

Taxation: **time to come clean**



UK INDEPENDENCE PARTY

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POLICY STATEMENT

A flat tax system for Britain

- Make all taxpayers better off (mostly by £1,100 per year) and take a further 4.5 million lower paid out of income tax altogether
 - by raising the tax-free personal allowance to £9,000
 - and merging existing income tax bands and employee's National Insurance contributions into a single *flat* income tax at a rate of 33%.
- Reduce the rate for capital gains tax to 33% and scrap inheritance tax altogether.
- Finance the revenue shortfall by halting the *growth* in government spending.

Britain's economy is being suffocated by high taxation and a mass of complex rules for tax and benefits that diminish the rewards from work and enterprise. Radical reform is essential if we are to remain competitive in the global economy and maintain our level of prosperity.

To make a start, the UK Independence Party proposes to raise the personal allowance and replace the existing income tax bands *and employee's national insurance* with a single rate of tax at 33%. We also propose to scrap inheritance tax.

These reductions in taxation will improve incentives across the income spectrum while the raised personal allowance shifts the tax burden further towards those who can afford to pay.

This initiative should be seen as just the beginning of much wider reform of the tax and benefit system. It should also be seen in the context of UKIP's insistence on drastic reduction in regulation.

September 2006

1. Britain's public finances

Hold back government spending ---

During the past 6 years, British government spending has risen by an astounding 51%, or 30% in real terms (after adjusting for inflation) and a further real increase of 6.7% is planned over the next 3 years.¹ Our government now spends 45% of national income, *equal to £9,000 per man, woman and child.*

High government spending means high taxation and, while most major economies have been reducing tax burdens, the British government has been taxing more. From being a low tax-and-spend economy relative to our EU neighbours, we are catching up fast.²

However, it is becoming harder and harder for our government to raise the necessary revenue to support its spending binge. As a result, government borrowing has now been driven up to £44bn per year or 3.6% of GDP, despite concealing a large proportion of spending under the veil of Private Finance Initiatives.³

This is not sustainable. If the government's share of the economy continues to rise at these rates, we shall continue to lose international competitiveness and our businesses will continue to move offshore, attracted by lower tax rates in other countries and particularly the emerging economies.

--- to allow for lower taxation

Much of the extra spending has gone into public services, notably the NHS and education, but only a fraction of this has paid for new 'front line' staff. In spite of repeated claims by the government that public services are improving, the extra resources have largely been dissipated on waste and low productivity.⁴ UKIP believes that the disarray and low morale in all our public services is the result of the government's obsession with micro-management, with streams of new centrally-imposed initiatives, restructuring and performance targets. Our public services need a change in management style to allow more control by the professionals that run the services, rather than more money.

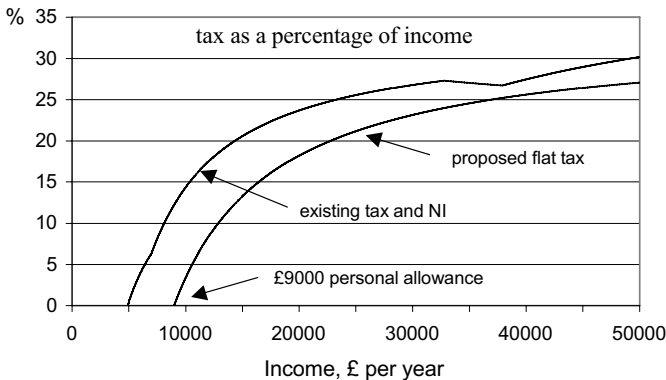
The other major cause of expansion in government spending is the social security budget which now absorbs £150bn or over a quarter of total spending, with means-tested benefits accounting for much of recent increases. State help must be available for those who cannot help themselves. However, it is painfully obvious that the current over-complicated benefit system is very poor at directing funds to those who need them and it provides powerful incentives against working. Again, the system needs drastic reform (see Section 3), not more money.

UKIP thus proposes to freeze government spending in real terms. Firstly, we do not accept the argument that improvements in services require ever-increasing government expenditure. Secondly, and more important, in sucking in more and more funds to pay for its spending, the government is killing off the productive activity that provides those funds.

With spending anchored, it will then be possible to halt the relentless rise in taxation and there will be sufficient funds to justify a modest reduction. Our proposal for a flat income tax is a first stage in the essential programme of easing the tax burden and, more generally, reducing the size of government.

2. UKIP's tax proposals

There have been several proposals for flat income tax in Britain, all of them directed generally at reducing taxation and simplifying the tax regime.⁵ UKIP's proposal recognises that national insurance payments (and self-employed NI) are essentially an additional income tax rather than contributions to a social fund. We would combine income tax and employee's NI contributions into an income tax at the single rate of 33% for all income above a raised personal allowance of £9,000 per year.



Income, £ per year	7000	9000	15000	20000	25000	30000	40000	50000
existing tax & NI	446	1106	3086	4736	6386	8036	10989	15089
proposed tax	0	0	1980	3630	5280	6930	10230	13530
reduction, £ per year	446	1106	1106	1106	1106	1106	759	1559

Fig 1. Tax before and after the change. Existing tax (2005-6) is calculated by adding the marginal rates for income tax and employee's national insurance contributions (known as class 1 primary).⁶

As is clear from Fig 1, all taxpayers are better off under the new regime. In particular, taxpayers with incomes in the range £9,000 to £33,000 (77% of all taxpayers) will gain £1106 per year. The 11% of taxpayers who now pay at the higher rate will enjoy a reduction in this rate from an effective 41% (tax plus NI) to 33%, but income tax remains highly progressive – the rich pay continue to pay more than the poor, as a proportion of their income. These changes will improve incentives across the income spectrum and help to drive economic growth.

Some further detail: NI contributions

Treating employee's NI contributions as a pure income tax requires some further changes:

1. Since pensioners do not pay NI, a 33% tax rate would imply higher tax payments (specifically, on incomes above £15,000). To prevent this, there would be a special flat rate of 25% for pensioners only, pending a review of overall pension arrangements. Given the £9,000 threshold, this would amount to a tax reduction for all pensioners with incomes up to £30,000.
2. The state pension would no longer be 'contributory', i.e. dependent on NI contributions, allowing for a reduction in means-tested pension credits.
3. 'Contracting out' would no longer be possible. Existing obligations under the Second State Pension would be upheld.
4. Income from self-employment would be taxed at the same rates as income from employment (no more class 2 and class 4 NI contributions and no more arguments about who is self-employed and who is an employee).

Inheritance tax

With income tax levied at a maximum rate of 33%, it would be inconsistent to continue charging tax on capital gains and investment income at the higher rate of 40%. These rates would simultaneously be reduced from 40% to 33%, giving a further boost to saving

Inheritance tax (IHT) is also currently charged at 40% on estates above £285,000 but, with increasing values of houses, more families with modest wealth are now becoming liable for IHT. As a result, there have been many justifiable calls for raising the threshold to, say, £500,000 or £1 million. There have also been suggestions to replace IHT with some form of wealth tax.

However, the small amount of IHT that is actually collected (£3.2bn per year) is evidence of the extent to which this tax is avoided by higher wealth individuals who can afford to pay for tax planning. Given this low yield, and since IHT is poorly directed and expensive to collect, UKIP's simple solution is to abolish it altogether with immediate effect.

Paying for the tax cuts

The *static* loss in revenue from these proposals is about £34bn,⁷ equivalent to 7% of total revenue collected in 2005-06. But this static loss is based on the assumption that the changes in rates have no effect on economic activity; it is calculated by multiplying the percentage cut in tax rates by the number of taxpayers currently paying the tax.

In practice, cuts in tax rates stimulate activity by raising the reward from working and they reduce avoidance and under-reporting of income.⁸ As a result of these *dynamic* effects, the loss of revenue from a cut in tax rates is never as severe as would be predicted by static calculations. There is widespread experience of this, including several historical episodes of tax cutting in the United States, the recent cuts under President Bush and the Thatcher reforms in Britain.⁹

However, the magnitude of these *dynamic* effects is uncertain: taking account of a variety of evidence and model predictions, a conservative mid-range estimate is that the revenue loss would fall to half of this amount, or £17bn, within, say, 2 years¹⁰ with further falls as the tax cut stimulates economic growth.

The saving from freezing government spending so that it remains constant in real terms over the next three years would be roughly £12bn per year, *cumulative*, i.e. the government would be spending £36bn less than projected by 2009/10. Hence, by the second year in operation this source alone would be sufficient to fund the flat tax.

The initial shortfall in revenue (£34bn) would be taken up by an increase in government borrowing. This is easily affordable at present, given that Britain's national debt (about 38% of GDP) is much smaller than the debt/GDP ratio of other large developed nations including our EU neighbours. True, the rise in deficit, to around 6% of GDP, would push Britain even further away from its commitment to the European Union's 'Stability Pact' borrowing limit of 3%. However, this limit has been routinely breached by most EU countries, and EU rules are anyway of no concern to UKIP.

Indeed, the extra borrowing should be viewed as an investment in a more vibrant economy. When it is followed by a programme of further reforms to the UK tax and benefit system, UKIP is confident that it will be handsomely repaid.

3. Further reforms

Our proposal for flat income tax covers only a small part of the overall tax-benefit system and comprehensive reform is also necessary in several other areas. Some suggestions follow, without any attempt to cover detail. We do not address pensions or the interaction of pension arrangements with the tax-benefit system.

Allowances, reliefs and exemptions

The amalgamation of income tax and employee's NI in this flat tax proposal will bring some welcome simplification. However, the main source of complexity is the many allowances, reliefs and exemptions from income tax, which are hard to justify and impose a tremendous bureaucratic cost. This is illustrated by the guide to completing the standard income tax return which runs to 56 pages or some 60,000 words. 'Self-assessment' is an attempt to offload some of this cost on to the private sector.

UKIP's attitude is generally to scrap reliefs and allowances (apart from the personal allowance) and some, like the Enterprise Investment Scheme and Venture Capital Trusts should go without delay. The question of relief for contributions to private pension schemes (costing £13bn per year) would have to form part of a review of pension arrangements.

Taxes on companies

Corporation tax (tax on company profit) is currently at the rate of 19% for small companies (profit up to £300,000 per year), rising to 30% for large companies (profit over £1.5 million per year). There are several reliefs of doubtful merit (notably for research and development) and complicated rules governing depreciation.

While other countries generally have been reducing their corporation tax rates, Britain has not. This is unquestionably a major factor in firms' decisions to relocate their operations to lower taxed countries. As with income tax, there is an urgent need to both reduce and simplify corporation tax.

The other tax on companies is employers' national insurance contributions (12.8% of wages), which is the most senseless tax as it taxes the payroll – it is a direct tax on employment. Employers' NI must be a deserving candidate for abolition or for combining into corporation tax as part of a reduction in the overall burden of taxation on business. We want to encourage businesses to grow and to provide jobs.

Other Taxes

The main sources of government revenue are income tax and National Insurance, Company tax, VAT and excise duty. These taxes together raise £373bn or 77% of all revenue. In comparison, inheritance tax raises only £3.2bn, capital gains tax raises £2.9bn and tax on dividends £6.2bn¹¹

Taxes on dividends and capital gains tax (on financial assets) represent double taxation because the company profits that gave rise to the dividends and capital gains have already been taxed. Moreover, the rules for the capital taxes – on inheritance and capital gains – are perhaps the most complicated of all, often absorbing large amounts of expensive professional time in administration, in estimating values of assets and in legitimate avoidance activities.

We have recommended the elimination of inheritance tax and a reduction in the rate for capital gains tax to 33% as part of our main proposal. However, given the damaging effect that all these taxes have on earning and saving and the comparatively small amount of revenue that is collected, there is a strong case for removing the taxation of dividends and capital gains as well.

The indirect taxes, VAT and excise duty, are *regressive* in that the poor pay far more as a proportion of their incomes than the rich. As part of the exercise of reducing tax, there is therefore a good case for reducing the rates for these taxes before seeking further cuts in income tax, which is *progressive*. To reduce the administrative burden of VAT, UKIP would consider replacing it with a sales tax payable at the wholesale point (not possible whilst Britain remains bound by EU tax rules).

The benefit system

For a large range of below-average earners, the combined effect of the tax system and means-tested benefits is that working brings only a tiny reward. For example, the head of a family earning up to £11,000 per year and drawing the main benefits and tax credits can face a *marginal deduction rate* of up to 95% (see Fig.2).¹² This means the family is only 5p better off from each £1-worth of extra work after accounting for tax, national insurance and the withdrawal of tax credits and benefits. This reward is eroded further by travelling costs and other ‘costs’ of working. At present, there are some 5 million claimants of major benefits who face this sort of ‘poverty trap’.

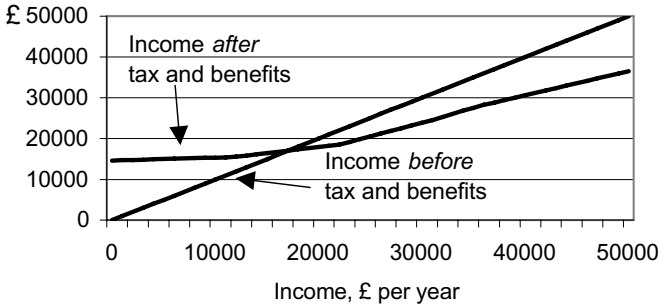


Fig 2. Extra work brings negligible reward. The effect of tax and benefits on the earnings of a family with 2 children living in local authority housing.

This absurd state of affairs causes real anger amongst those lower earners who are still trying to earn an honest living while they see others relying on handouts. And the complication of the system has led to easy abuse and abundant failures in administration, notably with the disastrous tax credit system.

To restore incentives, UKIP envisages a large reduction in the range of existing means-tested benefits which together cause the ludicrously high marginal deduction rates for low income families. We would consider replacing them with an income-related ‘basic cash benefit’ payable to all unemployed and low-income adults¹³ (transferable between spouses) and would aim for a maximum marginal deduction rate of, say, 50% after accounting for tax and the withdrawal of benefits. Instead of pocketing just 5p for an extra £1 of earnings, our family breadwinner would then at least keep 50p. We would also raise the (non-means-tested) child allowance. Housing benefit and its relationship with social housing merit special attention; details are beyond the scope of this note.

Taken together, these changes would improve the rewards from working right across the income spectrum and would be more favourable to families and married couples than at present. Provisional estimates indicate that this can be achieved without significant extra demands on the budget and without significant reductions in income/benefits of any lower paid individuals or families.

4. Conclusion

The key to revitalising the British economy lies in removing the many incentives against working, employing and investing that arise from onerous taxation, means-tested benefits and regulation. Economic health does not lie, as the European Union and our own government would have us believe, in spending more public money on enterprise conferences, entrepreneurship workshops, regionalised bureaucracies, ‘trans-European co-ordination networks’ and the like.

This policy statement has outlined a proposal for flat income tax – paid for by halting the real growth in government spending – and has indicated some other feasible reforms. These sorts of changes are not just desirable. They will be forced on us if we want to continue to support any reasonable standards of public services and welfare provision and if we are to remain internationally competitive.

Changes to tax regimes should always be undertaken cautiously because of the uncertainty that they cause. However, the changes proposed here can hardly be more disturbing than the incessant ill-considered meddling with taxation – quite often putting previous decisions into reverse – that has become the norm.

We need to deregulate, reduce taxation and begin to unravel the complex web of tax and benefit rules. Above all we need to resist further moves towards EU tax harmonisation.

The UK Independence Party believes in smaller government. Let us make a start by limiting the growth of the government budget and by making some modest tax reductions.

Notes

¹ HM Treasury, Public Expenditure Statistical Analyses 2006 (CM 6811) and Budget 2006.

² For instance, while personal tax rates (income tax and national insurance less benefits) have been falling, on average, in the EU and OECD countries, they have been rising in the UK (see 'Taxing Wedges', OECD 2006). UK government spending of 45% of national income may be compared with 47% in the eurozone and 37% in the US (OECD Economic Outlook Dec. 2005, Annex Table 25).

³ Private Finance Initiatives (PFIs) raise private capital to pay for assets such as hospitals. There are several types of contract. Typically, the private company owning the asset will lease it back to the government or charge the government for services provided. PFIs are, in essence, schemes for the government to borrow now and pay later, without the borrowing being formally recorded. There are serious doubts about the efficiency and cost of PFIs.

⁴ There are many sources that discuss waste and poor productivity across the range of government administration. See, for instance, Allister Heath and David Smith, 'At a price! The true cost of public spending', *Politeia*, April 2006, and Frank Blackler, 'Chief executives and the modernisation of the English National Health Service', *Leadership*, vol 2(1), 2006. In 2005, the Gershon report for the Labour Party claimed that £20 billion could be saved by eliminating inefficiency in public services whilst David James found £35 billion for the Conservatives. In 'The Bumper Book of Waste' by Matthew Elliot and Lee Rotherham (Harriman House, 2006), it is suggested that £82bn could be found.

⁵ See, for instance, Andrei Grecu, 'Flat Tax – The British Case', Adam Smith Institute, 2004; Richard Teather, 'A Flat Tax for the UK: a Practical Reality', Adam Smith Institute, May 2005; Patrick Minford, 'An Agenda for Tax Reform', Centre for Policy Studies, February 2006; Allister Heath, 'Flat Tax: Towards a British Model', The Taxpayers' Alliance and The Stockholm Network, February 2006; Mark Wadsworth, 'Tax, Benefits, Pensions', The Bow Group, August 2006. Heath's proposal also combines employee's national insurance into income tax. Robert Hall and Alvin Rabushka, 'The Flat Tax', Stanford, 1985, is often cited as the seminal work.

⁶ The chart in Fig 1 does not include any reliefs from tax or take account of higher personal allowances for older people which are anyway superseded by the proposed new £9,000 personal allowance.

⁷ Estimates of static changes in revenue are derived from HM Revenue and Customs, Income Tax Statistics and Distributions, Tables 2.5 and 2.6 2005-06, http://www.hmrc.gov.uk/stats/income_tax/menu.htm and HM Treasury, and Tax Ready Reckoner, December 2005, http://www.hm-treasury.gov.uk/media/FA1/96/pbr05_taxreadyreckoner_223.pdf.

⁸ This commonsense theory goes by the name of the 'Laffer curve', which notes that zero revenue is obtained if the tax rate is 0% and also if it is 100% because nobody would work if all income were taxed away. This implies that cutting tax rates leads to a less than proportional fall in revenue, and cutting high rates of tax can lead to a gain in revenue rather than a loss.

⁹ Several post-communist countries of Eastern Europe have adopted versions of a flat tax (not including national insurance) in which tax rates have been generally cut. However, comparisons with developed economies should be treated with caution because overall tax revenue in these countries is lower and the tax reforms were accompanied by other large-scale economic reforms.

¹⁰ See, for instance, the evidence collected in Heath, *op cit*. Heath himself suggests recovery of 40% of revenue within 2 years. Minford, *op cit*, claims a recovery rate of 100% from reductions in the higher rate of tax.

¹¹ HM Treasury, Budget 2006 and HM Revenue and Customs, Table 2.6, December 2005. The figures are estimates for 2005-6 tax year.

¹² See Tax Benefit Model Tables, Office of National Statistics and Department of Work and Pensions, April 2005, table 1.6a.

¹³ The basis of this scheme, including detailed calculations, is presented in Mark Wadsworth, 'Tax, Benefits, Pensions', *op cit*.



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Lextrum House, Unit 1, King Charles Business Park,
Heathfield, Newton Abbot
Devon, TQ12 6UT