, the very small are more likely to fail than their larger counterparts, and that, for young firms, probably the most powerful influence on their survival is whether or not they grow within a short period after start-up.[27]

Whilst survival cannot be predicted from an examination of the individual's personal characteristics, research has shown that an important factor in survival is the ability to adjust to changes in the environment.

An understanding of the psychology of the different types of owner-manager is aided by the following distinction between small-business owners and entrepreneurs:[28]

25 Part of the UK Department for Business, Enterprise & Regulatory Reform
26 Wynarczyk, P, Watson, R, Storey, DJ, Short, H and Keasey, K *The Managerial Labour Market in Small & Medium-sized Enterprises* (Routledge, 1993)
27 Storey, D *Understanding the Small Business Sector* (Routledge, 1994), p109 (referring to Smallbone et al)
28 Birley, S "The Start-up" in Burns, P and Dewhurst, J *Small Business & Entrepreneurship* (Macmillan Education, 1989)

- A *small-business owner* is an individual who establishes and manages a business for the principal purpose of furthering personal goals. The business must be the primary source of income and will consume the majority of one's time and resources. The owner perceives the business as an extension of his or her personality, intricately bound with family needs and desires.
- An *entrepreneur* is an individual who establishes and manages a business for the principal purpose of profit and growth. The entrepreneur is characterised principally by innovative behaviour and will employ strategic management practices in the business.

In summary, the above review suggests that the drive towards starting a business is influenced by a variety of factors both internal and external to the individual. The small-business sector is as diverse as the individuals who are the owner-managers within it[29] and comprises many lifestyle businesses whose owners seek only to earn a living[30] as well as a much smaller number of businesses whose owners harbour more ambitious entrepreneurial goals.

Storey finds that although firms which are rapidly growing (in terms of increased employees) are a small proportion of the small-firm population, over a 10-year period they make a significant contribution to job creation. Of these rapid-growth firms, a very small proportion will provide a majority of employment in the surviving firms 10 years after inception. The difficulty is in identifying at an early stage which are the rapid-growth firms in order for special incentives to be targeted.

Another study suggests that the entry and exit of small firms is of benefit to the economy as a whole, because "increased competition boosts productivity".[31] Therefore, although many small firms exit after a relatively short period of time, it is the activity of these firms that has a positive effect. Therefore there would seem to be a case for encouraging the entry of new small firms; however, these are already running at a high rate.[32]

Overall, perhaps the greatest contribution of small firms to the economy is a result of the commercial uncertainties they face. Small businesses have to be innovative in the way

29 Gibb, AA "Training the Trainers for Small Business" in *Journal of European Industrial Training* vol 14, no 1 (1990)
30 Binks, MR and Vale, PA "Nottingham Study Resume of Data", NUSFU working paper no 6 (July 1984)
31 Disney, R, Haskel, J and Heden, Y "Restructuring and Productivity Growth in UK Manufacturing" in *The Economic Journal* no 113 (July 2003)
32 Chittenden, F and Sloan, B "Taxation and Public Policy Towards Small Firms: A Review" in *Australian Tax Forum* vol 22, no 4 (2007)

they adapt to the challenges of competition, or they die. It is the destructive impact of competitive pressure that forces the discovery of Schumpeterian innovations, which lead to the challenge to existing firms and the creation of new wealth. Uncertainties created by constantly changing tax regulations are unlikely to be constructive in this respect.

Are there other reasons that small firms are important?

In the European economy more than 95% of firms are small, providing more than half of all jobs in the European Community;[33] these firms make a major contribution to private-sector output and employment, and this appears to be increasing over time. Crawford and Freedman make the following observations:

In 2005, there were an estimated 4.3 million private sector business enterprises in the UK, of which 99% were firms with fewer than 50 employees and 96% were firms with fewer than 10 employees (referred to as micro-businesses): these micro-businesses accounted for 32% of employment and 22% of turnover in the UK in 2005.[34]

Furthermore, they show how the statistics have changed over time and suggest that this behaviour has been encouraged by changes in tax policy:

… in 2005, around 73% of private-sector businesses in the UK had no employees (other than the self-employed owner-director or company director)… this split has been changing over time, and highlights the fact that almost all of the increase in the number of businesses in the UK (at least since 1999) has come from those with no employees. Much of this must reflect the increasing tax and National Insurance Contribution (NIC) incentive to move away from employment and towards self-employment or incorporation.[35]

This statistic shows that high numbers of individuals are affected by the increased NIC rates, and that their actions in response to the changes in tax policy may amount to a distortion in economic terms. However, as a consequence of the large numbers of self-employed and micro-firms, the majority of people (taxpayers and voters) have some kind of connection (direct or indirect) with a small business: either running their own, as an employee, supplier or customer, or through family members.[36] Additionally many tax

33 Storey, op cit, p7
34 Crawford, C and Freedman, J "Small Business Taxation: A Special Study in Selected Issues Undertaken for the Mirrlees Review" – conference draft (April 2007), p5
35 Ibid, p8
36 Ibid, p9

practitioners also fall into the category of small business and thus have a twofold motivation to make representations on behalf of the sector. Perhaps this partly explains the outcry following the pre-Budget report of October 2007 regarding changes to capital gains tax.

Tax issues of particular interest to small firms

A key issue for the owner of a very small business is whether to remain unincorporated and be taxed as a self-employed individual, or to incorporate and become subject to corporation tax and dividend tax.[37] Taxation status may not always be the key driver behind incorporation; large firms may encourage incorporation by a casual employee in order to avoid the responsibilities consequent on full employment status.

Another factor for the self-employed and the owner-manager of a small firm is the necessity to plan for the future: the business is the platform on which any retirement planning will be based. This long-term planning (which the government has stated it wishes individuals to undertake) requires clarity and stability in the tax system. Although the capital gains tax proposals outlined in the October 2007 pre-Budget report were simple, they generated an outcry of "Unfair!" because individuals had arranged their affairs around the existing legislation, and the subsequent debates have resulted in more uncertainty. Of course removing a relief, once given, is always going to be unpopular.

A related long-term issue for the small-business owner is the transfer of the business to another family member utilising the inheritance tax business relief. Crawford and Freedman[38] argue that there is no clear basis to support the transfer of a business to the next generation as better than the purchase by a third party. They suggest that neutrality would be preferable, because it would create a situation where the optimal commercial considerations would influence the outcome.

Another view concerning inheritance tax is that of Chen, Lee and Mintz,[39] who found that taxes on wealth might have an adverse effect on entrepreneurial activity as it is this wealth, particularly a windfall legacy, that is frequently used to finance new entrepreneurial ventures.

37 Ibid, p2
38 Ibid
39 Chen, D, Lee, FC and Mintz, J "Taxation, SMEs and Entrepreneurship" – working paper series (OECD Directorate for Science, Technology & Industry, 2002)

Is there a case for treating small firms differently for tax purposes?

Crawford and Freedman[40] examine the arguments that are often put forward in support of tax measures favourable to small businesses: asymmetric information; the disproportionate burden of compliance; the problem of obtaining tax relief for losses by relatively new firms; the wish to pass the business on to other family members (and prevent the break-up of the firm), necessitating relief from capital gains tax and inheritance tax.

The final point is that even if small businesses are considered to be important in terms of their role in driving the economy and their contribution to job creation – and these claims are not without controversy – it does not necessarily follow that small businesses require financial (or other) support, or that the tax system is an appropriate way to provide any such support as is appropriate.

They make the point that even if justifications underlying support for small businesses are accepted, the practicalities of achieving special reliefs and incentives via the tax system are problematic as follows:

- There are difficulties in targeting the reliefs, given the problems of (a) defining small business and (b) identifying those small businesses that would not be likely to grow or create jobs in the absence of reliefs, but would do so with their provision.
- The specific targeting of tax reliefs and exemptions for small businesses may distort the commercial decision making within that sector, thus leading to inefficiency.
- They may also lead to economic inefficiencies if they result in the transfer of resources from large, more efficient firms to smaller, less efficient ones.

This latter point was also made by Chittenden and Sloan,[41] who concluded:

There would appear to be justification for tax policies that favour small firms, provided these do not distort the workings of the whole economy, eg by causing a transfer of activities from large, efficient firms to smaller businesses that lack economies of scale; or from employment to self-employment.

The authors agree in principle that ideally an environment should be provided to encourage the small firms of today that will go on to become the large firms of tomorrow, although

40 Op cit, p9
41 Chittenden, F and Sloan, BA *Taxation & Small Business: A Review of the Literature*, report for the Small Business Service (2005), pp3-4

these are virtually impossible to predict, given the wide variety of influencing factors. The difficulties of attempting to provide this via the tax system have been seen before – for instance, the business expansion scheme.[42] The main problem is that any scheme such as this contributes to complexity; in order to reach the intended target the legislation needs to be tightly drawn, and because of the complexity of defining a small firm in the first place, and then targeting the tax legislation specifically, the process frequently results in loopholes that may be open to exploitation by some tax advisers, who may then market them as tax avoidance vehicles for the more wealthy.

Given the uncertainties and complexities already faced by the average owner-manager (who may well not have the additional financial resources required to pay for tax advice, or the time to work it out for himself/herself), it seems likely that in most cases these reliefs will not reach their intended beneficiaries, with the attendant cost to the taxpayer of (a) those reliefs being taken advantage of by unintended recipients and (b) the administrative efforts to plug the loopholes and the continuing cycle and consequent mushrooming of legislation. This circular process results in increased uncertainty for all taxpayers, but perhaps it is more keenly felt by small businesses because of the many uncertainties they experience on a daily basis.

In the first part of this paper we argued in favour of reducing complexity; therefore, rather than targeting tax reliefs as described above, perhaps the way forward is to reduce complexity for all taxpayers. Mike Truman[43] argues in favour of a reduction in complexity; he suggests the removal of all targeted reliefs which are designed to distort the operation of the market or the behaviour of individuals. To promote clarity he recommends purposive drafting – that is, a purpose clause at the beginning of each charging section, which would assist in interpretation when cases come to court, and might even reduce the numbers going to court.

Crawford and Freedman note the disproportionate burden of compliance on small firms (one of the issues perceived as unfair by small firms) and suggest that assistance with these costs could encourage compliance and thus could be justified.[44] This would be a step towards reducing the difficulties faced by new small firms. However, they also warn of the dangers of complexity in deregulation and the proliferation of thresholds, the resulting confusion and potential barriers to growth, and further complexity if anti-avoidance legislation is required as a result.

42 Truman, op cit
43 Ibid
44 Crawford and Freedman, op cit, p13

Conclusions

From the review of research it appears that in order for a tax to be perceived as fair, and thus accepted by the majority of taxpayers, a fundamental issue for government is to decide on the structure and purpose of the tax system, and to communicate clearly to citizens the rationale behind the individual taxes. However, we recognise the tension between formulating an efficient tax system and political acceptance by all sectors of society.

The small-business sector is diverse for a number of reasons: the differing motivations of the individuals who become owner-managers; the legal forms chosen; and the size and development stage of each firm. Added to this, there is a great deal of movement within the sector and a high exit rate, particularly among the younger firms. The heterogeneity of the sector, and consequent difficulties in defining a small firm, make it difficult to target special incentives and tax reliefs; particularly when those reliefs are intended to benefit a small percentage of the sector – that is, growth firms.

It is apparent that policy makers' views of the activities they wish to encourage have changed over time, thereby increasing complexity. From previous research, it appears that certainty is a key issue in evaluating fairness and that transparency and complexity have an important bearing on this. It is argued that these have a particular impact on small business, given the uncertainties faced by this sector on a daily basis. A related point is that previous attempts to encourage entrepreneurial activity have resulted in distortion of the market, missing the intended target and being taken advantage of as tax avoidance vehicles by the very wealthy.

The consequent exponential increase in legislation to plug the loopholes has resulted in increased complexity. The message to government is to reduce the volume of laws, regulations and directives and communicate compliance requirements clearly.

Consideration should be given to reducing the disproportionate burden of compliance on small firms by giving assistance with those costs, with the justification that this would increase compliance. However, the same caveats apply with regard to drafting the rules so that the benefits reach the intended recipients.

Just as policy makers' opinions have changed over time, so have public attitudes and perceptions towards fairness in taxation, and this appears to be encapsulated by Rawlings (see above), who described fairness as "deeply subjective … dynamic, fluid and contingent".

Public attitudes may be influenced by economic and social conditions; views may change as the environment changes. Additionally, Frey's work (see above) suggests that taxpayer ethics will operate at a higher level within a "trusting" constitution. The implication of this for the state is that by creating a "trusting" tax system and thus increasing the level of taxpayer ethics, more taxpayers will feel inclined to comply, thereby reducing the administrative cost of the (currently) adversarial system.

We summarise the key points for taxation policy makers, bearing in mind the issues we have raised with regard to small firms:

- Taxpayer acceptance is important for the workability of the tax system. In order to achieve this, the government needs to communicate clearly the rationale behind the individual taxes to citizens, including the small-business sector. Mutual trust and respect is an important factor in building and maintaining this acceptance.

- A recent study has found international agreement[45] that the chief contributing factor to complexity (and thus unfairness) is the volume of directives, laws and regulations. The difficulty with targeting a specific tax relief at the small-business sector is that the sector is so diverse that the problems of definition, and then further legislation to prevent abuse, results in an increased volume of legislation and thus complexity. Therefore a key message for the government arising out of this study is the need to reduce, or at least contain, the volume of directives, laws and regulations and thereby moderate complexity.

- The government should maintain neutrality in its dealings with all citizens and all sectors of society and be seen to do so. The tax legislation should not distort commercial decision making in the sense of influencing the choice of legal form adopted by a small firm; nor should it influence whether an individual opts for self-employment rather than employment.

- A reduction in the number of targeted initiatives each year and consequent reduction in complexity would result in more stability for all taxpayers and the possibility for all individuals to understand the tax system that applies to them.

45 See UK survey respondents and UK focus group in Chittenden and Foster, 2008

Chapter 4

Taxation and local government

Chris Wales, Managing Director of Lucida plc

Taxation and local government

Local government finance is structurally complex and is properly understood by very few people. Its interactions are also complex and need to be thought through in more than one dimension by anyone proposing changes to the present system. As Sir Michael Lyons, writing in the preface to the report of his inquiry into local government[1] in 2007, recognised:

... questions about local government taxation are not simply matters for technical analysis, but need instead to be considered in a wider context. They must be part of a broader debate about the type of country we want to live in: the balance we strike between citizen, community and government in terms of both power and voice, and how we manage the inevitable tensions between diversity, choice and a desire for common standards.

They also need to be considered in the context of the tax system as a whole.

In the political dimension, the reform of local government and its funding arrangements is extraordinarily difficult. No government in Westminster will ever lose the next election because it fails to tackle it; and today's political leaders remember only too well the impact that the introduction of the poll tax had on the Thatcher government. Those of us who have attempted, even in a small way, to engender debate in the national media about the reform of local government funding know that any proposal can provoke a wave of vociferous opponents.

Against that background, there would have to be a powerful rationale for a major overhaul of local government finance in order to justify the political risk. Does that rationale exist? The system still appears to work. Council tax, in spite of its well-publicised problems, has collection rates that few could fault. Business rates are paid as a matter of course. The whole network of grants and ring-fenced payments which keep the system going has labyrinthine complexity but it delivers cash to local authorities and allows them to maintain services. When incremental change, though infinitely slow, can create a sense of progress, why would any government risk the uncertainties of fundamental reform?

The simple answer is that no government will, unless it can be convinced that there is a significantly better way of funding the role that local government has today or that there

1 Lyons, M *Placeshaping: A Shared Ambition for the Future of Local Government* (Department for Communities & Local Government/HM Treasury, March 2007)

is a much better role for local government which will demand some consequential changes in its funding. The problem with the former is that it may only lead to half a solution. The problem with the latter is that it requires a double leap of faith and imagination.

Back in 2004, when he began his inquiry, Sir Michael Lyons must have thought that there were grounds for optimism about the potential for major reform. His work was intelligent and thorough and, in the body of his final report, he shares with us an impressive analysis of the current challenges and limitations. In setting out his place-shaping agenda he provides an important vision for the future of local government.

Looking at its role in the 21st century, he writes:

Local government has an important contribution to make as part of a single system of government, allowing different communities to make choices for themselves, and relating and shaping the actions of government and the public sector to the needs of the locality.

But is the contribution of local government important or does it exist solely as an agency for the local delivery of policy decisions made at Westminster? Should local and central government be part of a *single* system of government and, if they were, should either one of them have clear supremacy over the other? Should the system empower communities to make *real* choices for themselves? Can local government be trusted with the right to shape what central government has decided, to make it a better fit to the local community; or would ceding that authority allow too much power to ebb away from the centre? The answers to these questions are important both in their own right and in guiding the way in which we might address the reform of local government funding.

In this essay, I attempt two things: to take the Lyons vision of empowered local government and explore how reform of the funding mechanisms could help to deliver the aspirations that lie behind it; and to examine the possible reform of local government finance in the dimension of the tax system rather than as an issue to be considered only in the framework of local government. The latter was outside the remit of the Lyons inquiry.

Issues with the present system

Under the present system of finance, local government is able to make limited choices about spending preferences within an overall framework of budgetary control that is in effect set from the centre. Central government reserves to itself the right to intervene if local authorities exceed the limits that it considers appropriate.

There is a certain logic in this arrangement, given the way that local government is funded today. Central government raises more than 95% of all tax revenues in the UK and local government raises, according to the Lyons inquiry, as little as 16% of the money that it spends. Central government is responsible for all the taxes that it raises, including the substantial amounts that go to fund locally provided services, and (at least in theory) it is judged by the electorate on its use of those revenues every four or five years.

The present system is relatively efficient. Collection costs are low for the two taxes that explicitly fund local authority spending: council tax and business rates. Redistribution through the grant system might be cumbersome and relatively expensive, but any system that is put in place will need to be underpinned by a framework of grants so there will inevitably be some costs of that sort. Even in Sweden, where local income taxes play a major role in funding local government, there is an extensive system of grants to redistribute revenues between authorities with different economic characteristics. Any localisation of the taxation system is likely to be less efficient than what we have today.

However, the present system of accountability simply does not work for local government. It is accountable to its own electorate for the decisions that it makes on local spending, without any real control over its revenue base, except at the margin. The leverage that the present system of central government grants creates for any spending decisions by local authorities exaggerates perceptions of prudence and profligacy by councils that spend less or more than the norm. It is widely acknowledged that this is a fundamental problem and that it goes hand in hand with voter apathy at local elections. Across the country, no more than a third of the registered electorate will typically vote in local elections. In some areas, a third would be a good turnout.

There is widespread ignorance and confusion, particularly in areas with two-tier authorities, about which part of government is responsible for what service, which part of the government finance structure ultimately funds it, and the extent to which service levels are a matter for local or central decision. There is a strong case that the present system of funding is in conflict with the Lyons vision for local government in the 21st century. It limits the choices that communities can make and inhibits the functioning of local democracy.

Council tax itself is a problem. There are many who disagree with Sir Michael Lyons' view that "council tax remains broadly sound and should be retained as a local tax"; his explanation, based primarily on the tax's ease of collection and its stability as a revenue source, is unconvincing. The system, while sound as a collection mechanism today, is already under considerable strain at the policy level. It deals badly with the asset-rich, income-poor members of the community: the pensioner group are most at risk. It under-taxes the wealthiest members of the community and over-taxes those with modest means. The take-up of council tax benefit is well below target and the result is that council tax is seriously regressive.

The pre-election politics of council tax have highlighted many of the problems and led to a sticking-plaster approach that does little to diminish the long-term scale of the issues. Council tax would be unlikely to withstand the strain of becoming a more significant source of local government finance, even if the tax burden from central government was to be made correspondingly lighter.

What is needed to deliver the Lyons vision is a more fundamental solution that enhances clarity and political accountability and also dovetails effectively with the broader scheme of taxation in the UK.

Tackling the problem

There is, of course, more than one way to deliver clarity and accountability. At one extreme, central government could be made responsible for *all* taxation. In such a system, central government would set the precise financial limits within which each local authority operated and political choices would be limited to spending priorities within a fixed financial framework. If accountability at the local level is at best distorted today, why not make it clear that local councils are responsible only for choice within pre-set financial limits and not for overall spending levels? It would be relatively easy to achieve. In principle, it could be done by converting council tax into a national property tax. There might even be some efficiency gains. But it would not deliver empowerment to local communities and the authorities they elect.

At the other end of the spectrum, it is possible to envisage a system in which local taxation could be the main source of tax revenues, with local authorities empowered to levy taxes not just to fund local spending but also to fund national programmes. From where we start today, a shift to such a system is all but unimaginable. It would involve the devolution of power to units of administration that, in the UK, are considered far too small to have autonomy and far too small to be effective as tax-raising bodies. There is a low level of public confidence even in the large local authorities.

Yet it is not universally true that small is untrustworthy or that public confidence needs to be so low. Across Europe, there are nation states with populations much lower than those of our largest cities, whose governments have demonstrated a high level of competence in financial administration. Luxembourg, with its population of much less than half a million, is a case in point. If its government can be trusted (and it is) to run an independent tax system, why not those of London and Leeds, Birmingham and Bristol?

Government at Westminster could be funded explicitly out of locally raised revenues and responsible only for external relations, foreign policy, international aid, defence, and the like, with everything else funded and organised by well-co-ordinated local authorities. However, there is no public clamour for change on that scale, and even the most ardent advocates of localisation stop well short of setting it as an objective.

Options for change

In between these two extremes are a wide range of options. What would most help to deliver the Lyons vision of "allowing different communities to make choices for themselves"?

At a conceptual level, the answer seems obvious. It is to give significantly more revenue-raising powers to local authorities and to balance this with a reduction in the taxes levied by central government. The more difficult question is the mechanism. The answer is not to push up the yield from council tax, for the reasons already given, but there are other possibilities. Over the years a number of different solutions have been proposed, among them a more extensive tax on land, a local income tax, re-localised business rates and a wider scheme of user charges for locally provided services.

Land value tax

Professor Iain Maclean and others have advocated the use of a land value tax. Writing in an Institute for Public Policy Research publication entitled *Time for Land Value Tax* in 2005, he concluded:

Land value tax (LVT) could replace Council Tax, business rates, or both. It could (and probably should) also replace Stamp Duty and Inheritance Tax …

Land value tax is conceived of as an annual tax on the market rental value of land. It ignores any development that has occurred and it is levied whether the land is occupied or vacant. According to its advocates, there have been successful experiments with such a tax in Denmark and New Zealand, although both have apparently drawn back from the original pure concept of the tax.

There is a good argument for more effective taxation of property in the UK, particularly domestic property. Professor John Muellbauer has argued strongly in favour of land value tax as a macroeconomic stabiliser. He suggests that a tax of this type would provide an incentive against keeping property vacant and encourage the release of land for development, which could help to address the shortage of land for housing development. However, his interest in land value tax is more as a national tax than as a replacement for council tax.

Dominic Maxwell, writing in the same Institute for Public Policy Research publication as Iain MacLean, noted that "property taxation does not currently efficiently or equitably promote government objectives". Steps have been taken by both Conservative and Labour governments to tax land more effectively, for example through the abolition of mortgage interest relief and ratcheting up stamp duty. However, some of the effects of this have now been undone. The substantial uplift in the threshold for stamp duty and the recently announced changes in the capital gains tax treatment of second homes both run in the opposite direction.

As a main source of revenue for local authorities, property is fundamentally not buoyant enough. Unless revaluations are frequent, there is no natural increase in yield so the local authorities have no choice but to put up the rate of tax to deal with inflationary and choice-based pressures on funding.

Income tax

Income taxes suffer from no such disadvantage and there is evidence from polling that they have a relatively high degree of acceptability among the public as a method of financing local government. A local income tax could deliver a more buoyant revenue base than council tax and it could potentially be levied at a rate that allowed centrally raised taxes to be reduced without the strains that would be evident if a similar amount was raised through council tax. If local authorities had more flexibility in rate setting than they currently do over council tax, accountability could be improved. However, the abandonment of council tax would leave the UK tax system more unbalanced than it is today. Council tax may be unsatisfactory as a tax on property values, but simply to abolish it would leave the system as a whole based more on income and expenditure than is desirable.

User charges

A number of other possibilities exist for giving greater funding independence to local authorities. One is to allow them to levy a wider and heavier range of "user charges" for local services. This could just be for car parks and swimming pools or the collection of rubbish, but as a source of revenue, charges of this type would be unlikely to replace much of the present system of grant income from central government unless they could be scaled up. A radical alternative which might achieve that would be to allow local authorities to charge explicitly for basic services such as education, replacing all the funding for them that at present comes from central government. However, there would, rightly, be some serious political opposition to such a proposal.

Business rates

Another possible change that has been widely debated is the re-localisation of business rates. Business rates are something of an anomaly. Essentially a tax on property value, since 1990 they have been levied centrally but in effect hypothecated for local authority use. The funds are disbursed on a basis that reflects factors other than their source. So there is no geographical link in the present system between the location of the business and the ultimate recipient of the business rates that it pays. It would be easy to regard business rates as a central government property tax.

There is some appeal in the idea of re-localisation from a local government perspective. It would potentially reward local authorities that were successful in attracting businesses to their area. However, in recent years business has been very reluctant to return to the pre-1990 situation and the Confederation of British Industry has lobbied actively against it. There have been fears that, at least in the short term, local authorities could take advantage of a relatively captive business base to shift the burden of taxation from council tax payers who can vote to businesses that cannot and would be powerless to object.

There is some justification in the concern that local authorities are less accountable to local businesses than to council tax payers. However, addressing that concern, even in a small way, raises difficult questions about democracy and accountability. The proposals in the present government's white paper on business rate supplements attempt to deal with issues about accountability, but in doing so they introduce some awkward concepts. The proposed arrangements for supplementary business rates allow businesses (as defined) to vote on the proposals where the planned expenditure would be more than one-third funded from the supplement. In our society, it is unusual for "businesses" rather than individuals to have voting entitlements that affect the rights of citizens. Still stranger is the apparent absence of a parallel right for the local electorate to have a veto power over the same project, even though it might be 60% funded out of council tax revenues.

The argument that re-localisation of business rates is necessary to give local authorities the benefit of the businesses that they attract to their region would largely drop away if local authorities were given an income tax base as the mainstay of their funding. In most areas, local business investment puts income into the hands of local people and the authorities concerned would benefit from the enhanced local income tax revenues that would follow.

Complex solutions

What begins to emerge from this analysis is that the most promising solutions to the funding issues around local government might be better used in combination than on their own. How would that work? There are some key factors to consider, including the balance within the tax system as a whole.

- The tax system in the UK is very centralised by international standards – and probably too centralised. On that, there is a broad consensus. It is also in danger of becoming too focused on income and not enough on capital.

- The national tax system needs a tax on property that is rational, coherent and consistently applied across the country. That tax is not council tax. It might be a tax levied solely on domestic property or it might be a tax that, with modifications, also embraced the business sector.

- The needs of local government are for a revenue base that is more dynamic and that represents a much more significant proportion of the revenues spent than is currently the case. That would improve clarity and accountability.

One way to reconcile and meet these needs would be to make two fundamental changes: first, to give local authorities the power to set the basic rate of income tax for those living in their area; and, second, to abolish council tax in favour of a national property tax.

Income tax could continue to be collected centrally through the same systems that are used today, with the addition of a mechanism for tagging PAYE and self-assessment returns with address-based codes. Initially, the power to set the basic rate could be framed within a limited range, following the precedent of the powers given to the Scottish parliament. Higher-rate tax would be levied centrally as a fixed proportion of income.

This would give local authorities a much more dynamic revenue base. It would create a structure very similar to that in Sweden, where a significant proportion of local government funding is raised directly by local authorities through a tax that is broadly equivalent to our basic rate of tax, with the rate set on a commune-by-commune basis. It would still need to be underpinned by a balancing system of grants, but the aim would be broadly to invert the present ratio of locally to nationally raised taxes.

Such a system could potentially change dramatically the public perception of the role and significance of local government and drive up voter interest and participation. When Sweden reviewed its system a number of years after implementation, the conclusion was that there should be no change in the structure of local taxation because it had clearly encouraged a high degree of interest and participation in local politics.

There are two important preconditions to changing the basis of local taxation in this way. One is that the structure of local government would have to be modified by replacing the present two-tier framework, where it exists, with larger, single-tier authorities. There would be two main benefits to this. A system of larger authorities would help to mitigate the risk that there would be multiple tax rates applying to individuals living within a short distance of each other; and the larger authorities would have the ability to attract management and councillors of a much higher calibre, particularly if their powers had been significantly increased.

The other important precondition is a commitment on the part of central government to put money into improving public-sector skills, particularly those in local government. This would have a significant effect on the quality of local service delivery. It would also be a clear signal from central government that it was serious about empowerment and devolution.

Alongside the changes to income tax, council tax could be abolished in favour of a more broadly based, nationally set tax on land and property. On the domestic property side, bringing to an end the rather tenuous link between the taxation of land and property and the delivery of local public services could only be helpful. It would allow the tax to be levied on a basis that was fairer across the country as a whole, rather than just within communities. In moving to a national basis it would become easier to eliminate the present anomalies that affect those that are asset-rich but income-poor. One approach would be to limit the property tax burden by reference to a proportion of the income tax payable by the occupier; another, more radically, could see an overall limit imposed on the proportion of an individual's total income and gains payable in tax.

With these changes in place, as Iain MacLean observed, it is possible to see a much stronger case for removing inheritance tax, a significant element of which is land and property based. If the value of land were more effectively taxed on a current basis than it is today, the argument for taxing its value again on death would be weakened.

However, none of this is easy. Like any major reform that takes time to implement and time to deliver its benefits, getting it done would be helped immeasurably if there were broad consensus in parliament, at least on the main thrust of the reforms. Even with political consensus, the process of reform would have to move slowly, not least because of the structural changes in local government that would be necessary before the reform of the funding arrangements could sensibly be implemented. Without consensus, there would be a serious risk of the process being halted with the job only half done.

There would also have to be broad consensus outside parliament, requiring a process of consultation and public debate of a kind that is rarely seen on tax matters. It would require vision and commitment on the part of government. It would also require the government of the day to be genuinely committed to devolution. It was not apparent from the outcome of the Lyons inquiry that there was an appetite yet for the devolution of such extensive powers to the regions.

Conclusion

The importance of reform in local government funding should not be underestimated. It is true that the present system is still functioning, but it has serious flaws. It distorts accountability for local government and it frustrates many of the best people who are working to achieve balanced and sustainable economic development in the regions. From a tax policy perspective, council tax leaves much to be desired. It is easy to collect but it collects too much from the wrong people and not enough from the right people. It would not be missed. There are alternatives to the present system. All of them require proper debate and a lot of development work, but there are some real options that deserve closer examination by a government committed to the vision of empowered communities.

Chapter 5

Capital, wealth and inheritance taxes

Dr Irwin Stelzer, Senior Fellow and Director of Economic Policy Studies at the Hudson Institute

Capital, wealth and inheritance taxes

All systems of taxation are designed to accomplish three goals: efficiency, fairness, and the shaping of society. Unfortunately, these goals often pull politicians in opposite directions.

Efficiency dictates avoiding taxes that deter the most talented, hard-working and risk-tolerant members of society from doing their utmost to add to their own and the nation's wealth. Taxes, taught Adam Smith, should not "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".[1]

Efficiency also requires that taxes be levied on consumption in instances where that consumption imposes significant costs on others, or externalities – such as the pollution caused by the consumption of fossil fuels, to take a prominent example. Such taxes add to the efficiency with which resources are allocated by forcing consumers to pay prices that reflect the full costs of their consumption choices, and by generating revenue that reduces the need for incentive-reducing taxes on the incomes of workers and risk-taking entrepreneurs.

In short, tax policy should encourage the optimally efficient use of the nation's human and other resources. At least, so economists would argue.

But considerations of fairness often trump economics; not a bad thing in a democracy in which citizens' notions of fairness must be satisfied lest tax evasion become a national sport. Fairness, or equity, is of course, a concept of infinite elasticity. As John Selden[2] long ago noted:

Equity is a roguish thing. For Law we have a measure, know what to trust to; equity is according to the conscience of him that is chancellor, and as that is larger or narrower, so is equity. 'Tis all one as if they should make the standard for the measure we call a foot a chancellor's foot. What an uncertain measure would this be! One chancellor has a long foot, another a short foot, a third an indifferent foot; 'Tis the same thing in the Chancellor's conscience.

1 Smith, A, Campbell, RH and Skinner, AS (general editors), Todd, WB (textual editor) *An Inquiry into the Nature & Causes of the Wealth of Nations* (Clarendon Press, 1976), p826
2 Reynolds, SH (ed) *The Table Talk of John Selden* (Clarendon Press, 1892), p61

In practice, the quest for fairness becomes a search for means of making post-tax incomes more equal than unfettered market forces would make pre-tax incomes.[3] Different societies have different tolerance levels for inequality, but most deem it appropriate to impose some form of "progressive" taxation on incomes – higher rates of tax on high earners than on those lower down on the income scale. They find support in Smith, who argued that those who benefit most from "the protection of the state", as measured by their earnings, ought to pay a higher proportion of their incomes to the state.[4] Recent experience suggests that such policies at some point raise marginal tax rates to levels that so discourage work, and/or increase the value of avoidance techniques, that the increases become counterproductive.[5]

The shaping of society

Which leaves the third objective of tax policy: what has come to be called social engineering. Some policies favour families as traditionally structured, others confer benefits on farmers in the interests of "food security" or the preservation of the countryside, others encourage home ownership, still others favour certain technologies. The list is rather close to infinite.

With social engineering comes complexity; and with complexity, a reduction in efficiency. For one thing, a complex tax code creates uncertainty: it makes investment planning more difficult, as the net after-tax proceeds of any venture will depend importantly on which of the several provisions of the complex tax code applies.

For another, complexity is costly, both to the taxpayer and the tax collector. Smith warned of a tax structure that "may require a great number of officers, whose salaries may eat up the greater part or the produce of the tax"[6] – an extreme example, perhaps, although some taxes are indeed extraordinarily costly to collect, and others to compute.

Unfortunately, both the search for equity and the desire to create greater satisfaction with the tax system not only create inefficiencies: they fail to achieve their own stated objectives by themselves creating "all sorts of inequities. … It makes people feel that the tax system is unfair and that they are not getting their fair share of tax breaks."[7]

3 In this connection see: Friedman, M *Capitalism & Freedom* (University of Chicago Press, 1982), Chapter X, "The Distribution of Income"
4 Op cit, p825
5 RJ Barro argues that "a roughly uniform tax on the broad middle class" produces fewer inefficient distortions than does a progressive tax on incomes. See: *Getting it Right: Markets & Choices in a Free Society* (MIT Press, 1996), p126
6 Op cit, p826
7 Burman, L "Comment on Tax Policy" in Frankel, J and Orszag, P (eds) American Economic Policy in the 1990 (MIT Press, 2002), p180

Balancing the conflicting goals of efficiency, fairness, and social engineering is difficult enough when dealing with currently earned incomes – witness the periodic furores over executive compensation, and the heated debates about whether and how tax policy should be used to narrow the income gap between high and low earners. It is even more difficult when we are dealing with wealth.

The pursuit of wealth can, and does, drive people to work and take risks; in short, to seek to earn as much as they can. The income they derive from that pursuit is taxed by the state, somehow balancing the often competing demands of efficiency, equity, and social policy. That portion that the state does not seize remains in the hands of the individual – and what is not spent becomes his or her wealth, the accumulation of after-tax income that is not spent on current consumption.

It is therefore arguable that, having once passed through the tax wringer when earned, wealth should be exempt from further taxation. For it seems both unfair to double-tax this wealth,[8] and inefficient in that such a tax might reduce incentives to accumulate wealth by working hard to maximise earnings.

Would that life were so simple. Wealth includes not only the accumulation of the proceeds of work and risk taking, but windfalls, additions to personal wealth completely unrelated to any contribution to society. Homeowners, for example, have accumulated wealth in many countries merely by "being there": the availability of cheap credit, constraints on the supply of housing and other factors unrelated to the skills or effort of homeowners have enriched them significantly.

This is not the place to resolve all of the issues surrounding taxation of all forms of wealth. I leave the resolution of the general problem of wealth taxes to other contributors, and confine myself, first, to the narrower question of whether such accumulated wealth should be taxed when transferred from the person or persons who earned it, to others, when the original accumulators shuffle off this mortal coil. Then, a few more general comments on the making of tax policy.

The "least controversial tax"?

Past experience suggests that inheritance tax is a subject that stirs deep emotions, not least among vote-seeking politicians. Anthony Crosland was simply wrong when he wrote

8 In this connection see: statement by Lord Burnett, House of Lords debate, 1 February 2007, in *Hansard*, column 451

that one advantage of a tax on inheritances is that "they are politically perhaps the least controversial of taxes".[9] Crosland overlooked what Hayek calls "the natural instincts of parents to equip the new generation as well as they can",[10] and Tim Hames more recently called "the powerful psychological appeal to the idea that a little part of us carries on from beyond the grave through what we do with our financial bequest, particularly if it is handed to the children".[11] Will Hutton, although an advocate of inheritance taxes, puts it slightly differently, recognising that: "The human impulse to pass on what you own to your heirs is one of the most primeval and elemental of all."[12]

Indeed, the recent proposal by the Conservative Party to exempt large portions of accumulated wealth from inheritance tax proved so popular, even among the 94% of people who are in no danger of paying inheritance tax, that the Labour government found itself forced to make a similar proposal lest it face an electoral disaster. The government was forced to make up the resulting revenue deficiency, and decided to tax the very resource Smith warned should not bear a heavy burden – work and risk taking, in this case by foreigners resident and working in the UK,[13] and British entrepreneurs. Clearly one among many examples of politics and a sense of what is fair, or at least politically expedient, trumping economists' notions of what is efficient.

Before wading into the controversy surrounding what have come to be called "death taxes", it is useful to note that it has become fashionable for the very rich, and in some cases the only moderately rich, to favour very high inheritance taxes lest their offspring be afflicted with "affluenza" or "brat-lash" – a disinclination to work. Never mind that a survey of children from wealthy families by PNC Financial Services Group found that 80% of these teenagers, "even if born with a silver spoon in their mouths … don't expect life to be handed to them on a silver platter", according to Bruce Bickel, who provides financial counselling to the group's clients.[14]

Such prominent billionaires as George Soros and Warren Buffett have opposed repeal of inheritance taxes, and pledged themselves to limit the amounts they will leave to their

9 Crosland, A *The Future of Socialism* (Jonathan Cape, 1956), p303

10 *The Constitution of Liberty* (Routledge Classics, 2006), p80

11 "It's Time for the Last Rites over Inheritance Tax" in *The Times*, 8 October 2007

12 "The Case for Keeping Inheritance Tax" in *The Observer*, 10 July 2007

13 A mobile group that counts this author among its members

14 "Affluent Teenagers Know Value of Work, Study Says" in *The Wall Street Journal*, 15 March 2007. It is, of course, highly unlikely that a teenager responding to such a survey would declare an intention to become a couch potato or international gad-about on the receipt of a substantial inheritance. His parent and potential benefactor might not be amused.

children so as not to remove the youngsters' incentives to work. Buffett plans to leave each of his three children about £3 million, enough "for a comfortable but not spoilt middle-class existence".[15]

Inheritance as a disincentive

These very rich and self-made men are arguing that receipt of large windfalls is a disincentive to work. As I pointed out in an earlier study of the effect of inheritance taxes,[16] such data as we have supports that view. The major motivation to continue working in Britain is to earn "money to live" and with which to "buy extras", according to a survey by the Economic & Social Research Council. Only 16% of "higher professionals" say they work for "enjoyment", as do a tiny minority of administrators (6%), routine non-manual (3%), supervisor/technician (4%), skilled manual (3%) and semi/unskilled manual (2%) workers.

Robert Taylor of the ESRC points out:

[T]he figures for 2000 suggest that technological innovation and work reorganisation have actually increased rather than diminished the proportion of people who say they work for mainly instrumental reasons.[17]

Other surveys confirm that, given a windfall, many in the UK would simply pack up their tools, shut down their computers, and fail to show up at business meetings. Michael White of the Policy Studies Institute and Stephen Hill of the London School of Economics & Political Science found that 70% of the men and half the women they questioned say the main reason they work is to "earn money for necessities". And Jeff Hyman, from Glasgow Caledonian University, surveyed several companies in Scotland and found, according to the ESRC report of their work: "Working is still seen as a means of securing enough pay to enjoy life outside the job."[18]

These findings are similar to those in the United States. Several studies by economists there have found that the larger the inheritance a person receives, the more likely he is to drop out of the workforce. Scholars at the Maxwell Center for Demography & Economics

15 Quoted in *The Sunday Times*, 16 February 2003

16 *From Grave to Cradle: Building a Meritocracy* (Social Market Foundation, 2002)

17 *Britain's World of Work: Myths & Realities* – Future of Work commentary series (Economic & Social Research Council, undated), pp14-15. Taylor is media fellow on the ESRC Future of Work programme.

18 These studies are reported in: Taylor, R *The Future of Work-life Balance* (Economic & Social Research Council, undated), pp11-13

of Aging at Syracuse University, although very careful not to stretch the data beyond acceptable limits and therefore careful to ring their findings with appropriate caveats, conclude:

An inheritance received by a family reduces the probability that both spouses will continue to work, and increases the probability that both will retire.[19]

And a survey by the Gallup polling organisation found that only a little more than half of working Americans say they would continue to work if they won a lottery jackpot of $10 million.[20]

After summarising these studies, James K Glassman, an economist and journalist affiliated with a conservative think tank in America, is inclined to agree with Andrew Carnegie's much quoted statement: "The parent who leaves his son enormous wealth generally deadens the talents and energies of the son and tempts him to lead a less useful and less worthy life than he otherwise would."[21] That argument was put more recently by Lord Campbell-Savours:

Inherited wealth devalues the value of money by undermining understanding of the relationship between effort, wealth creation and earning through work ... Inheritance too often only generates idleness. Sometimes this demotivation can start well before the windfall as people organise their lives in expectation of inheritance.[22]

This loss to society of the productive effort by inheritors and potential inheritors might, of course, be offset by the inclination of parents and other donors to work less if they know a significant portion of their accumulated wealth is to be conscripted by the tax collector. Deprived of the possibility of passing on their wealth, they might simply take to the golf course, the garden or the couch at an earlier age than would otherwise be the case.

A precise computation of the net effect on the available productive labour supply of inheritance taxes – more work from those who would otherwise be content to live off

19 The income effect producing this result "is statistically significant, although its magnitude is small". Holtz-Eakin, D, Joulfaian, D and Rosen, H *Estimating the Income Effect on Retirement*, Ageing Studies Programme paper no 18 (Syracuse University, April 1999). Other portions of this complicated empirical study suggest limitations on any conclusions about the effect of inheritance on retirement behaviour in many cases.
20 Reported in: *Business Week*, 4 October 2004
21 Glassman, JK "Inheritance and Sloth" in *Forbes*, 11 October 1999
22 *Hansard*, 1 February 2007, column 455

their windfall, less from earlier retirees – is not possible. But there seems no reason to believe that society will incur a net loss if inheritance taxes result in the trade of some years of the labour of mature folks who retire early to avoid taxes, for some years of more intense labour by younger folks whose inheritance has been reduced by taxes.

Indeed, there is good reason to believe that the threat of inheritance taxes will prompt parents to step up their investment in their children's human capital by spending more on their education, acculturation, nutrition[23] and other "contributors to their economic success".[24] That means, of course, that any society having as its goal equality of opportunity will always be frustrated by the fact that offspring of wealthier parents have something of a head start, best described by Nobel laureate economist Gary Becker as "the reputation and contacts their family, their genetic inheritance, and the values and skills absorbed through membership in a particular family culture".[25] But it is clear that equal opportunity would become a still more elusive goal if inheritance tax, labelled by *The Economist* "a meritocratic tax",[26] were eliminated.

The cost of abolishing inheritance tax

It is also clear that if inheritance taxes – indeed, any taxes on wealth – were eliminated, taxes on current productive effort would have to be raised to make up any shortfall, barring an inclination to increase the national debt or cut spending. From an efficiency point of view, that is a poor trade-off, even if the prospect of paying tax when wealth is transferred reduces incentives to work.

Keep in mind that for all of the talk of "death duties" and "double taxation", inheritance taxes are paid by the recipient, not the dear departed. We have already shown that in most cases the recipients will work less. We also know that the originator of the wealth at issue by and large is not persuaded to work less simply because on his passing the government will acquire a portion of his accumulated wealth. The reasons for this are obscure, but

23 See: Loury, G "How to Amend Affirmative Action" in *The Public Interest* no 127 (Spring 1997), p34
24 Mulligan, C *Parental Priorities & Economic Inequality* (University of Chicago Press, 1997), p2. Hayek (op cit) offers the admittedly "cynical" thought that the inability to pass on an inheritance would prompt parents to put their offspring in positions of power to which they are ill-suited, causing "a waste of resources and an injustice much greater than is caused by the inheritance of property".
25 Becker, G *A Treatise on the Family* (Harvard University Press, 1993) (enlarged edition), p179. Anthony Crosland made a similar point more than 50 years ago: "Furthermore, inherited property confers a number of advantages which cannot be measured in money terms, but are manifestly of great significance. It confers access to the best possible education and professional training. It confers security, especially against old age. It confers the freedom to take risks. And it confers a wider range of economic choice between occupations, and between work and leisure." (Op cit, p298)
26 *The Economist*, 10 June 2006

seem to include a fear that ill health late in life can be expensive, and that it is important to continue to accumulate and retain wealth to meet those unpredictable costs. Then there are the usual human motives: "status-seeking … philanthropic ambitions … power lust … [and] job satisfaction" keep even the wealthiest noses to the grindstone.[27]

As with all aspects of tax policy, the arguments in favour of a particular tax must be weighed against often equally powerful arguments against it. Inheritance taxes reduce the possibility that society will be characterised by a self-perpetuating wealthy elite. But they also prevent private parties from becoming powerful counterpoises to state power – unless (and here is one of those wonderful complications that makes policy making so challenging) these taxes encourage the departing wealthy to "cheat the tax man by establishing large philanthropic organisations with sufficient resources to attack government policies".

The lesson to be learned from this exercise is quite straightforward: arguments built on the notion that maximising economic efficiency is the sole goal of policy will not carry the day. Which is a good thing. Economists are most useful when they explain, and if possible measure, the costs and benefits of any policy proposal, and attempt to force politicians to honestly confront those computations. Democratically elected representatives might reasonably decide that the economic costs are worth bearing – that inheritance taxes, although more efficient than other revenue-raising measures, are abhorrently "unnatural"; or that the health benefits of cleaner air are worth having even if the costs of scrubbing the air exceed the measured benefits.

This does not mean that economists should shut down their computers and confine themselves to the production of meaningless results from unrealistic models, leaving the policy world to others. Rather, they should accept, even if grudgingly, that their role in policy making is not decisive. And should not be, in a democratic society.

27 Carroll, CD "Why Do the Rich Save So Much?". At: www.econ.JHU.edu/Papers/Carroll/why.pdf

Chapter 6

Environmental and behavioural taxes

Paul Ekins, Professor of Energy and Environment Policy at King's College London and Director of the Green Fiscal Commission

Environmental and behavioural taxes

Taxes and economic distortions

Most taxes are not intended to change behaviour. In fact, it is conventional wisdom among economists that most taxes are "distortionary", by which is meant that, by changing the decisions and behaviour of economic actors, lower economic welfare is delivered than might have been the case. Thus income taxes reduce the disposable income of workers, so that they receive less for their work, and so are inclined to do less of it. Business taxes (depending always on complex questions of incidence, which cannot be explored here) reduce profits, so that the efforts of entrepreneurs receive less reward and so those efforts are reduced.

Calculating the size of these economic distortions is no easy matter, but one frequently cited calculation from 1985 found that the "marginal excess burden" of taxation in the US at that time ranged from 17 cents to 56 cents, for different taxes, meaning that for every extra US dollar of revenue, US economic output was reduced by 17-56 cents. The figures, calculated by complex economic models with little prospect of validation, are uncertain and contestable. But even at the lower end of the range this is a not insignificant economic cost to pay for the benefits of government spending, over and above the cost of actually delivering the benefits.

There are two kinds of taxes that do not suffer from being distortionary. The first kind, not the subject of this article, consists of taxes on what economics call rents. Windfall taxes on oil extraction, when the oil price has risen significantly, are one example. A tax on land values is another. The auction of radio spectrum licences is a third. These taxes have the benefit, in economic terms, of *not* changing behaviour and therefore of not incurring distortionary costs.

The second kind of tax consists of those that *are* intended to change behaviour, because the behaviour in question is considered to be damaging or socially undesirable in some way. These taxes in fact can have a double benefit. They will reduce the damaging behaviour, making society better-off as a result; and they will raise some revenue which, for a given level of revenue and spending, will not then have to be raised by a distortionary tax, so the distortion is avoided.

Environmental taxes, which are the principal subject of this article, are obvious examples, but there are others that are just as familiar, such as taxes on tobacco and alcohol. These are important because they have behavioural effects (people drink less and smoke less than if these taxes did not exist), but they also raise very significant revenues on a long-term basis, because people continue to smoke and drink enough for revenues to be remarkably stable. This is an important point, which will be revisited below in the context of environmental taxes.

Theory of environmental taxation

The theory of environmental taxation dates from the work of Arthur Pigou, a professor of economics at the London School of Economics, in the 1930s. It is to him that we owe the idea of the "optimal environmental tax". The idea is that the tax rate should be set at the level which will ensure that the marginal environmental damage will exactly equal the marginal economic benefit of the activity that is causing it.

The major difference between the with-tax situation and the situation without the tax is that there is less environmental damage, either because the economic activity becomes less damaging through changes in technology, or because the activity decreases, or some mixture of the two. Unlike the situation with distortionary taxes, these changes in technology or behaviour are socially beneficial, in that economic welfare is increased by the tax (although economic output, which is not the same thing, may be reduced – this is an empirical issue).

In order to arrive at the optimal environmental tax, one has first to calculate the marginal environmental damage, not just in the present situation, but also at the level of the optimal environmental tax. This requires the specification of the whole marginal environmental damage function, also called the marginal environmental cost curve. For complex environmental problems such as climate change, especially, this is a formidably difficult (if not an impossible) task, and much environmental economic ingenuity, in terms of finding ways of valuing those environmental damages that do not register in markets, has been devoted to addressing it.

Another, less challenging approach to setting the environmental tax rate was proposed by Baumol and Oates in 1971, and is called the "standards and pricing" approach, after the name of their article. The approach involves choosing environmental standards on the basis of their desired effects on, for example, human health, or on quality of life more generally, and then using environmental taxes on an iterative basis to bring levels of environmental damage down to meet the standards. Baumol and Oates showed that such environmental taxation had the property that it would achieve the desired environmental improvement at minimum cost to society at large. This has now become the principal approach to and justification of environmental taxes, including those on carbon. Certainly, all the carbon taxes that have been implemented to date have been put in place in order to contribute to defined programmes of carbon dioxide emission reduction, rather than on the basis of any optimality calculations.

Environmental taxes and revenues

The theory of environmental taxation clarifies why it is fallacious to imagine that environmental (or other behaviour-changing) taxes are necessarily unreliable sources of revenues. It is rarely either optimal, or the objective of environmental policy, to drive emissions (or whatever else is being taxed) down to zero. Rather the objective is either to balance the marginal costs of environmental damage with the marginal benefit of the activity causing it (the optimality approach), or to achieve some desired level of environmental quality, which can nearly always accommodate some level of emissions or resource extraction.

Now, tax revenues are the product of two factors: the tax rate and the quantity of consumption of the taxed product. As the former changes, their relationship, and the relevant variable here, is what economists call the price elasticity: the proportional reduction in consumption compared with the price change (due in this case to the increase in the tax rate). If the elasticity is minus one, then a price increase due to an increase in the tax rate will reduce consumption by the same proportion, and revenues from the tax will be unchanged. It is well established that, for example, for most energy use and transport (which comprise the great majority of current environmental taxes), price elasticities are between zero and minus one – meaning that an increase in the tax rate will change behaviour to some extent, *and* result in increased revenues.

If the increased revenues are used to reduce other, distortionary taxes, this might be termed a win:win:win outcome: for society, which gets less pollution, climate change or other environmental bad; for non-polluting taxpayers, who get reduced other taxes; and for the Treasury, which is able to rebalance the tax base away from labour and firms, which are becoming more difficult to tax. This kind of tax shift is sometimes called a green tax shift or green fiscal reform.

UK experience of environmental taxes

The UK has had energy taxes (particularly on road fuels) since well before they were called environmental taxes. They were, and still are, an important part of the revenue base.

However, interest in environmental taxes as such gathered pace through the 1990s, and the first environmental tax in the UK that was explicitly implemented as such was probably the landfill tax, implemented in 1996 at £7 per tonne for active waste and £2 per tonne for inert waste.

This was based on detailed calculations of the environmental damage caused by landfill, and therefore was initially intended to be an "optimal" environmental tax, but it was soon perceived to be inadequate to achieve the kind of shift away from landfill that was desired, and has been raised many times over the past 10 years. Currently at £24 per tonne for active wastes, it is due to increase by £8 per tonne each April until at least 2010/11, in order to contribute to meeting the targets agreed under the EU Landfill Directive. The setting of the rate of the landfill tax now explicitly adopts a "standards and pricing" approach.

The other major environmental tax innovation of the 1990s was the invention of the "escalator", a pre-announced increase in the tax rate of an environmental tax set to continue over a number of years. The Conservatives introduced a 3% escalator on road fuel duty in 1993, and the following year increased it to 5%. There is some doubt as to whether the motive for the escalator was principally environmental or fiscal (the public finances were not in great shape at the time), but as the finances improved, and as the escalator generated substantially increased revenues year on year, there is little doubt that this contributed materially to the ability of the Conservative government to cut income taxes in the years before 1997 – what one might call a "stealth tax shift", because no connection was ever explicitly made between the escalator and the reductions in income taxes.

When it was elected in 1997, the new Labour government early on committed itself to a green tax shift with the publication of a forthright statement of intent on environmental taxation. For some years it pursued this intent with vigour, in its first term of office bringing in the climate change levy (CCL) and the aggregates levy, both on a revenue-neutral basis by matching their revenues with reductions in employers' national insurance contributions. It also raised the fuel duty escalator to 6%.

But the unremitting hostility of business to the CCL, and the oil price increases and fuel tax protests of 2000, allied to lack of cross-party consensus on the need for environmental taxation (the Conservatives withdrew their earlier support of it and denounced it in 2000), caused new Labour in effect to abandon this agenda. By 2006 environmental tax revenues (the great majority of which are energy based) were lower than in 2000, and as a share of taxation had fallen to 7.3%, substantially lower than the 9.1% they accounted for in 1993, before green taxes featured on most national mainstream policy agendas at all.

The issue of environmental taxation has now been placed in high relief by the level of political concern to achieve reductions in carbon emissions to mitigate climate change. In their coverage of Gordon Brown's first major speech on climate change, delivered on 19 November 2007, in which the Prime Minister mused on the possible need for the UK to adopt a stronger emissions target than the present goal of a 60% cut by 2050, the papers reported that Mr Brown had been advised that such a cut would require a significant carbon tax. While not committing to this himself, Mr Brown acknowledged that addressing the issue would require hard choices. Carbon taxes, and environmental taxes more generally, are one of those choices that he will need to make if his carbon-reduction targets are to be achieved.

The future of environmental taxes in the UK

Looking forwards, the argument is sometimes made that the policy scene has shifted, that emissions trading has now become the economic policy instrument of choice for the environment in those sectors that are most responsive to price, and that environmental impacts in other sectors are best dealt with by other policy instruments, such as regulation, voluntary agreements, information or public spending. These arguments seem to me wrong.

First, in respect of those sectors covered by emissions trading there are strong arguments to underpin with a carbon tax the young and embryonic trading schemes – the EU emissions trading scheme (ETS) and the UK carbon reduction commitment (CRC) for large organisations. One reason is to provide a floor for the carbon price and therefore some safeguard for investors against the kind of excessive volatility exhibited in phase one of the EU ETS. Another is that it would tax away some of the windfall gains that have been associated with the grandfathering of EU ETS permits, and allow other taxes to be lowered – in other words, it would give scope for a tax shift.

As more permits were auctioned, as envisioned in the European Commission's proposals for phase three of the EU ETS, the effect of a European carbon tax in parallel with the EU ETS would not be to increase the price of carbon, because this price would be set by the quantity of emissions permits in the EU ETS. Rather, it would divide the price of carbon between the carbon tax and the permit price: the higher the carbon tax, the lower would be the price of permits. Once auctioning reached 100% of permits, of course, there would be no need for both instruments, but an escalating carbon tax would be a very good way of preparing the market for this desirable state of affairs.

Similarly with the carbon reduction commitment – which is already paralleled by the quasi-carbon tax, the climate change levy – raising the CCL steadily over time would not increase the overall price of carbon, but reduce the price of the CRC permits, while providing revenue to government to allow other taxes to be reduced.

In other areas, environmental taxes provide an essential foundation on which other policy instruments can build. History shows that human ingenuity in finding new uses for energy is almost limitless. All energy sources have some environmental impacts, so that some tax on energy use is always justified on environmental grounds to encourage efficient use and to curb such new uses as, for example, patio heaters (where the tax, if desired, could be levied on the product rather than the energy use), which seem a particularly inappropriate innovation in a society trying to get to grips with greenhouse gas emissions and climate change.

Thanks to the policy innovation around environmental taxes in the UK in recent years, there is now quite a diverse environmentally differentiated tax base on which to build. Greatly increasing the vehicle excise duty on low-miles-per-gallon motor cars could send a powerful signal about running costs at the point of vehicle purchase, which could of course be reinforced by substantial purchase taxes for these vehicles, as are in place in a number of European countries. Higher household energy taxes would increase the information value from the energy labels that are now shown on many new white goods – and increase the advertised financial savings too. They would also reinforce the message, which still seems so difficult to get across, that many household energy-efficiency measures actually save money over reasonable time scales.

The 2006 Stern review, *The Economics of Climate Change*, identified the three necessary elements of an effective policy response to climate change as: a robust carbon price, the stimulation of technological innovation in respect of low-carbon technologies, and action to remove barriers to energy efficiency and encourage behaviour change that reduces carbon emissions. The most important of these elements is the carbon price, which is at present nowhere near large enough to achieve the kinds of step changes in energy efficiency that are both feasible and required to meet the emission-reduction targets adopted, or to drive the scale of low-carbon technological innovation that is similarly required.

In fact, systematic implementation of green fiscal reform through energy and carbon tax escalators would give people and businesses time to adjust, but over time would transform the economy. It is not clear that the dramatic reductions in greenhouse gas emissions now being sought by the government, and about to be enshrined in the Climate Change Bill, can be achieved in any other way.

Political challenges of environmental taxation

Apart from the issue of revenue stability discussed above, two reasons are routinely given for why it is either undesirable or impossible to use environmental taxes to achieve behaviour change or reinforce other policy instruments to the desired extent.

The first is their possible effect on competitiveness. In fact, this is a problem that arises for relatively few economic sectors: those that are both energy-intensive and exposed to intense international competition. The right policy approach here is not, because of these few sectors, to back off from environmental taxation for everyone else, but to put in place measures that will mitigate the competitiveness effects in those sectors that are particularly vulnerable.

In fact, two policy approaches are under discussion in this regard: the global sectoral agreements that are on the table in the context of the post-Bali climate change negotiations; and the border tax adjustments that have been advocated by the French President, Nicolas Sarkozy, and which were mooted as a possibility by the European Commission in its most recent proposals on how Europe should seek to reach its climate change objectives. Both policy approaches should be developed in parallel. The UK has much relevant experience in this context, with its own experience of the climate change agreements associated with the CCL, and the border tax adjustments should be used to deter countries or sectors that might be inclined not to join global carbon-reduction efforts but to attempt to free-ride on the efforts of everyone else.

The second reason for concern specifically about household energy taxes is their possible effects on low-income people and households. In fact, these effects only arise because of the still deplorable nature of much of the UK building stock (arguments about fuel poverty are unknown in those Northern European countries that have already invested in energy-efficient buildings), and this is something that needs to be comprehensively addressed anyway if the UK is to have any chance of moving to a low-carbon economy.

There are a whole range of institutional and financial innovations that could be brought into play to accelerate greatly the pace of improvement in UK household energy efficiency, starting with the homes lived in by poor people. A rising tax on the household use of energy would signal to everyone else that the longer they waited before making their homes energy-efficient, the worse-off they would be, and a one-stop energy-efficiency advice service (already largely in existence) should then be available to tell them what to do.

Nevertheless, it is politically unfortunate that carbon taxation occupies such a necessary and central place in carbon-reduction policy, because governments everywhere have found it a seriously challenging policy option. But at least six Northern European countries have addressed the challenge and introduced carbon or quasi-carbon taxes. The task for climate policy that must now be addressed is to introduce these taxes in more European countries, and elsewhere, and to increase their rates substantially over time.

It is clear that such an increase in tax rates will only be politically feasible if done on a broadly revenue-neutral basis, meaning that it is carried out explicitly as an exercise to *shift* the burden of taxation, as discussed above, from "goods" like labour, wages and profits, to "bads" like pollution and resource depletion, rather than *increase* the tax burden overall. It was to explore the full implications of such a tax shift, and break the political logjam on green fiscal reform, that the UK Green Fiscal Commission was launched in late 2007.[1]

Breaking the logjam on green fiscal reform

The political logjam on green fiscal reform arises from the fact that opinion polls, including one carried out for the Green Fiscal Commission prior to its launch, generally show public support for the green tax shift that is the central element of green fiscal reform, but much less backing for the individual taxes, such as those on energy or road transport, that are essential components of such a shift. For example, in the commission's poll, 77% of those polled expressed support for a tax shift, but this fell to 48% support for taxes on petrol or home energy use, with 35% opposed, a level of opposition that makes such taxes politically problematic. But without them there can be no substantial tax shift.

The Green Fiscal Commission, the membership of which includes experts from business, leading academics, senior MPs from all three main UK political parties, three members of the House of Lords, and representatives from consumer and environmental organisations, will assess the social, environmental and economic implications of a substantial tax shift,

1 Information on the Green Fiscal Commission is available at: www.greenfiscalcommission.org.uk

such that, for example, 20% of tax revenues come from green taxes by 2020. It will explore how the environmental benefits of the shift can be amplified by the selective use of a small proportion of the tax revenues to incentivise less environmentally damaging behaviour and investment in technologies that reduce environmental impacts.

The commission will also look into how the shift may be designed so that it does not have a disproportionate impact on already disadvantaged groups, and so that it takes account of business competitiveness, seeking both to mitigate negative effects on competitiveness and to foster new sources of comparative advantage as the basis for new businesses. Finally, the commission will seek to communicate the results of its work in order to raise awareness and understanding of the options for green fiscal reform and stimulate public and political debate on these issues.

Limited green fiscal reforms have so far been implemented in six Northern European countries (Denmark, Finland, Germany, the Netherlands, Sweden and the UK), but the general level of ambition in their implementation has been signally weak. Yet all these green fiscal reforms have been positively evaluated for both their environmental and economic effects. They reduce environmental resource use and achieve environmental improvement at least cost, by promoting both static and dynamic efficiency, through equalising abatement costs and giving incentives for innovation respectively. They raise awareness of inefficient resource use and stimulate new technologies that can lead to new industries. The revenues can allow other, distorting taxes to be reduced, lowering the net cost of abatement. If the benefits of innovation, awareness, industrial cost reduction and reduced distortions are greater than abatement costs, environmental improvement can be achieved at net gain to the economy.

If the environmental challenge, and especially climate change, is one of the defining features of this century, as has often recently been claimed, then finding ways of implementing a green tax shift is going to be an abiding political and economic concern.

Chapter 7

User charges – a reassessment

Dr Jonathan Leape, Senior Lecturer in Economics at the London School of Economics & Political Science

User charges – a reassessment

Over the past two decades, the debates over whether particular services or goods should be produced in the public or private sector have become less ideological as the focus has shifted to a consideration of the relevant legal, institutional and market factors – any of which can be decisive in the real-world context of imperfect information, limits to contracting, imperfect governance (in the public and private sector) and uncompetitive markets. Ideological differences naturally remain, but extreme positions in either direction are difficult to sustain in what has become a more thoughtful and substantive debate on the specific factors relevant in each case.

At a slower pace and with a much lower profile, a similar transition has been occurring in debates over the appropriate role of user charges – or, to put it another way, the appropriate role of pricing and price subsidies – in publicly financed goods and services, whether produced in the public or private sector.

The primary impetus has been a broadly shared concern to improve the efficiency of the public sector in an environment where the public are more demanding consumers of public services and more reluctant taxpayers.

Revenues from user charges are significant and have risen sharply over the past 10 years. A comprehensive measure of these revenues is not available – due to problems associated with decentralised collection (for instance, of local authority charges), definition (the dividing line between charges and taxes, in particular) and accounting practices, among other factors. However, revenues raised from passport fees, for example, increased from £41 million in 1998/99 to £346 million in 2006/07, TV licence revenues increased from £2.2 billion to £2.7 billion over the same period, and it was estimated in 2004 that university tuition fees in England would, by this year, generate net income of £2.8 billion.

Discussions within government have focused primarily on the supply-side impact of user charges, reflecting the emphasis on improving the efficiency of service delivery in the public sector. However, important issues also arise on the demand side, relating to externalities and, more generally, to the efficiency of the choices made by individual consumers – issues that can be understood by viewing the problem from the perspective of the theory of optimal taxation. Finally, user charges raise questions of equity that have, to date, attracted little serious consideration; it is to these questions that I turn first.

User charges and fair taxation

Discussions of "fair" taxation have, historically, been dominated by two views: "ability to pay" and the "benefit principle". Public debate has, for some time, focused primarily on the appropriate role of ability to pay in determining how the tax burden is allocated across individuals – that is, on the appropriate degree of vertical equity.

The benefit principle, in contrast, starts from the recognition that individuals and companies benefit directly from a broad range of goods and services provided by the government. Those that receive more value from these goods and services should, it is argued, pay more. Benefit taxation is thus motivated primarily by concerns about horizontal equity.

Some have argued that the simple fact that a good or service is produced by the public sector implies that it should be available, by right, to all free of charge. But whether a good or service is produced in the public or the private sector is a poor indicator of the appropriate degree of subsidy in its provision. Few would argue that the maps produced by Ordnance Survey, an agency of the government, should be available at no charge to interested firms or individuals. Equally, it would be inappropriate to require the long-term unemployed to pay for job-search assistance, even where that service is contracted out to a private firm. The question of the appropriate price for a public good or service is wholly distinct from the question of whether it should be produced within the public sector or contracted out to private firms.

Where the benefits received by an individual or firm from a publicly financed service or good are readily identifiable and "private" – in the sense that there are no positive spillover effects on others (a point discussed further below) – the case for user charges is strong. Indeed, it is the broad range of such cases that seems to underpin popular support for the notion that "the user pays", a broadly accepted principle of fairness.

Wholly missing from debates over the equity of user charges, however, is their potential role in the taxation of companies. The question of fair taxation has seemed problematic when it comes to companies. Although there is some popular support for the notion of progressive company taxation or, more generally, for the idea that "ability to pay" can be applied to companies just as it is to individuals, there is little economic basis for this position.

The burden of taxes can, ultimately, only be borne by individuals, not by legal entities. Since the shares of large corporations form the basis of the pension portfolios of individuals on lower (as well as higher) incomes, while the (riskier) shares of small companies are, if anything, held disproportionately by higher-income individuals, there can be no presumption that progressive corporate rates are, in the end, progressive in their economic incidence. (Note, however, that there may still be a market-failure-based argument for a lower rate of taxation on small companies.)

While ability to pay is thus of little help in assessing the fairness of company taxation, there is a natural role for the benefit principle. Companies are large-scale consumers of publicly provided services and goods: from legal services such as company registrations and patents, to information such as mapping services and national statistics, to infrastructure in transport and other areas. Where the use and benefits of such services and goods can be identified and measured, the case for user charges, on equity grounds, seems strong.

Free provision of public services and goods implies, in economic terms, that companies bear only a fraction of the cost, with the remainder paid, in effect, by taxpayers generally. A corporation tax rate of 30% implies that even profitable companies pay, in effect, only £30 for each £100 of publicly financed goods and services (since free provision reduces their costs, and hence increases their profits, by £100, leading to an increase in their tax liability of £30). And loss-making companies may pay nothing at all.

User charges can thus help to bring the measure of corporate profits used for tax purposes more in line with economic profits, and thereby contribute to a more rational and equitable allocation of the tax burden between profitable and loss-making companies, between heavy and light corporate users of public goods and services, and between shareholders and non-shareholders. Moreover, as discussed further below, the incentive effects of user charges work to increase the efficient use of resources by companies and may also, by establishing a more effective market, improve the quality of goods and services provided by the public sector.

Taken together, these arguments suggest that user charges – for both individuals and companies – can, as part of the tax mix, work to improve the fairness of the tax system.

User charges and optimal tax theory

For many goods and services provided by the government – including national defence, law and order, and street lights – voluntary user charges are simply not feasible, because the goods are *non-excludable*: it is not possible to prevent from consuming the good those who do not pay for it. Often in such cases it is not desirable to impose user charges, because the goods or services involved are also *non-rival* – that is, once a good is provided, the cost of extending the benefits (for instance, of national defence) to another individual is essentially zero. These are classic "public" goods, whose provision is typically regarded as a core activity of the public sector since the absence of enforceable property rights makes it impossible for private markets to provide them efficiently.

But many of the services and goods provided by government are, in economic terms, "private" goods that could, in principle, be provided by the market. The list is long, from healthcare and education to passports, driving licences, company registrations, MOT testing and even roads.

From a theoretical perspective, user charges are simply one of many price-manipulation policies that may be adopted by governments. Other examples include excise and value-added taxes as well as price subsidies, special cases of which are in-kind benefits and free provision (equivalent to a 100% subsidy). It is widely understood that where governments have distributional objectives, these will, in most cases, be best achieved through income transfers – rather than through price subsidies or in-kind benefits. Whether a particular good or service – say, healthcare, education or food – is "affordable" is not a question about prices but rather about the appropriate level of support to those on low incomes.

The optimal scope and level of user charges (or, conversely, the appropriate role for price subsidies) is, theoretically, part of the generalised, second-best optimal tax problem, which is now understood to encompass three separate objectives. The first and most important of these is revenue collection; the second is interpersonal equity; and the third objective is efficient resource allocation.

From the theoretical results in this field, we know that, with respect to the first objective, price subsidies will be most distortionary – and, conversely, user charges most appropriate – where the good being subsidised is complementary to leisure. In such cases, price subsidies (including free provision) further distort the work/leisure choice, exacerbating the inefficiency caused by income tax.

A price subsidy will be most effective as an instrument for redistribution where consumption of the good is highly concentrated in the target population. Both the "horizontal" and "vertical" efficiency of the subsidy must be considered. The subsidy will be more horizontally efficient the greater the proportion of the target population that consume the good or service being subsidised (so that there are few gaps in coverage). The subsidy will be more vertically efficient the less the good or service is consumed by other groups (so that there is little leakage).

With respect to the third, resource allocation, objective, price subsidies will be most efficient where consumption of the good or service being subsidised generates a positive externality – or, to put it another way, where the social return from the consumption activity exceeds the private return. Health and education are examples where the positive externalities are generally considered to be significant. Interpersonal externalities arise in vaccination and treatment for contagious disease, as well as in the benefits of education in promoting civic responsibility. But there can also be *intra*personal externalities. Where, for example, individuals have a limited understanding of preventive medical interventions – or are simply myopic – subsidies can be welfare improving.

Intrapersonal externalities are an example of behavioural considerations relevant to price manipulation policies. Other important examples include bounded willpower and, especially, bounded rationality. The issue of bounded willpower arises when individuals face self-control problems that lead to short-term choices at odds with their long-term interests. In principle, price subsidies can help to overcome such problems, although in practice other policy instruments such as compulsion or the strategic use of defaults (requiring individuals to opt out of rather than opt into optimal options) may be more effective.

Alongside positive externalities, bounded rationality provides a compelling justification for subsidised or free provision of certain goods and services. Where individuals' access to information, or ability to process it, is limited, their choices are likely to be sub-optimal. This problem is pronounced in healthcare, where individuals lack not only information but also the knowledge necessary to understand it. As a result, individuals are, for example, likely to under-consume diagnostic and preventive healthcare, with adverse implications for their own well-being and, in cases such as contagious disease, for the welfare of others as well. In such cases, free or subsidised provision can enhance efficiency. It was primarily on these grounds that, while endorsing an extension of user charges for non-clinical services (such as private rooms or access to IT services in patients' rooms), the 2002 Wanless report[1] argued strongly against the introduction of user charges for clinical services such as visits to a GP or a specialist.

1 Wanless, D, *Securing our Future Health: Taking a Long-term View* – Final Report (HM Treasury, 2002)

Similar arguments can be made for primary and secondary education, which, although "private" goods (in the sense of being excludable and rival, with identifiable, personalised benefits), generate substantial positive externalities that are generally thought to justify free provision. In the case of higher education, however, studies suggest that these externalities are proportionally lower and a greater proportion of the benefits derive directly to the individual (for instance, in the form of higher salaries). These considerations contributed to the most important extension of user charges in recent UK history: the introduction of university tuition fees. Since the maximum allowable tuition fee was set lower than the costs to universities of educating students, the policy change was, in effect, a shift from a 100% subsidy of university tuition costs to a partial subsidy. Tuition fees also raised incentive issues, around access, which are discussed further below.

Where, conversely, consumption of goods generates negative externalities, free provision (or subsidies) will be distortionary and user charges can play an important role in improving efficiency. Where, for example, roads are subject to congestion, free access leads to inefficient outcomes, as drivers have no incentive to take into account the negative impact of their actions on other road users. As shown by the experience of the London congestion charge, introducing user charges can reduce congestion and lead to a more rational allocation of scarce road space.[2]

So, what are the lessons from this demand-side analysis for user charges? To begin with, the above discussion suggests that where services or goods are excludable and rival, free provision (that is, a 100% subsidy) is likely to be efficient or desirable only in special cases. These include, most importantly, services and goods that have pronounced positive externalities or suffer most from information problems. In general, the optimal subsidy is less than 100% and may even be negative, depending on the nature and scale of any externality as well as the characteristics of consumer demand. For example, while free provision is arguably optimal for many aspects of healthcare (although international practice is mixed), a partial subsidy appears more efficient for higher education and a negative subsidy (that is, a congestion charge) most efficient in the case of road use in large cities.

User charges and supply-side efficiency

The foregoing assessment of the lessons from optimal tax theory and from behavioural economics has focused on the demand side. In order fully to assess the potential role

2 Leape, J "The London Congestion Charge" in *Journal of Economic Perspectives* vol 20, no 4 (2006), pp157-176

of user charges it is also essential to understand issues on the supply side, including the production and provision of services by the public sector as well as the potential market impact. As these issues have received far more attention within government and in the (limited) public debate, I will review them only briefly.

Improving the efficiency of public service delivery has been the primary motivation for introducing user charges. The paper launching the Wider Markets initiative, published by the Treasury in 1998,[3] begins with the statement: "The Government is committed to increasing the efficiency of the public sector, both through the more effective management and delivery of public services and the fuller utilisation of public assets." The incentive effects of user charges have long been recognised; 100 years earlier, in 1897, the government decided to allow Ordnance Survey to retain the revenues raised by selling maps so as to encourage a more commercial operation of the service.[4] One of the three statutory tests imposed by the 1973 Government Trading Funds Act was that financing operations by means of a trading fund, which is allowed to retain revenues from user charges, would improve efficiency and effectiveness in the management of these operations.

User charges can improve the efficiency of public goods and services in various ways. By making the costs of these goods and services more transparent, user charges elicit more reliable information on the benefits of these services to individuals and firms, and to other government departments, while creating stronger incentives for the public-sector providers to control costs. As recognised in the Wider Markets initiative, user charges can also provide a vehicle for the more productive use of public assets, both physical and non-physical (including software, data, skills and intellectual property, as well as equipment, buildings and land). User charges can therefore generate additional resources for core government activities by exploiting the commercial potential of public assets.

User charges can improve the quality of publicly provided goods and services by strengthening incentives for innovation in their development and delivery and for greater attention to customer needs and the costs of meeting those needs. In this way, user charges can enhance knowledge and improve practice in the public sector, with positive spillover effects for the provision of non-user-charged services as well.

3 Enterprise & Growth Unit *Selling Government Services into Wider Markets: Policy & Guidance Note* (HM Treasury, July 1998)
4 James, D "Charging for Mapping Services: The UK Ordnance Survey" in *User Charging for Government Services: Best Practice Guidelines & Case Studies,* public management occasional paper no 22 (Organisation for Economic Cooperation & Development, 1998)

The benefits in terms of quality can, in certain circumstances, be further enhanced through formal contracting between providers and users. This approach has been adopted by Ordnance Survey, which has service agreements with utilities and local authorities to define the services to be provided and prices. In its submission to the Varney report, the Hundred Group of Finance Directors has recently advanced the idea of service agreements between companies and government for key services.

These benefits arise not only with respect to services or goods provided to individuals and firms, but also to those provided to another part of the same government department, to other departments and to the wider public sector. In this respect, user charges can create both supply-side and demand-side incentives within the public sector for improved efficiency. Moreover, the accounting systems required to implement full-cost pricing – which go beyond normal government accounting requirements that are concerned mainly with cash movements – enhance transparency regarding costs and facilitate benchmarking against private-sector providers.

Benchmarking is important because user charging can, if poorly managed, be anti-competitive. The challenges are greatest where there is or may be competition from the private sector and where the public-sector entity is in a dominant position in the relevant market. Although the *Fee & Charges Guide*, last published by the Treasury in 1992,[5] sets out guidelines regarding the target return on capital employed depending on the competitive position, a more formal regulatory framework may be necessary in certain cases.

Implementation issues

The Organisation for Economic Co-operation & Development[6] sets out a number of best-practice guidelines for user charging – including clear legal authority, user consultation, determination of full costs, collection system efficiency, monitoring of agency performance, treatment of receipts, appropriate pricing, equity considerations and competitive neutrality – the full examination of which is beyond the scope of this paper.

It is perhaps useful, however, to highlight several of the important trade-offs that emerge, notably where implementation and political economy issues overlap. One of these relates to the attraction of user charges as an instrument for reducing the tax burden. User

5 HM Treasury *Fee & Charges Guide* (October 1992)

6 Organisation for Economic Cooperation & Development *User Charging for Government Services: Best Practice Guidelines & Case Studies*, public management occasional paper no 22 (1998)

charges reduce the claims on general tax revenues and, formally, count as negative public expenditure, thereby reducing department budgets, all things being equal. However, they can be perceived as "stealth" taxes, especially where usage is near universal, while also attracting criticism on the grounds that they represent a regressive move in the financing of government activities. These issues were highlighted in early 2006, when the Office for National Statistics ruled that the TV licence fee – which raises more than £2.5 billion in revenues – would, in the national accounts, no longer be classified as a user charge but instead as a tax.[7]

A second trade-off relates to the treatment of receipts. Allowing agencies to retain user charge revenues maximises the incentive to improve quality and reduce costs over time. It can also help to increase popular support for the charge, as was apparent in the introduction of the congestion charge in London. At the same time, however, it constrains government from allocating revenues efficiently to priority spending areas – which is why governments have traditionally resisted calls for earmarking and hypothecation.

A third potential trade-off can arise between the incentive effects of a user charge on the choices made by individuals and firms, on the one hand, and the administrative costs of implementing and collecting the charge, on the other. Road pricing provides a classic example. Although the net economic benefits of the London congestion charge seem clearly to be positive, they are less than originally anticipated because the implementation costs far exceeded expectations.[8] Initial proposals for a national road-pricing scheme foundered on concerns at the high level of administrative costs. This latter case illustrates the potential role for – and limitations of – proxy user charges. Existing fuel taxes provide a natural proxy for a general, mileage-based road user charge, with very low administrative costs. Fuel taxes are, however, of little benefit if the policy objective is to reduce congestion.

Concluding comments

The time has come for a more thoughtful and more public debate over the appropriate scope and level of user charges for publicly financed services and goods. A well-conceived increase in the role of user charges can, as I have argued above, enhance both equity and efficiency. By eliminating inappropriate (implicit) subsidies for particular goods or services,

7 Kellaway, M and Shanks, H *National Accounts Classifications: Public Sector Broadcasting*, NACC case 2003/27 (Office for National Statistics, 2006)
8 Leape, op cit

user charges can lead to a more rational and horizontally equitable distribution of the tax burden across individuals and companies.

By facilitating a shift to more differentiated pricing of publicly provided goods and services – replacing the 100% subsidy implied by free provision with a partial or perhaps even negative subsidy – user charges can increase efficiency on both the demand side and the supply side. On the demand side, user charges can allow the pricing of goods to reflect the positive and negative externalities that can arise where there are spillover effects in consumption. On the supply side, by making the costs of public goods and services more transparent, user charges can elicit more accurate information on the value of the goods and services to consumers while also strengthening incentives for public-sector providers to reduce costs and improve quality over time.

At the same time, the foregoing analysis indicates the limits to user charging. Where goods and services are non-excludable or non-rival, user charging will be infeasible or inefficient. Where positive spillover effects are strong, information problems severe or administrative costs high, user charging will be undesirable.

Even in such cases, however, the analytical framework for assessing user charges can be useful as a tool for decentralising information and decisions on the appropriate level of public services. More generally, viewing government services from the perspective of user charging can provide useful insights into the appropriate scope of government, helping to clarify the dividing line between core government activities – such as transfer payments and the provision of key public goods and private goods with broad social benefits – and other activities, where provision may be possible through the public or private sector and where differentiated pricing, through subsidies or taxes, may be appropriate.

Chapter 8

Is tax avoidance “fair”?

Professor Judith Freedman, KPMG Professor of Taxation Law at the University of Oxford

Is tax avoidance "fair"?

Tax avoidance attracts extreme views. Some see it as a great evil, placing a burden on taxpayers who do not, or cannot, avoid tax and thus creating unfairness in the tax system. Others see legal avoidance devices as mechanisms that enable the tax system to operate in a competitive and efficient way: "a tax system breathes through its loopholes".[1] On this view, especially in a business context, avoidance may make arrangements viable by counteracting barriers to commercial activity created by taxation. Which viewpoint one takes depends to a considerable degree on one's philosophical and political starting point.

There is no simple way of resolving this issue by providing a juridical definition of avoidance. We can say that evasion is illegal and avoidance is legal, but this does not help as much as might at first appear.[2] The common thread in all cases of evasion is concealment.[3] A system in which evasion is easy and widespread will be unfair in the sense that the burden of taxation will not be shared in the way in which the legislature has intended it to be.[4] It is harder to tell whether avoidance is fair or not because, since it is legal, it does not, on the face of it, go against the express, or literal, intention of the legislature. The problem is whether one should look beyond that literal intention to some kind of underlying purpose (sometimes referred to as "the spirit of the law") and, if so, how that should be discerned and whose responsibility it should be to decide what it is. Classifying avoidance as *legal* does not tell us whether it is, or should be, *effective* to achieve the end desired by the taxpayer using this method.

Many have tried to come up with a definition of tax avoidance,[5] but at root the problem is that this definition, like one's general view of avoidance, depends on one's philosophical

1 A phrase attributed both to Barry Bracewell-Milnes and to Professor GSA Wheatcroft
2 This is actually a relatively new distinction. See: Kessler, J "Tax Avoidance Purpose and Section 741 of the Taxes Act 1988" in *British Tax Review* no 410 (2004), p377. It is even now sometimes argued by the revenue authorities that avoidance may all too easily slip into evasion. For example, the chairman of HM Customs & Excise has written: "It may be that as the legal principles of avoidance become defined in case law, a business which implements an avoidance scheme which has been held by the courts to be avoidance could be embarking on a course of conduct which amounts to evasion" (Broadbent, R "VAT Compliance in the 21st Century" in *British Tax Review* no 122 (2003), p128). Nevertheless, avoidance is used in this essay to refer only to legal activity.
3 *Report of Committee on Enforcement Powers of the Revenue Departments*, report of the Keith committee, Cmnd 8822 (HMSO, 1983)
4 Of course, whether that is truly unfair depends upon whether the system created by the legislator is fair in itself. Evasion may be both a reaction to an inequitable tax system and a cause of inequity. See: Torgler, B *Tax Compliance & Tax Morale* (2007), p72
5 There is a massive literature. For some classic statements, see: *Tax Avoision*, IEA readings 22 (Institute of Economic Affairs, 1979); Cooper, GS (ed) *Tax Avoidance & the Rule of Law* (1997)

starting point. Helpful legal definitions are possible only where there is a clear underlying concept.

I argue in this chapter that we are lacking the conceptual and principled framework we need in order to evolve a sensible policy towards tax avoidance. Governments are ambiguous about what they are trying to do with the tax system. They want to raise revenue, of course, but they also want to redistribute income and wealth to a greater or lesser degree and they wish to use taxation to mould behaviour and influence the economy. Sometimes these multiple aims conflict and cause confusion. They also create complexity in the tax system.

Ministers and officials make statements castigating tax avoidance, but they also encourage it by virtue of the structure of the systems they create. They offer tax breaks as incentives to behave in certain ways, and these special provisions and incentives create a culture in which tax planning is encouraged and actions are tax driven. This applies, for example, to individuals who obtain capital gains tax relief on their main residences, thus skewing investment decisions and house prices. It applies to employees who are encouraged to participate in a "tax-efficient" salary sacrifice schemes – complex devices to give tax relief (to some and not all) for such benefits as childcare and bicycles – or otherwise to take employee benefits in a "tax-efficient" way. It applies to the small-business owner, for whom the choice between being a sole trader and forming a company can make a large tax difference. And it applies to large businesses, which are encouraged, for example, to be "green", or to invest in certain types of technology or research.

In this way, the prize for behaving "well" is often seen to be a reduction in taxation. This sits uneasily with the idea that tax is the fair price to be paid for participating in a civilised society.[6] Further, the creation of an environment in which tax is associated with tax planning and there is active encouragement to take tax considerations into account when making everyday decisions tends to reduce the stigma that might otherwise attach to the use of artificial constructions entered into for tax purposes, since it appears to the taxpayer to be a normal part of the way our rather incomprehensible tax system operates.

Taxpayers, not unreasonably, see tax as a cost they wish to reduce and are only too pleased to take advantage of opportunities offered by the system – not always in the way intended by the government in introducing the legislation. Tax advisers are highly paid and have

6 Oliver Wendell Holmes, Jr, US Supreme Court of Justice

the resources and ability to spot any gaps in the provisions. In the past, when rates of tax were very high, this was said to be the result of excessive levies, but although tax rates have come down, some still have an appetite for tax reduction and all is relative – if rates are lower, or even nil, elsewhere, then there will be an attraction in moving income to that other jurisdiction.

Often there are opportunities due to great mobility of investment capital available, especially given new technologies. Highly mobile individuals and multinationals may not have any strong sense of owing a duty to a society in which they happen to be for the time being – hence the argument of non-domiciled UK residents that they should pay tax on a different basis from those who are domiciled, and schemes by multinationals to use lower-rate tax jurisdictions or even to move their headquarters to such locations. If tax is a price to be paid for participation in society, how are we to define such participation?

Underlying all these forms of behaviour and the entire psychology of tax avoidance is the belief inculcated by the factors described above: that tax avoidance is legal and, moreover, "normal" (and therefore not "wrong" or "unfair").[7] There may have been some shifts in this attitude over recent years, but to the extent that such a change has occurred it is largely the result of changes in the law, especially new provisions requiring immediate disclosure of many tax schemes,[8] and new forms of anti-avoidance legislation. These have signalled a tightening of the government view on tax avoidance and have made it less cost-effective for promoters of schemes and their users alike.

HM Revenue & Customs gets earlier notice of tax schemes and can shut them down more quickly, even retrospectively in some cases, although that remains contentious and is only done in limited circumstances. In a business context, the approach of HMRC in emphasising the reputational risks and costs of engaging in tax avoidance has created a greater sense of the need for risk management and the need to be able to show that tax-planning schemes have a commercial purpose.[9] Anecdotal evidence suggests that this may have suppressed some of the most artificial forms of tax avoidance over the past three or four

7 For further discussion of these issues, see: Freedman, J "The Tax Avoidance Culture: Who Is Responsible?" in Holder, J and O'Cinneide, C (eds) *Current Legal Problems 2006* (Oxford University Press, 2007)
8 The rules were introduced in the Finance Act 2004 and widened in 2006. For further details, see: http://www.hmrc.gov.uk/aiu/summary-disclosure-rules.htm
9 For information on the HMRC "Tax Law in the Boardroom" initiative, see: http://www.hmce.eu/lbo/tax-in-the-board-room.htm. This may mean that fewer off-the-shelf tax schemes are being undertaken but it is quite possible that some of this activity has moved over to tailor-made schemes that can be demonstrated to have a commercial purpose.

years, in a business context at least, but it is clear that not all tax avoidance activity has ceased[10] and it is highly unlikely that it ever will.

Rational people will always attempt to minimise their tax bills within the law. Calls to act in a socially responsible way will be effective only if backed by regulation, because social responsibility does not work clearly in a uniform direction in a tax context, because of the differing philosophies of taxation. As a result, if avoidance is to be reduced, the focus must be on removing distortions from the tax system that make artificial behaviour worthwhile and even necessary for commercial purposes and on improving the techniques used by the law to place legitimate limits on this activity.

A new guiding principle?

It was established in 1936 by the House of Lords in the *Duke of Westminster* case that "every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be".[11] In other words, tax minimisation seems to be sanctioned in a statement from the highest judicial authority, a statement that has not been directly overturned by the courts or parliament. Moreover, it is sometimes argued that for a trustee or a company director, tax minimisation can even be seen as a duty.

This statement of the current position is over-simplistic,[12] and some would say that it has now been qualified by subsequent case law, but exactly how far this subsequent case law goes is far from clear. It may be that we have a judicial principle, the so-called *Ramsay* principle,[13] which enables the courts to look at a transaction as a whole in some circumstances to combat tax avoidance, but it has recently been stated by the House

10 The TUC claims that the public purse loses £13 billion a year through tax avoidance by the wealthy and £12 billion a year through tax avoidance by corporations. Altogether this adds up to £25 billion – or around £1,000 a year for everyone at work in the UK (TUC press release of 30 January 2008, based on 2008 TUC report *The Missing Billions*). These calculations rely upon a broad, and sometimes contentious, definition of avoidance. HMRC has been reticent about estimating the "tax gap", particularly in relation to direct taxes, and is not convinced that it has robust figures. See: HM Revenue & Customs *Developing Methodologies for Measuring Direct Tax Losses* (October 2007)

11 *IRC* v *Duke of Westminster* [l936] AC I, per Lord Tomlin

12 In the case of company directors, the duty is neither to minimise tax payable nor to maximise profits but, under section 172 of the Companies Act 2006, to promote the success of the company for the benefit of its members as a whole. This can take into account longer-term considerations, including: (a) the likely consequences of any decision in the long term; (b) the interests of the company's employees; (c) the need to foster the company's business relationships with suppliers, customers and others; (d) the impact of the company's operations on the community and the environment; (e) the desirability of the company maintaining a reputation for high standards of business conduct; and (f) the need to act fairly as between members of the company.

13 From the case of: *WT Ramsay Ltd* v *IRC* [1982] AC 300 (HL)

of Lords that this is not a special principle of revenue law but simply an application of normal principles of statutory interpretation, so it is far from certain whether there is any special judicial approach in revenue law now or not.[14] In any event, the *Duke of Westminster* principle described above is widely seen to be the correct starting point for a discussion on tax avoidance even today.

If we are to make progress on tax avoidance, the *Duke of Westminster* principle requires explicit legislative qualification, preferably in the guise of a further principle or set of principles explaining the limits of permissible and effective tax minimisation. It would be naive to think that this could resolve all the issues. A general legislative provision along these lines, known as a General Anti-Avoidance Rule or GAAR, is used in other jurisdictions[15] and has not solved all the problems in those countries.

Nevertheless, a GAAR, or preferably a General Anti-Avoidance Principle (GANTIP),[16] embodied in legislation, would give us a democratically agreed starting point. It is the task of government to set out the parameters, rather than leaving this to administrators, the courts and the media, even if the first two of these bodies will have to flesh out the provisions and make them workable. These institutions need a legitimate framework within which to develop the law.

Avoidance and the philosophy of taxation

Libertarians will start from the viewpoint that tax should be levied only so far as essential to maintain a minimal state and that there should be as little interference as possible with property rights. Thus Nozick suggests that redistribution is a serious matter indeed as it involves the "violation of people's rights".[17] Irwin Stelzer has argued that avoiders (since

14 For further discussion of this question, see: Freedman, J "Interpreting Tax Statutes: Tax Avoidance and the Intention of Parliament'" in *Law Quarterly Review* vol 122, no 52 (2007)

15 Including Australia, New Zealand, Canada, South Africa and Hong Kong as well as many civil law countries. For a survey of GAARs around the world, see: contribution by D Pickup in Freedman, J (ed) *Battling with Boundaries* (Oxford University Centre for Business Taxation, forthcoming), and: http://www.sbs.ox.ac.uk/NR/rdonlyres/ADCF9118-236D-4E86-88B5-EF793FBC7ED9/0/Pickup.pdf)

16 A term coined by this author in: Freedman, J "Defining Taxpayer Responsibility: In Support of a General Anti-avoidance Principle" in British Tax Review no 332 (2004); and now adopted in the TUC paper *The Missing Billions – The UK Tax Gap* (2008), where the call for such a principle has been taken up and repeated. This should be a principle rather than a rule because it needs to be broader than a detailed rule so that it can be used as a guide to interpret the rule. See: Braithwaite, J "Rules and Principles: A Theory of Legal Certainty" in *Australian Journal of Legal Philosophy* no 47 (2002). The UK government has made some progress in this direction through the use of what it has called Targeted Anti-Avoidance Rules or TAARs, which apply only to specific areas but which are nevertheless wider than ordinary specific anti-avoidance provisions.

17 Nozick, R *Anarchy, State & Utopia* (Basic Books, 1974), p168

they act legally) render unto the government that part of what they earn and own that is by law the government's, and keep the rest for themselves, *since it is their own* (my italics). He states that "to stigmatize this process of avoidance is to assume that all of the nation's income belongs to the Treasury, which then benignly allows the public to keep some portion of it".[18]

If one assumes a starting point in which there is an entitlement to existing property rights provided they came about in a just way, then the views expressed above appear logical but, as Green has pointed out, in reality property ownership is not so simple.[19] All property comes with inbuilt limitations to which it is subjected by society, and many acquisitions will have been tainted by some injustice in the system somewhere along the way. Thus, even for libertarians, some redistribution may be needed to achieve a rough system of reparative justice.

The libertarian position tells us only that redistribution requires justification and not that it should not take place. The question then becomes the way in which it is decided and conveyed to the taxpayer that tax is to be levied on his property or earnings. If that is done in a proper democratic fashion, any complaints should be dealt with through the political process and not by an argument that taxation is a form of expropriation, since once it is legitimately decided that tax is due, this part of the relevant property is no longer the taxpayer's "own"; perhaps we can say it never truly was.

The question is then how this process of levying tax (that is, deciding what does not belong to the taxpayer) is to be legitimately undertaken. It would be widely agreed that an elected government needs to apply settled criteria and the rule of law requires that it do so with sufficient clarity to ensure that the levy of taxation is not arbitrary. For a libertarian, the onus would be on the government to show that property rights were curtailed in a justifiable way. This approach has been used in the past in the UK in the courts and elsewhere to justify a strict and even a literal approach to statutory interpretation of tax statutes. In Monroe's colourful words:

If Government was to interfere with property, pry into a man's affairs and take his money one thing was certain – there must be clear statutory authority. Parliament was the starting point – so be it. There could be no taxation without representation: that was not

18 Lecture delivered by Irwin Stelzer to Politeia in March 2006, reported in *The Times*, 7 March 2006
19 Green, L "Concepts of Equity in Taxation" in Maslove, A (ed) *Fairness in Taxation: Exploring the Principles* (University of Toronto Press, 1993)

just an entertaining historical anecdote. It was the stuff of society, the faith of our fathers. And if Parliament intended to tax, it must have said so clearly.[20]

An alternative philosophy of taxation might alter the onus of proof described above. For example, Murphy and Nagel argue:

It is logically impossible that people should have any kind of entitlement to all their pre-tax income. All they can be entitled to is what they would be left with after taxes under a legitimate system, supported by legitimate taxation – and this shows that we cannot evaluate the legitimacy of taxes by reference to pre-tax income.[21]

This theory does not deny the importance of taxation being legitimate. The rule of law applies; arbitrariness is unacceptable. The starting point is not, however, one of an entitlement to the whole pre-tax income that is being undermined by taxation, but of an acceptance that taxation is essential to the existence of the system and institutions that make government (and, for that matter, the market) possible. This perspective might be thought to support the view that there is a social responsibility to pay taxes and that there might be a duty on the taxpayer to abide by the *spirit* of the law in order to fund the society that makes his activities possible.[22]

Reconciliation of views – interpreting the law

The philosophical differences on taxation law which give rise to different attitudes to tax avoidance cannot be resolved by legal technique, but we can achieve a reconciliation sufficient to give a workable result. In practice, there is a considerable degree of consensus. All serious players in the debate are agreed that tax can be levied legitimately, and that there is a duty to pay such tax as is thus imposed. There are differences on the optimal size of the state and thus on the level of deduction desirable, and there are value judgments to be made on how progressive (or redistributive) that tax should be. This has to be decided by the law based on a democratic political decision.

What is a "fair price" to pay for being a member of society is not determinable as a matter of morality, for as Professor Tony Honoré has pointed out:

20 Monroe, HH *Intolerable Inquisition? Reflections on the Law of Tax* (Stevens & Son, 1981)
21 Murphy, L and Nagel, T *The Myth of Ownership: Taxes & Justice* (Oxford University Press, 2002), p33
22 See, for example: Polly Toynbee "Fairness is Forgotten in a Culture of Tax Avoidance that Shames Britain" in *The Guardian*, 29 February 2008

Taxpayers cannot settle [a reasonable contribution] for themselves, as people can within limits settle for themselves, say, the proper way of showing respect for the feelings of others. Apart from law no one has a moral obligation to pay any particular amount of tax. An obligation to pay an indeterminate amount is not an effective obligation; it requires only a disposition, not an action. So, apart from law no one has an effective obligation to pay tax.[23]

So, once there has been a political decision about what and how much to tax, the law has to describe this obligation by using proper parliamentary procedures. What is a "fair" contribution then becomes a question of statutory interpretation.

Interestingly, the TUC's definition of tax avoidance includes a situation where "less tax is paid than might be required by a reasonable interpretation of the law of a country".[24] The problem with this definition is that it is not particularly useful unless we go on to address the question of how one decides, and who should decide, what is a reasonable interpretation. Given that there is often uncertainty about the outcome of tax cases, and that the judges of the highest courts in the land can be divided, is it unreasonable to apply an interpretation of which the taxpayer and his advisers are 80% certain? What about 50%? How unreasonable should the interpretation be before it is considered reprehensible tax avoidance under this definition?

The answer is that ultimately, at the borderline, which schemes succeed and which fail is a question for the judiciary. Most tax avoidance will be on this difficult borderline, since tax advisers are generally too clever to advise clients to undertake schemes that will surely fail. The legislation means what it is held to mean by the courts. If it applies in the way the taxpayer suggests, there will not, strictly speaking, be any avoidance since parliament will have been held to intend this.

In the words of Lord Hoffmann:

... tax avoidance in the sense of transactions successfully structured to avoid a tax which Parliament intended to impose should be a contradiction in terms. The only way in which Parliament can express an intention to impose a tax is by a statute that means that such a tax is to be imposed. If that is what Parliament means, the courts should be

23 Honoré, T "The Dependence of Morality on Law" in *Oxford Journal of Legal Studies* vol 13, no 1 (1993), p5
24 TUC *The Missing Billions – The UK Tax Gap* (2008)

trusted to give effect to its intention.[25]

If we do not trust the courts to interpret the tax legislation as parliament intended, it may be because parliament is not giving clear enough signals or statements of the purpose of the legislation. Perhaps the law has become too complex to do this, or perhaps the purposes are unclear, even to the legislators. In that case the answer lies with better legislation, and not with some imprecise call to honour the "spirit of the law". Reliance on some form of "social responsibility" is also impractical and unfair where the law is unclear since, as argued above, how much tax should be paid is not a question of moral intuition but a question of what is imposed by law.

For a taxpayer, the strongest case for looking beyond the law for guidance on whether to enter into a tax scheme is that of reputational risk: would the taxpayer be happy for the media to publicise its activities? The problem here is that the media or other commentators may not understand the position properly due to the complexity of the tax system. A recent example was the line of questioning in the Public Accounts Committee when it was suggested that one large company, a household name, had paid no corporation tax and that this was reprehensible, when on further questioning it appeared that this was due to a deduction for pension contributions provided for in the legislation for policy reasons.[26]

Neither is it clear what the public reaction will be to publicity about tax minimisation by taxpayers. There may well be adverse reaction to tales of those who fail to disclose their income or wealth and hide it in tax havens illegally, but whether this criticism would extend to a business that reduces its DVD prices by selling them from an offshore base to avoid VAT, for example, is far less clear, especially if the result is cheap DVDs for consumers. If and to the extent that this is not prevented by legislation, would, or should, a corporate taxpayer feel that it had anything to hide?

It is not clear that it is desirable to substitute the judgment of the media for that of the legislature and the courts in deciding what is acceptable Sometimes there is a case where it is obvious that parliament has left a gap and that this is being exploited by the taxpayer. In that case, the courts may agree that this contravenes the intention of parliament. Taxpayers will take a risk if they go ahead with any such scheme. The question the courts

25 Hoffmann, L "Tax Avoidance" in *British Tax Review* no 197 (2005), p203
26 *Management of Large Business Corporation Tax*, uncorrected transcript of oral evidence to be published as HC 302-I Public Accounts Committee, 28 January 2008

will ask is "whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically".[27] It is up to the legislator to provide the information needed for that question to be answered sensibly and to provide a mechanism for the courts to use to fill such gaps.

This takes us back to the suggestion of a GANTIP made at the start of this essay. A GANTIP could assist by providing a principle that, for example, would apply to override the specific legislation where a transaction was undertaken for the sole or dominant purpose of conferring a tax benefit on a person. The words used here are based in the formulation used in Hong Kong – others are possible and the precise wording would require much discussion should such a provision be considered for the UK.

Such a principle would still require the judiciary to exercise a good deal of skill in interpreting the provisions before them, but it would give them a new starting point and they would not have to rely solely on possibly unclear specific legislation. Ideally, specific legislation would also be improved to include statements of its purpose, but attempts to do this have proved contentious so far,[28] and this is a topic that requires a good deal of further attention.

I have argued here that there is a need for an overriding principle that looks beyond literal interpretation. To some extent this has already been achieved by the judiciary using normal principles of statutory interpretation, but the results from the decided cases are not consistent. Covering every possibility in the legislation is not possible: tax law is too complex and too much detail can itself give rise to loopholes since something is bound to be left out. A GANTIP would not necessarily increase certainty nor answer all the questions, but it need not reduce certainty either and it could prove a valuable base principle.

We cannot answer the question of whether tax avoidance is "fair" in abstract terms. It is only "unfair" if it runs counter to the intention of parliament, and in order to determine that we need proper and predictable principles of statutory interpretation rather than guesswork on the part of the taxpayer, the revenue authorities and the courts. The "spirit of the legislation" and the proper interpretation of the legislation should be one and the same thing if fairness is to be achieved. A GANTIP would provide a bridge to reconcile these two meanings.

27 *Collector of Stamp Revenue* v *Arrowtown Assets Ltd* (2004) 1 HKLRD 77 (Hong Kong)
28 Proposals for a principles-based approach to financial products for avoidance were published by HMRC in December 2007 but the approach was not utilised in the Finance Bill 2008 due to criticism. However, work continues on this new approach to legislation.

The Smith Institute

The Smith Institute is an independent think tank that has been set up to look at issues which flow from the changing relationship between social values and economic imperatives.

If you would like to know more about the Smith Institute please write to:

The Director
The Smith Institute
3rd Floor
52 Grosvenor Gardens
London
SW1W 0AW

Telephone +44 (0)20 7823 4240
Fax +44 (0)20 7823 4823
Email info@smith-institute.org.uk
Website www.smith-institute.org.uk

Registered Charity No. 1062967

Designed and produced by Owen & Owen