



# IN PLACE OF CUTS

Tax reform to build a fairer society

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Published by Compass – Direction for the Democratic Left Ltd  
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# Executive summary

The depth of the recession is great and it will continue even if we get a small positive growth rate over the next few quarters.

Mervyn King, 15 Sep 2009<sup>1</sup>

Inexplicably Britain has moved from a credit crunch and an economic recession caused in large part by the excesses of bankers to a public expenditure and public services crisis. Those at the top have been bailed out by the public, while those at the bottom will have pay and benefits frozen and services cut. We simply cannot allow this to happen.

'In this report we show not merely that cuts in spending in the midst of a recession is a bad idea, but also that any 'hole' can more sensibly be financed through tax reform which makes the current system fairer'

Across the three main parties there is a Dutch auction about spending cuts. The Tories and Liberal Democrats are the worst but Labour is not sufficiently differentiating itself. This report directly challenges this sort of Micawberesque economics which bizarrely and quickly has become the new orthodoxy. In this report we show not merely that cuts in spending in the midst of a recession is a bad idea, but also that any 'hole' can more sensibly be financed through tax reform which makes the current system fairer.

Britain urgently needs tax reform. Overall tax incidence in Britain is currently regressive: taxes fall more heavily on the very poor than on the very rich, so contributing to growing income inequality. Regressive taxation – together with relatively low social benefits – places Britain close to the bottom of the EU league table in terms of fairness.

Tax reform is also needed to finance public spending. As many commentators have noted, Britain cannot have high level Nordic-style public services with low level US rates of taxation. Yes, bailing out the banks has added billions to the

public borrowing requirement (PBR), doubling our indebtedness. But priority must be given to modernising public services and to major investment in a newer and greener economic and social infrastructure. Far from 'crowding out' private-sector growth, such investment is an essential prerequisite for sustainable future growth. Cutting public expenditure by 8% of GDP (by £120 billion over the period 2011–2014) as advocated by some politicians would be a disaster. Far from restoring prosperity, such a move would condemn Britain to a 'lost decade' much like Japan in the 1990s. Private investment demand depends on aggregate demand – including both public investment and public consumption – rather than simply the rate of interest, and balancing the budget would shrink aggregate demand.

Increased investment for sustainable growth – 'green Keynesianism' under current conditions – requires progressive tax reform for another important reason. Many green taxes are indirect (for example, those on fuel or on congestion) and thus regressive. Gaining public support for the introduction of green taxes means making direct taxation more progressive. If only to offset this effect, tax reform is an essential component of a green new deal.

Finally, we show how tax reform could finance Britain's structural deficit in the medium term, by which is meant between now and 2014, assuming the UK emerges from recession in the coming year.

The quantified reforms proposed in this report more than cover the estimate by the Institute for Fiscal Studies (IFS) of an annual structural budget gap of £39 billion per annum for 2011–2014, or about 3% of current GDP.<sup>2</sup> The IFS says that only by radical cuts to public spending, tax rises or some combination of the two can the 'structural' deficit be resolved. We oppose spending cuts of the sort announced by the Chancellor in April 2009 for the period 2011–14, cuts likely to be extended in his upcoming pre-budget statement in autumn 2009. Moreover, we think that tax reform would alleviate the need for further cuts recommended to plug the £45 billion gap forecast by IFS for the period 2014–18.

Our recommendations would raise additional revenue equivalent to roughly £47 billion (all

<sup>1</sup> See Giles, C. (2009) 'King rules out rapid recovery', *Financial Times*, 15 September.

<sup>2</sup> See O'Grady, S. (2009) 'The £39 billion black hole in the Chancellor's budget', *Independent*, 7 April.

figures are annual) over the next four years (Table 1). This is enough both to reduce the government deficit (although we strongly oppose ‘balancing the budget’) and, more importantly, to finance a major green investment programme. Crucially, the cumulative impact of these reforms helps the bottom 90% of income earners as only those who can afford it, the top 10%, are asked to contribute more.<sup>3</sup> There are nine key measures for 2011–14:

- 1 Introduce a 50% Income Tax band for gross incomes above £100,000. This raises £4.7 billion compared with the current (2009/10) tax system, or an extra £2.3 billion compared with introducing this band at £150,000 as proposed by the Chancellor.
- 2 Uncap National Insurance Contributions (NICs) such that they are paid at 11% all the way up the income scale (although pensioners would continue to be exempt); make NICs payable on investment income. This results in further revenue of £9.1 billion.
- 3 In addition to (1) above, introduce *minimum* tax rates of 40% and 50% on incomes of above £100,000 and £150,000 respectively; these raise an additional £14.9 billion.
- 4 Introduce a special lower tax band of 10% below the poverty line (below £13,500 per annum), while restoring the ‘basic rate’ to 22%. This costs £11.5 billion.
- 5 Increase the tax payable (higher multipliers) for houses in Council Tax bands E through H

(while awaiting a thorough overhaul of property valuation and local authority taxation) raising a further £1.7 billion.

- 6 Minimise personal and corporate tax avoidance by requiring tax havens to disclose information fully and changing the definition of ‘tax residence’; these two reforms are estimated minimally to yield £10 billion.
- 7 Introduce a Financial Transactions Tax (FTT) at a rate of 0.1%, applicable to all transactions. This would raise a further £4.2 billion.
- 8 Immediately scrap a number of government spending programmes (including ID cards, Trident, new aircraft carriers, PFI schemes), reforms totalling £15.1 billion.
- 9 Urge that all current small limited companies be re-registered as limited liability partnerships to simplify their administration and reduce opportunities for tax avoidance.

Table 8 shows that although the cost of implementing some individual measures fall on the middle deciles, other measures offset this; the cost of the package *taken as a whole* falls in the richest decile of the population.

Britain does not lack the fiscal means to reduce the deficit and/or to provide decent incomes for its poorer citizens while investing in modernising and greening its infrastructure. Tax reform is not an optional extra – it is an urgent priority if recession and stagnation are to be avoided and the basis laid for a sound, sustainable and prosperous future.

**Table 1 Extra annual fiscal revenue raised by recommended measures (£ billion)**

Measures	Extra revenue (£ billion)
1 50% Income Tax band at £100,000	2.3
2 Uncap NICs and make payable on investment income	9.1
3 Minimum Income Tax bands	14.9
4 Reintroduce 10% tax band and 22p basic rate	-10.5
5 Higher Council Tax bands	1.7
6 Abolish tax havens and tax ‘non-doms’	10.0
7 Financial Transactions Tax	4.2
8 Cost cutting measures described in section 6 below	15.1
<b>Total</b>	<b>46.8</b>

<sup>3</sup> Our recommendations for tax reform have been quantified using an updated version of the tax model developed for the Institute for Public Policy Research (ippr) or by the authors directly.

# Introduction

Britain is not bankrupt. British taxes are not, historically, 'too high,' but they are structurally regressive and unfair. It was not big government that got us into this economic mess but free markets beyond democratic and social control. Overall public spending does not need to be cut; this would only make matters worse. We suggest certain targeted cuts in socially unacceptable budgets, but what Britain needs is tax reform to make the country fairer and to make our climb out of recession sustainable in every sense of the word.

The crash and its aftermath provide us with an opportunity, a turning point in which we can reconsider what sort of world we want to live in. Do we want to go back to how things were before: unsustainable growth, boom and bust, growing inequality, stress, anxiety and exhaustion for all? Or is it time we had a different vision of the good society, one that is more equal, sustainable and democratic? The decision we make now about how to tax and spend will shape the debate about what sort of society we want to be for a decade or more. Now we must make different choices; better choices.

What we need more than anything else is a more balanced economy and a better balanced society; a balance between rich and poor, private affluence and public squalor, between consumption now and sustainability over the long term. The old ways of prioritising the City, tax cuts and private consumption got us into this mess – they won't get us out. We need a new way and a new settlement around tax.

We do not underestimate the political hurdles of building a consensus for progressive tax change. But if it is not attempted now there is unlikely to be a better moment for decades to come. The public knows that something has gone wrong, that they are paying the price rather than the real culprits. It is time for tax fairness, not public spending cuts.

Since 2007 UK public indebtedness has grown, largely in order to prop up the banking system and to prevent the recession from turning into a full blown depression.<sup>4</sup> In this report we ask 'how can the tax burden be shared more equitably?'

since, as we show, the weight of taxation falls more heavily on the poor than on the rich. Britain's overall personal taxation system is regressive. Crucially, in the absence of the increased revenue that revamping our tax laws will bring, the pressure will mount for Britain to undertake drastic social spending cuts after 2010. The burden of such cuts will fall largely on poor and middle income households.

That the right in Britain has managed to switch the agenda from market failure to public debt reflects the continued ideological hegemony of finance capital.<sup>5</sup> But spending cuts are neither essential nor inevitable. If Britain were to cut public spending now, it would prolong the recession and further reduce tax receipts. What is needed is tax reform. But – as emphasised throughout this report – at present such reform should not aim primarily to reduce public debt, but rather to finance sustainable public investment and stop Britain becoming an even more unequal society.

Not only is income inequitably distributed, but – as we show – so is taxation. Among EU member states, the UK ranks 17th (with Greece, Hungary and Poland) in terms of top rates of personal Income Tax.<sup>6</sup> When direct and indirect taxation are looked at together, *the poorest 10% of UK households pays a higher proportion of its income in tax than the richest 10%*. To redress this situation, we first look at an 'ideal' progressive tax model – one which flattens the Lorenz curve.<sup>7</sup>

Then, using a tax micro-simulation model first developed with the support of UNISON for the Institute of Public Policy Research (ippr), we explore the impact of changing the existing tax regime in a progressive manner by means of introducing higher tax bands for very high income earners and making other taxes more progressive, for example, uncapping National Insurance Contributions (NICs), introducing a 10p tax band and re-banding Council Tax. We then look at reducing tax avoidance, closing tax loopholes, introducing taxes on speculative activity which destabilises the economy and eliminating unproductive expenditure on Trident and the like. We show that the long-term fiscal position can be greatly improved without axing capital and recurrent social expenditure across the board.

<sup>4</sup> At present public debt is estimated to be £800 billion, or about 55% of GDP (less than the comparable percentage in France, Germany or the USA) and less than the Maastricht target of 60% of GDP. But methods of calculation vary. In February 2009 the ONS decided to include the liabilities of Lloyds and RBS in the public debt, raising public indebtedness to over 100% of GDP. But since the 'nationalised banks' are expected to pay back part of what they have received and since their share prices have risen, the 'true' share of public debt is something of a grey area.

<sup>5</sup> See Milne, S. (2009) 'The cuts agenda is a brilliant diversion from the real crisis', Guardian, 16 September.

<sup>6</sup> See European Commission (2009) *Taxation Trends in the EU: Main Results*, Eurostat, graph 2, p.8.

<sup>7</sup> The 'Lorenz curve' shows in graphical terms how egalitarian the income distribution is; the flatter the curve, the more equal the distribution.

These measures are not exhaustive but have been chosen because they move us towards a more equitable tax system and can be implemented easily in the short term.

Taxation is regularly attacked in the press; Labour is accused of being the ‘tax and spend’ party; and yet taxation is a communal contract which binds us together. As each generation benefits from free education, healthcare, unemployment insurance, transport infrastructure and other forms of social and economic support, they inherit the obligation to repay this debt. The Nobel Laureate, Amartya Sen, first set out what he called ‘the paradox of isolation’ – individuals in isolation may minimise their social obligations while recognising that if everybody did so, the collective would be worse off. Critically, as numerous studies have shown, when taxation becomes less progressive and inequality grows, the social costs of failing to reverse inequality are high.<sup>8</sup>

Of course, the view that tax is part of a communal contract was not shared by Margaret Thatcher, whose notion of reciprocal social obligation was summed up by the phrase ‘there is no such thing as society’, and for whom the market was all powerful. This conflation of individual choice exercised in the market and collective social choice exercised in the sphere of politics is one of the most damaging legacies of Thatcherism. It has led to the sort of thinking which says that if the poor remain poor, it is because they have exercised poor judgement in the market (or its converse, which is that the super-rich are ‘wealth creators’ who deserve their large salaries, bonuses and pension pots). Crucially, Thatcherism introduced the notion that the private is always superior to the public, a toxic piece of ideology, which eventually contaminated the early promise of New Labour.

Concretely, Thatcherism led to the dismantling of much of the public sector, the downgrading of pensions and the neglect of vital social services such as healthcare. Inequality increased more rapidly during the Thatcher years than at any time in the 20th century – in part because rich individuals and corporations were given huge tax breaks and cuts, and in part because of deindustrialisation and financialisation. Too little has been done by New Labour to reverse Thatcher’s legacy. The deregulation of the financial sector by Thatcher and Reagan (starting with the ‘Big Bang’

in 1986), as is now widely recognised, set in motion a chain of events, which has given us the ‘credit crunch’. Ironically, it is revenue drawn from the general public that now props up much of the UK banking system.

How can we escape such a state of affairs? This is the central issue addressed by this report.

<sup>8</sup> See for example Wilkinson, R.G. and Pickett, K. (2009) *The Spirit Level: Why More Equal Societies Almost Always Do Better*, Penguin, and Frank, R.H. (2007) *How Rising Inequality Harms the Middle Class*, University of California Press.



# I. Creating wealth?

According to January 2009 projections by the IMF, UK GDP will have contracted by 2.8% at the end of 2009, and it will continue to contract in 2010.<sup>9</sup> The OECD's projections are even gloomier: in its Interim Economic Assessment in September 2009 it has revised its 2009 UK GDP figures from a 3.7% fall to one of 4.7%, close to the 4.3% figure reported by the British Chamber of Commerce.<sup>10</sup>

Ostensibly, this bleak picture results from the fact that economic recession is taking place on a global scale; the contagion of financial collapse is having a worldwide impact. But there are deeper historical reasons for the crisis. In both Britain and the USA, the Reagan-Thatcher era aimed to reverse the gains secured by the labour movement in the post-war years. In the decade of the 1980s under Thatcher, inequality in households' gross disposable income rose by ten percentage points on the Gini scale, from 0.25 to over 0.35 – where it has remained, rising slightly in recent years (see Figure 1 for UK Gini coefficient based on IFS data). At present, the richest fifth of households in Britain receives 51% of all original income while the bottom fifth receives only 3%.<sup>11</sup>

De-industrialisation, financial deregulation, the growth of a 'parallel' banking sector and the establishment of a 'flexible' labour market – which greatly weakened the trade unions – transformed the 1970s 'profit squeeze' into a wage squeeze, and the profit share in GDP rose accordingly.<sup>12</sup> The 1990s dotcom boom, followed by the housing boom during the current decade, saw the income of the poorest 40% fail to keep up with GDP growth in the UK. In turn, low income and cheap credit meant that household debt exploded.

The high-debt economy was fuelled by the growth of the financial service sector; the enormous bonuses earned in the City were not about 'wealth creation' but about income redistribution. The gains from higher labour productivity, which should have accrued in the form of increased wages to workers, were increasingly siphoned off by the financiers.<sup>13</sup> Because of greatly weakened trade unions, wages could not be pushed up nor working conditions improved. As Will Hutton argued over a decade ago in *The State We're In*, the obsession with making large profits for shareholders in contrast to raising industrial productivity has been the Achilles heel of the British economy.<sup>14</sup> By 2008 Britain had the most unequal tax structure (see below) and income distribution of any of the large EU economies. Nevertheless,

9 See IMF (2009) *World Economic Outlook Update: Global Economic Slump Challenges Policies*, 28 January, Table 1.1.

10 See Elliot, L. (2009) 'OECD: world economy will grow next year – but not in Britain', *Guardian*, 24 June; figures released in September by the British Chamber of Commerce foresee a 4.3% fall. Also see: OECD (2009) *What is the Economic Outlook for OECD countries? An Interim Assessment*, OECD, 3 September.

11 See Irvin, G. (2008) *Super Rich: The Rise of Inequality in Britain and the United States*, Polity, p.69; and Barnard, A. (2009) *The Effects of Taxes and Benefits on Household Income 2008-09*, Office for National Statistics.

12 See for example Glyn, A. (2006) *Capitalism Unleashed: Finance, Globalisation and Welfare*, OUP; and Irvin, G. (2009) 'From profit squeeze to wage squeeze', *Renewal*, 17(3), Autumn.

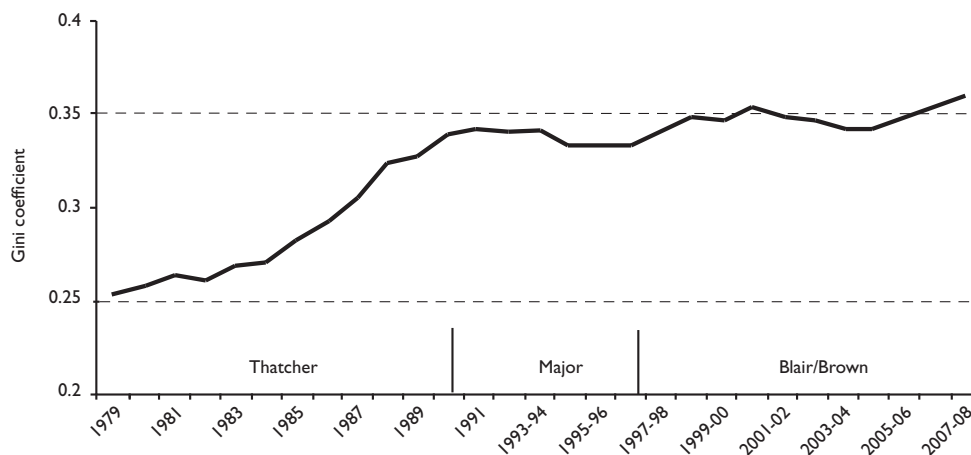
13 An excellent account is given in Mason, P. (2009) *Meltdown: The End of the Age of Greed*, Verso.

14 Hutton, W. (1995) *The State We're In*, Cape.

15 Figures relate to gross disposable income before housing costs.

16 Brewer, M. et al (2009) *Poverty and Inequality in the UK: 2009*, Institute of Fiscal Studies.

Figure 1 Rise in UK Gini coefficient since 1979<sup>15</sup>



Note: The Gini coefficient has been calculated using incomes before housing costs have been deducted. Author's calculations using Family Expenditure Survey and Family Resources Survey, various years. Source: Brewer et al, *Poverty and Inequality in the UK 2009*, Figure 3.7<sup>16</sup>

debt-fuelled consumption continued to rise, placing investment and economic growth at the mercy of a bubble.<sup>17</sup>

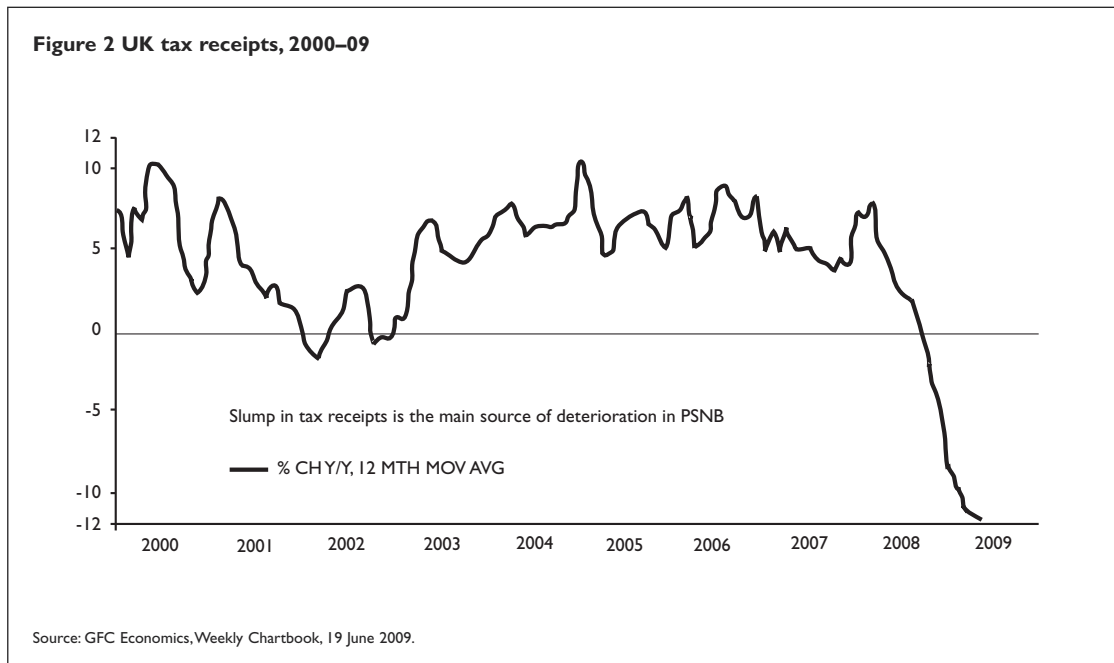
Viewed in a historical context, it should be clear that redressing the economic and political balance in labour's favour must be central to any strategy of economic recovery. Redistribution, in part by means of radical fiscal reform, is not an 'optional extra'. Redistribution lies at the heart of creating a high-wage, low-debt economy; creating a 'sustainable' growth path requires not merely a greener Britain but a more egalitarian Britain.

Nor has the credit crunch and recession stopped the rich getting richer. Until 2007, London was booming, and the square mile of the City (London's financial centre) was at the heart of the boom. The average salary for somebody working in the financial sector in 2006 was reckoned to be £100,000, up by a fifth from the previous year.<sup>18</sup> Yet even after the crunch, according to the Office for National Statistics, in the period until April 2008, 'City workers took home £16 billion, almost exactly the same as in 2007. The period covers the Northern Rock nationalisation and the UK employees hit by the Bear Stearns implosion.'<sup>19</sup> In June 2009 we learned that the CEO of the Royal Bank of Scotland (RBS), Stephen Hester – the man who succeeded Sir Fred Goodwin of 'pension pot' fame – stands

to collect nearly £10 million in salary and bonuses.<sup>20</sup> A month later, Barclays – the new owners of Lehman Brothers' US operation – announced huge bonuses for top earners while closing its final-salary pension scheme for many of its ordinary staff.

Meanwhile, since early 2008 the recession has swept away thousands of jobs, leaving workers trying to get by on jobseeker's allowances, mortgage top-ups, child allowances and other means-tested benefits averaging just over £7,000 per annum. Tax revenue has fallen sharply (see Figure 2).<sup>21</sup> UK unemployment at the time of writing (October 2009) is nearing 2.5 million. Indeed, it has been suggested that if cuts in government spending of the scale reported in the popular press were to occur, at least 2 million more would be unemployed. These figures help explain why inequality in Britain has actually risen recently despite New Labour having been in power for the past dozen years.

The government believes that the City generates wealth; but is this really true? The answer depends on whether one thinks 'wealth generation' is simply about making money – or more precisely, making money out of other people's money – or about making goods and services. London used to have a large industrial base. It is certainly difficult to claim that those



17 In 2006 a YouGov survey found that one in five adults – or 8 million Britons – had unsecured debts of more than £10,000; see Inman, P. (2006) 'Britons leave prudence to Europe', *Guardian*, 27 September.

18 See Irvin, *Super Rich*, p.13.

19 Clark, N. (2008) 'Bankers' £16 billion bonus bonanza', *Independent*, 18 October.

20 See Clark, N. (2009) 'Bankers still trapped by bonus backlash', *Independent*, 23 June.

21 A recent publication from the LibDem thinktank CentreForum shows how recession has dramatically reduced revenue and argues for rebuilding Britain's tax system; see Wilkes, G. (2009) *A Balancing Act: Fair Solutions to a Modern Debts Crisis*, [www.centreforum.org/publications/a-balancing-act.html](http://www.centreforum.org/publications/a-balancing-act.html) (accessed 27 October 2009).

who make fortunes from casino capitalism are 'generating wealth'. Indeed, Adam Smith – writing half a century before Ricardo – argued decisively against the mercantilist notion that the accumulation of gold (through trade or otherwise) could be counted as 'wealth creation'. Smith argued that Britain's 'wealth' was its productive capacity.

The boom in the UK financial sector after deregulation in 1986 was remarkable, but the financial boom was a *worldwide* phenomenon. Half a century ago, much of the money flowing around London served to lubricate the wheels of trade, whether providing insurance for ships, fees for merchants or finance for cargoes. Today the flow of money around the world in general – and through London in particular – greatly exceeds what is needed to make or transport goods.<sup>22</sup> In 1977 the ratio of foreign exchange dealings to world exports was just over 3:1; in 2007 it was 86:1. The power of 'finance capital' has grown out of all proportion to that of industrial capital. In essence, Britain's financiers are not in the business of producing real wealth in the sense of adding to the world's productive capacity; rather, they make money out of money. This is a crucial distinction, which classical economists like Smith and Ricardo wrote about, but which Britain's political elite today has chosen to ignore.

At the other end of the scale sits London's underclass; has the wealth trickled down to them? In boroughs like Hackney and Tower Hamlets unemployment is typically twice the average national rate. Five of the ten most deprived boroughs in the UK are reported to be in London.<sup>23</sup> A piece in the *Observer* illustrated the contrast between rich and poor with particular poignancy.<sup>24</sup> On one side of the page is a picture of the City banker, Bob Diamond, head of Barclay's Capital, the bank's investment banking arm. He lives in the rather expensive area of Kensington, where the average family home is said to cost several million pounds. In 2005, his basic salary was a mere £146,000, but he received a £4.4 million cash bonus and £1.9 million in share awards. In 2007, he became Barclay's highest paid executive with total earnings reported to be £18.5 million. In 2008, that figure was £22 million.<sup>25</sup>

On the other side of the page is a picture of Charlie Sawyer, a 58-year-old cleaner who works for the London underground. Charlie says:

I start at 11pm, finish at 6:30am and earn £6.05 an hour. I live in southeast London, in Peckham – I'm a council tenant. What they pay me is not sufficient: I do another job as a porter... I came from Sierra Leone nine years ago. Most of the cleaners are migrants. People don't respect us, but without cleaners the Queen couldn't live in Buckingham Palace... We only get 12 days' holiday pay. We don't get a tube pass, and we're cleaning the tube.

And it is not just the low-paid who struggle. Teachers, nurses, civil service clerks and other public service workers who once thought of themselves as 'middle class' now struggle to survive with rent and travel costs eating up their take-home pay. Despite the fall in house prices, higher deposits and tighter credit mean that most of these people – never-mind the unskilled and semi-skilled – will never manage to get onto the property ladder within ten miles of central London, and that many will never be able to afford property anywhere in London. The middle class is being hollowed out. London's entrepreneurial spirit and 'wealth creation' may be good for a few – including the political elite – but for the majority who are being left far behind, there is real pain.

22 Before the recession, daily financial transactions in London were estimated to be in excess of \$3 trillion, and it is thought they will soon return to that level.

23 See Irvin, *Super Rich*, p.14.

24 See Stewart, H. (2006) 'A bit rich: scandal of the capital's two-tier economy', *Observer*, 19 November.

25 See Treanor, J. (2009) 'Bob Diamond contracted to obscure Delaware branch of Barclays', *Guardian*, 27 April.

## 2. Spending cuts and the recession

How is the so-called 'hole in Britain's finances' ever to be fixed – the structural deficit which the Institute for Fiscal Studies has recently estimated to be of the order of £39 billion per annum? We could inflate it away, but while everybody agrees that high inflation would be a bad thing, few seem to notice that quite mild inflation (say 3% as in the post-war period) over 20 years would halve the real value of the debt.

Alternatively, we could cut public spending – but as most economists agree, doing so either during or immediately after a deep recession would be foolish and counter-productive. Finally – and this is the option we favour – we could reform the tax system so that those who can afford it pay more. Following the 'polluter pays' principle, it is those who got us into the present crisis who must now share the burden of helping rebuild our economy.

The Tories are promising across-the-board public spending cuts of 10% or more if they come to power in 2010. Much of the popular press seems to think that a drastic cutback in public sector spending is not just inevitable, but highly desirable. Fiscal conservatives are having a field day.

There are several reasons why cutting back on public spending during a major recession won't work. First is the 'paradox of thrift' first signalled by Keynes during the Great Depression of the 1930s. Keynes argued that what is sensible medicine for the individual cannot be applied to the economy as a whole. The more a country tries to save, the more income and investment fall and the less is available to save. And as national income falls, so does tax revenue. This point is fundamental, but many journalists and politicians ignore it.

Second, the combination of financial meltdown and economic recession is deadly. Why? Because not only are banks not lending in order to restore their balance sheets, but their customers – businesses and households – are rebuilding savings as well. As Nomura's chief economist Richard Koo has warned, during a

recession individual firms switch their attention from profit maximisation to debt minimisation, particularly when falling share prices exacerbate the mismatch between their assets and liabilities.<sup>26</sup> With all private sector actors trying to save, only the public sector can boost aggregate demand. Despite real sterling devaluation, export-led growth is not an option because the recession is worldwide. The state is 'investor of the last resort', restoring the conditions necessary for profitable private investment to resume. Although the British taxpayer now owns most of the banks, the government has steadfastly refused to run them.

**'Only by increasing revenue through tax reform – in contrast to 'shrinking the state' through cuts – can we finance sustainable growth in the longer term.'**

Third, Britain and the USA may be poised for a 'double dip' (or at least an 'L-shaped') recession, with the rest of the EU not far behind. In the UK in 2009, second quarter output was down by 0.8% (or 3.2% annualised).<sup>27</sup> A report in early October by the National Institute of Economic and Social Research suggests that third quarter output has stagnated, and that the UK is not emerging from recession.<sup>28</sup> The fact that US unemployment grew from 9.5% in June 2009 to 9.8% in September is particularly worrying because the USA is still the engine of the world economy.<sup>29</sup> While some economists think the UK will emerge from recession in late 2009, others (including Prof David Blanchflower) argue that even if we do, it may be many years before healthy growth resumes.

Attempting major public cuts under current conditions could well turn the recession into a decade of stagnation as experienced by Japan. For this reason, as Britain emerges from recession, fundamental tax reform will be needed if public finances are to be put on an even keel. Only by increasing revenue through tax reform – in contrast to 'shrinking the state' through cuts – can we finance sustainable growth in the longer term.

Equally important, as shown below, the micro-economic results of making nominal cuts are far less than commonly thought.

<sup>26</sup> See Koo, R. (2008) *The Holy Grail of Macroeconomics*, J Wiley & Sons.

<sup>27</sup> See Elliot, L. (2009) 'UK GDP falls faster than expected', *Guardian*, 24 July.

<sup>28</sup> See [www.xe.com/news/2009-10-06%2010:15:00.0/718441.htm?c=4&t=](http://www.xe.com/news/2009-10-06%2010:15:00.0/718441.htm?c=4&t=) (accessed 21 October 2009).

<sup>29</sup> See [www.wsws.org/articles/2009/oct2009/jobs-o03.shtml](http://www.wsws.org/articles/2009/oct2009/jobs-o03.shtml) (accessed 21 October 2009).

## A hypothetical case study

Consider the detailed case for public sector cuts. The public sector employs roughly 5 million people. Therefore, public sector cuts of 10% will result in roughly 500,000 people losing their jobs. Table 2 shows the financial impact of job loss on a person earning £25,000 per annum who is a single parent with a child of school age, paying £500 a month in rent and £700 a year in Council Tax. The assumptions are slightly simplifying: benefits are harder to calculate in more complicated households. The rate of pay is slightly above mean and significantly above median UK pay. But £25,000 is a good, round number.

**Table 2 Taxes and benefits of an employed person earning £25,000 per annum**

Income	£25,000
Income tax paid	-£3,705
National insurance paid	-2,120
Net pay	19,175
Council tax paid	-700
Income after council tax	18,475
Add: Child benefit	1,040
Child tax credit	1,110
	2,150
Disposable income pre rent	20,625
Rent paid	-6,000
Disposable income after rent	14,625
Tax (VAT, petrol duty, car tax, TV licence, alcohol duty, etc) paid out of disposable income (approximately 15%)	2,300
Income tax paid (as above)	3,705
Council Tax	700
National Insurance paid (as above)	2,120
Total tax paid	8,825
Add, National Insurance paid by employer	2,465
Total tax paid as a result	11,290
Less, benefits received (as above)	2,150
Net contribution to government	£9,140

Table 3 shows the benefits that this person would get if he or she was unemployed.

The total lost to the government if this person loses their job in the private sector is the addition of the total contribution lost plus the total cost paid – £21,300. It could be argued that the cost is less in the public sector because tax deducted goes straight back to pay the employment cost. However, the net effect is the same. In that case the comparison with the private sector is maintained here.

The total cost when second-round effects are included is higher though. The person in work has disposable income of about £14,625; the same person unemployed spends £7,260. That is a difference of £7,365. In other words the person is twice as well off in work as out of work. But, most importantly, of that difference at least 65% will support other people's wages plus the taxes spent on goods and services.<sup>30</sup> Assuming these other people pay taxes at about the same overall rate as the person in the above exercise (and this is likely), that means about 36% of that difference will indirectly go in tax as well – about £1,700. So now the benefit of

<sup>30</sup> See National Statistics, *Quarterly National Accounts: 1st quarter 2009*, [www.statistics.gov.uk/pdfdir/qna0609.pdf](http://www.statistics.gov.uk/pdfdir/qna0609.pdf) (accessed 27 October 2009), Table D using 2008 figures.

**Table 3 Taxes and benefits of someone previously earning £25,000 per annum after job loss**

Job seeker's allowance	£3,353
Child tax credits	2,785
Child allowance	1,040
Housing benefit	6,082
Council tax benefit	700
<b>Total income</b>	<b>13,960</b>
Tax paid: council tax	-700
<b>Net income after tax</b>	<b>13,260</b>
Rent paid	-6,000
<b>Net income after rent</b>	<b>7,260</b>
Tax (VAT, petrol duty, car tax, TV licence, alcohol duty, etc) paid out of disposable income (approximately 15%)	1,100
Add, council tax paid, as above	700
<b>Total tax paid</b>	<b>1,800</b>
<b>Net cost to government</b>	
Total benefits paid	13,960
Less: tax paid	-1,800
<b>Net cost to government</b>	<b>£12,160</b>

keeping the person in work is 92% of their earnings – £23,000 of £25,000. Put it another way: cutting a £25,000-a-year job results in a public expenditure saving of less than £2,000 under conditions of less than full employment.

It is clear that paying to keep people in work is a good thing – particularly if what they do has long term benefit that saves on future costs. That cost saving – for instance from green efficiencies – need only be £2,000 for it to be worthwhile to keep this person in work. And that is before any account is taken of the social costs of being in employment, which are substantial in terms of reduced crime, improved educational outcome, better health and more besides.<sup>31</sup>

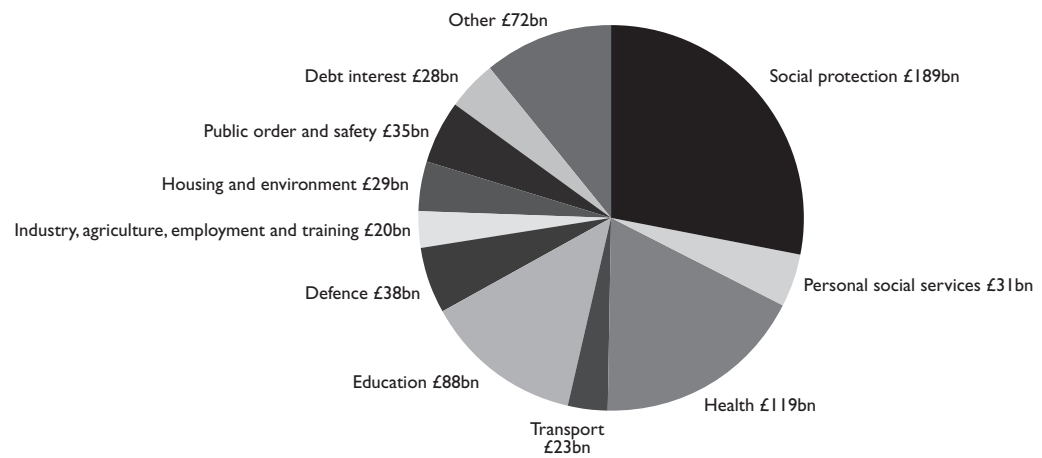
Now let's reflect on the fact that, in reality, the average direct cost of employing an average public sector employee is less than this. Let's make it around £21,000 – more like median pay – and then note that making 500,000 redundant at this pay rate will supposedly save £10.5 billion in the wage cost of the government. Putting these half million people out of work will save us about £0.8 billion. That equals misery for 500,000 people and their dependants, imposed to save just £1,600 per job lost.

That, however, is not the end of it. Total government spending is £671 billion, broken down as shown in Figure 3. So, to cut spending by 10% means that £57 billion in extra cuts are required on top of sacking 500,000 people. These savings would need to be made up of:

- reduced benefits, which will result in reduced consumer spending, or
- reduced payments to private sector contractors to provide work to the government.

Either way, demand falls by £57 billion. Of this total, approximately 65% will go to labour, or £37 billion. At £25,000 or so a head (approximately) that's over 1.5 million more unemployed. That, together with the losses from the public sector, adds more than 2 million to unemployment – making well over 4 million in all. Some commentators consider this likely.

31 One difficulty of presenting such an estimate for a couple, because if one member of a couple loses their job, a household means test eventually kicks in.

**Figure 3 Breakdown of public spending: projections for 2009**

Source: HM Treasury, Budget 2009, *Building Britain's Future*, Chart 1.1.

But what is the effect on public spending? Around 92% (£23k/£25k) of this cost in lost wages will fall on government either in the form of extra benefits paid or revenue lost. That adds up to £34 billion. And that is before we deal with the massive social and crime related costs of that level of unemployment and the collapse in longer term growth prospects.

So, to achieve total savings of maybe a net £4 billion in borrowing (£3 billion net from private sector cuts and about £1 billion net from public sector employee cuts), this policy would put 2 million people out of work.

Clearly, there are problems of extrapolation here. Not everyone will get benefits in the way we have outlined above (and those who don't will suffer even greater losses in income – compounding losses elsewhere). All analysis in this area moves into the hypothetical, economically and statistically speaking. And losses to government may also be bigger than we suggest. Out of the £57 billion of non-labour cost cuts required, £20 billion will be lost profits and rents – and they could result in £6 billion of additional government tax losses, tipping the equation in the direction of any cuts in government spending having a negative impact on government saving.

The key point is that cutting government spending when there are no jobs for those we make unemployed makes no sense at all – the state's attempt to cut spending will reduce National Income payments and employment to a lower level of aggregate savings than we started

with. It's profoundly annoying to have to reinvent the whole Keynesian argument – because that is exactly what we are doing – but needs must precisely because many do not understand the basic logic involved.<sup>32</sup>

Put simply, spending cuts may increase government debt. By contrast, to increase spending now means that the multiplier effect in the above analysis goes into reverse: more jobs are created, revenue flows to government, benefit spending falls and government debt goes down with it.

The answer is simple: if we want to get out of the mess we're in, we need public spending. It is the only way to reduce government debt at this stage in the economic cycle.

<sup>32</sup> In fact, ignorance of Keynes is a pervasive – and extremely worrying – feature of modern macroeconomics. Nobel Laureate Paul Krugman gave an incisive account of the problem in his Robbins lectures at the London School of Economics in June 2009, 'The return of depression economics part I: the sum of all fears', [www.lse.ac.uk/collections/LSEPublicLecturesAndEvents/events/2009/20090311t1955z001.htm](http://www.lse.ac.uk/collections/LSEPublicLecturesAndEvents/events/2009/20090311t1955z001.htm) (accessed 27 October 2009). Also see Blanchflower, D. (2009) 'And next for Britain, the semi-slump', *Guardian*, 14 July.

### 3. The regressive nature of personal taxation in the UK and an alternative 'ideal'

The tax system itself contributes to widening the gap between rich and poor. We can see this when we examine the proportion of gross household income<sup>33</sup> taken by all taxes, not just by Income Tax but by all the taxes levied on individuals and households: VAT, National Insurance and Council Tax.

If we examine the distribution of tax across 'all households', that tenth of all households<sup>34</sup> with the highest household incomes (the highest decile group) pays a *smaller* proportion of its gross household income in tax than every other decile, except the second, third and fourth (middle Britain) who pay about the same proportion.<sup>35</sup> In essence, this situation has hardly changed since New Labour came to power. Put simply, the well-to-do pay a lower percentage of their gross income in tax than the poor (decile 1) or than 'middle income' decile groups 5, 6, 7, 8 and 9.<sup>36</sup> The reasons for this in relation to tax policy are discussed by Byrne and Ruane;<sup>37</sup> in summary they derive from: (a) the combined effects of regressive indirect taxation; (b) the effective capping of Council Tax and National Insurance; (c) low top rates of Income Tax; and (d) the lower rates of tax charged on property incomes. The UK's tax system is certainly *not* progressive when considered in relation to its overall impact on households.

In order to make it easier to understand the argument, see Table 4, which shows the percentage of total household income paid in all taxes, direct and indirect. Income Tax and Council Tax are counted as net payments – net of tax credits and any Council Tax benefit. Figure 4 provides the same information in graphical form.<sup>38</sup>

With the UK economy heading for a severe downturn and likely to be the worst affected of all advanced economies, some have proposed tax *cuts* in order to enhance effective demand in the economy.<sup>39</sup> One possibility is a reduction in the base rate of Income Tax, currently 20% charged on taxable incomes up to £34,600. Before March

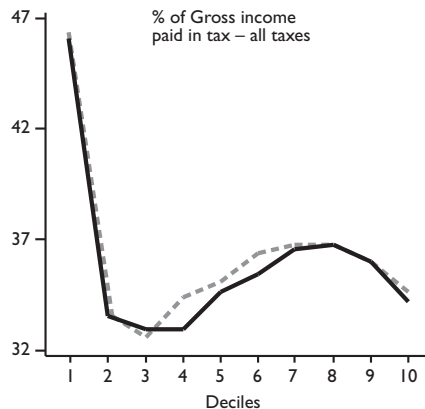
**Table 4 Average gross income for UK households and percentage of gross income paid in tax, by decile group, 2006/07**

Decile group	Pre-tax average gross income for households in this decile (£)	Gross income paid in all taxes (%)
10 (highest)	94,524	34.2
9	54,609	36.0
8	44,759	36.7
7	37,100	36.6
6	29,938	35.1
5	25,795	34.6
4	20,362	33.0
3	16,826	32.9
2	13,616	33.7
1 (lowest)	9,076	46.1

Source: Byrne and Ruane, 2008, based on 2006/7 data derived from Jones (2008), Table 14.<sup>40</sup>

2008 the rate was 10% on taxable incomes up to £2,230 and 22% on taxable incomes between £2,231 and £34,600.<sup>41</sup> Taxable incomes are real incomes minus allowances, the most important of which is the personal allowance, in 2009 £6,035 for most taxpayers (although there are higher allowances for those aged 65 or above and still higher for those over 75).<sup>42</sup> One key change explored in this report is the re-introduction of the 10% band for very low income earners.

**Figure 4 The percentage distribution of UK taxation by decile group (poorest to richest), 2006/07**



Source: Byrne and Ruane, 2008.<sup>43</sup> The dotted line refers to the average for the first ten years of the Labour government (until 2006/07). The continuous line refers to 2006/07 only.

33 Gross household income includes 'original income' (such as wages, occupational pensions and investment income) plus cash benefits, both contributory and non-contributory (such as retirement pension, Jobseeker's Allowance and Child Benefit).

34 A household is one person, or a group of persons, who have the accommodation as their only or main residence and (for a group) share the living accommodation, that is a living or sitting room, or share meals together or have common housekeeping.

35 Discussions of the distribution of income regularly use the term 'decile' or (strictly speaking) 'decile group'. This refers to tenths arranged in order from lowest – first decile (the tenth of households with the lowest incomes), to highest – tenth decile (the tenth of households with the highest income). In Table 4, decile 1 is the poorest tenth and decile 10 is the best off tenth.

36 Although some might think of decile groups 5–9 as constituting 'middle Britain', there is much disagreement about how 'middle Britain' sees itself and which groups to include in it. For an excellent discussion see Lansley, S. (2008) *Life in the Middle: The Untold Story of Britain's Average Earners*, Touchstone Pamphlet 6, TUC.

37 Byrne, D. and Ruane, S. (2008), *The UK Tax Burden: Can Labour be Called the "Party Of Fairness"?*, Compass Thinkpiece 40, Compass.

38 See Jones, F. (2008) 'The effects of taxes and benefits on household income, 2006/07', *Economic & Labour Market Review*, 2(7), July, p.38, for details of method.

39 Moss, V. (2008) 'Exclusive: Gordon Brown planning £15 billion tax cut package', *Sunday Mirror*, 9 November.

40 Byrne, D. and Ruane, S. (2008), *The UK Tax Burden: Can Labour be Called the "Party Of Fairness"?*, Compass Thinkpiece 40, Compass.

41 Up until 1999, the 22% rate had been 23%.

42 The figure for 2008/09 is £6,035 and that for 2009/10 is £6,475.

43 Byrne, D. and Ruane, S. (2008), *The UK Tax Burden: Can Labour be Called the "Party Of Fairness"?*, Compass Thinkpiece 40, Compass.



In addition, most taxpayers who are not of pensionable age pay some form of NIC. The commonest category is that paid by employees, who pay 11% of all earnings between £4,940 and £43,888 per annum and 1% on earnings above the latter figure. There are no offsetting allowances for NICs. National Insurance benefits are flat rate,<sup>44</sup> the same regardless of contribution paid in this range. Many researchers now recognise that National Insurance is in effect a hypothecated tax, which funds basic state pensions and also funds about 20% of the NHS. The combination of National Insurance and basic rate tax at 20p means that the marginal rate of tax (MRT) for a large majority of workers, including many on or below the poverty line, is 31%. The injustice in this MRT is one of the key problems that this report seeks to address.

We should note, too, that Income Tax in the UK is now collected from individuals whereas historically it was collected by household – from married couples on a basis of the aggregation of both incomes if there were two incomes. So all our tax collection now ignores the reality of the household, the actual unit of shared consumption and lifestyle, which is the basis of everyday economic life. We do not propose to examine household-based approaches to taxation in this report but recognise that a thorough overhaul of the tax system would address this, drawing on the experiences of different tax systems in other European countries.

The argument presented is that our tax system should be designed not merely to ‘plug the budgetary hole’ if/when appropriate, but primarily to make the tax system more equitable. We also argue here that we should collect *more* taxes, through a sustained assault on tax avoidance and evasion, and at the same time redistribute the current tax take so it falls more heavily on the very affluent and much less heavily on middle and low income households.

The effect of the latter proposal will be to increase effective demand by redistribution towards poorer households with a much higher marginal propensity to consume – poorer people spend all their income on getting by. This combined approach – restructuring the tax system equitably and taking aggressive action against tax avoidance and evasion – will raise additional revenues to fund public investment for sustainable growth.

We know that the top tenth of households have seen much greater increases in their post-tax

incomes over the past decade than other households due to the comparatively low rates of tax they pay (see Byrne and Ruane, 2008<sup>45</sup>). The time to redress this imbalance is long overdue. We know that the top 1% and 5% of individuals pay even lower rates of tax, mainly because much of their income comes in forms other than earnings<sup>46</sup> and this carries through to the households to which they belong. They have been the prime beneficiaries of the deregulation of the UK economy and the economic focus in recent years on financial services. As discussed above, deregulation and the growth of risky lending practices within the financial services sector have created the economic crisis the UK is now experiencing.

We have two available sets of estimates of the scale of tax avoided or evaded by UK individuals and corporations.<sup>47</sup> There are strong grounds for supporting reasonable proposals to limit the capacity of corporations to avoid tax by moving their tax base to national regimes with lower corporate taxation rates. This would require international co-operation, probably initially at an EU level. In this section, however, we focus on the tax system as it is applied to individuals.

### The proposal: an ideal personal tax system?

If we take individuals alone, then Murphy estimates that the UK Exchequer loses £13 billion per year through legal tax avoidance.<sup>48</sup> Her Majesty’s Revenue and Customs (HMRC) was forced by the Information Commissioner in early 2008 to disclose its estimate that the combined total loss to the exchequer from tax avoidance and evasion was between £11 billion and £41 billion per year, compared with total tax revenues from all sources of £575 billion. It seems reasonable to assume that a hard crackdown on tax avoidance and evasion by individuals would yield at least £15–20 billion (although we use a more conservative figure below). Such a crackdown would start with an assault on tax havens (or ‘secrecy jurisdictions’), particularly those under British Crown rule. It is worth noting that President Obama is engaging in such an assault on behalf of the US tax payers.<sup>49</sup>

The substance of the ‘ideal tax system’ outlined here is a radical readjustment of the tax structure in the UK so that the lower income households

44 Other than for those still in the state-earnings-related pensions scheme, who pay a higher rate for a higher benefit.

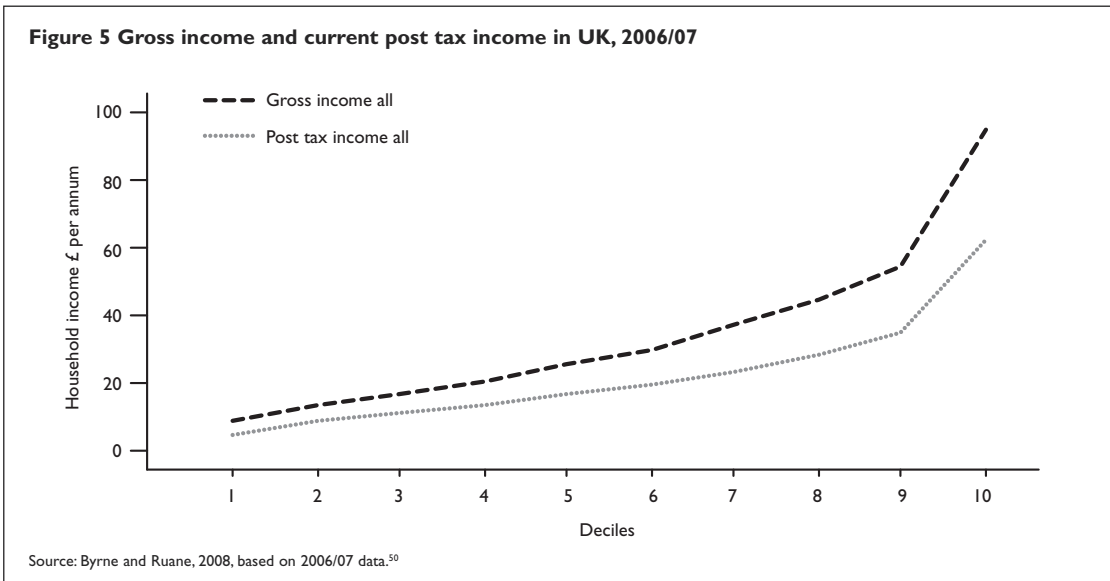
45 Byrne, D. and Ruane, S (2008), *The UK Tax Burden: Can Labour be Called the “Party Of Fairness”?*, Compass Thinkpiece 40, Compass.

46 Brewer, M., Sibieta, L. and Wren-Lewis, L. (2008) *Racing Away: Income Inequality and the Evolution of High Incomes*, Institute for Fiscal Studies, [www.ifs.org.uk/lbns/bn76.pdf](http://www.ifs.org.uk/lbns/bn76.pdf).

47 Murphy, R. (2008) *The Missing Billions: The UK Tax Gap*, Touchstone Pamphlet 1, TUC.

48 Murphy, *The Missing Billions*.

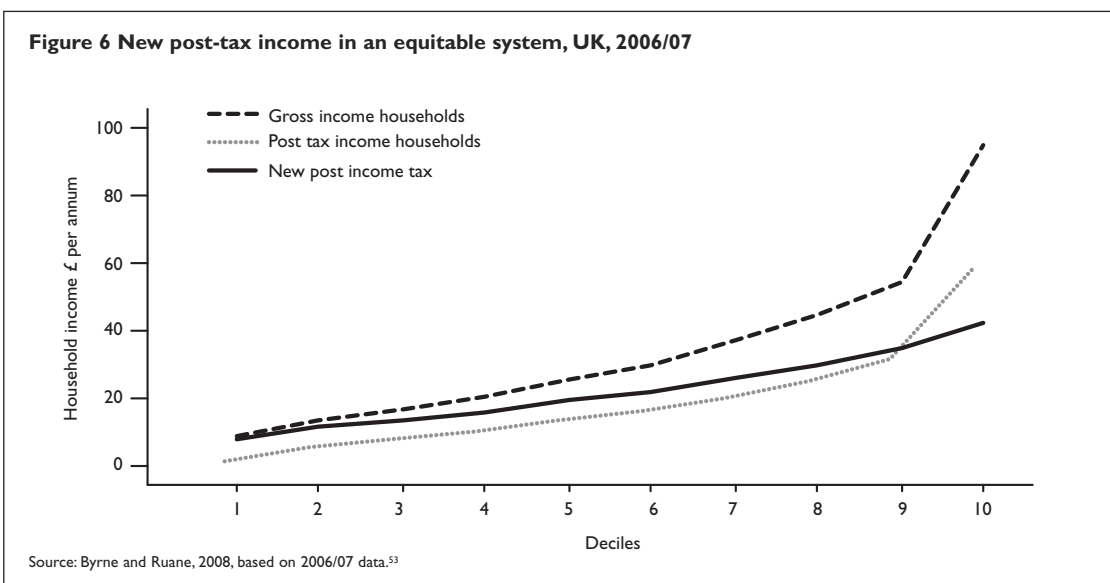
49 See the *Observer Business Section*, 9 November 2008, p.1; also note the current dispute between the USA and Switzerland.



pay less tax in total and the very highest income households pay more. The proper form of the overall household tax take – the amount taken from each household in all taxes, direct and indirect – should be one which is essentially progressive. That is to say, the higher the gross household income, the higher should be the total rate of tax paid. The total rate of tax includes direct taxes (such as Income Tax, National Insurance and Council Tax<sup>51</sup>) and indirect taxes (such as VAT and excise duties).

Moreover, the tax system should also be equitable in relation to the overall income distribution. One good way of defining equity is that increases in post-tax income should proceed in such a way that if

graphed out, the line is reasonably straight and does not have a severe angle. In other words, post-tax incomes should increase gradually and there should be no sudden jumps which demonstrate that higher income households have disproportionately higher post-tax incomes. Using data derived from the Office for National Statistics' publication on household incomes and taxes,<sup>52</sup> we can work out what the overall rate of tax should be to achieve these twin objectives and compare it with the present situation. Figure 5 shows graphically the current pattern of income distribution by decile in the UK for gross incomes and post-tax incomes by decile. In addition, Figure 6 shows the picture when taxes are deployed to render the system more equitable.



<sup>50</sup> Byrne and Ruane, 'The UK tax burden'.

<sup>51</sup> In Northern Ireland, rates are collected instead of Council Tax. We do not propose changes to the rates in this document.

<sup>52</sup> See Jones, 'The effects of taxes and benefits on household income, 2006/07'. These are the most recent figures at the time of writing (October 2009).

<sup>53</sup> Byrne and Ruane, 'The UK tax burden'.

**Table 5 The effects of changing total tax take by household decile**

Decile group	Gross Income (£)	Current tax rate (%)	Current tax take (£)	Post tax Income (£)	Proposed tax rate (%)	Proposed ed tax take (£)	New post-tax Income (£)	Change in total tax (£)
Bottom	9,076	46.1	4,185	4,891	12.0	1,089	7,986	-3,096
2nd	13,616	33.7	4,583	9,033	15.0	2,042	11,573	-2,541
3rd	16,826	32.9	5,532	11,294	18.0	3,028	13,797	-2,503
4th	20,362	33.0	6,727	13,635	21.0	4,276	16,085	-2,450
5th	25,795	34.6	8,937	16,858	24.0	6,190	19,604	-2,746
6th	29,938	35.1	10,503	19,435	27.0	8,083	21,854	-2,419
7th	37,100	36.6	13,562	23,538	30.0	11,130	25,970	-2,432
8th	44,759	36.7	16,446	28,313	33.0	14,770	29,988	-1,675
9th	54,609	36.0	19,648	34,961	36.0	19,659	34,949	11
Top	94,524	34.2	32,281	62,243	55.0	51,988	42,535	19,707

Source: Byrne and Ruane, 2008<sup>55</sup>

It can immediately be seen that currently the highest decile group in the UK – the tenth of households with the highest incomes – pull very rapidly away from all other deciles even after the impact of all taxes on their household incomes. Again, all are derived from Jones (2008).<sup>54</sup>

The new post-tax income levels are arrived at by making the changes to total tax take for each decile shown in Table 5. The changes have been made in such a way that the proportion of gross income taken in tax is progressive through all deciles and that no decile but the highest pays a higher proportion of gross income in tax than at present.

Table 5 shows that by having marginal tax rates starting at 12% for the lowest household decile group and rising by 3% increments to the 9th decile but increasing to 55% for the highest decile group, we can achieve a smooth and not unduly steep income inequality line (Lorenz curve) in the UK. This is a hypothetical revenue-neutral scheme, but it provides a good illustration of the kind of tax progression gradient we should be moving towards. The total amount of tax raised from households would remain the same under these proposals. The very affluent would pay more and something approximating to a fair share. Everybody else would either pay less or the same as now.

Obviously, in the current economic context, we need to drop the ‘revenue neutral’ assumption if the policy aim, in addition to improved equity, is to

achieve an increase in total tax take. The details of revision of the tax structure in order to approximate this progressive pattern better requires careful work, including appropriate micro-simulations as set out in the next section. However, even now we can make some preliminary suggestions.

The key elements in collecting more taxes from the highest decile would be an extension of the standard rate of National Insurance through the full range of earned incomes, the removal of the capping level on Council Tax valuation bands, and the introduction of higher Income Tax bands. Of course, raising tax rates would be a major incentive towards tax avoidance and/or evasion, which is why vigorous action on avoidance and evasion is a necessary part of the process.

At the other end of the income ladder, the main methods for reducing the amount of tax taken from low income households would necessarily involve the raising of thresholds for National Insurance and Income Tax and for full remission of Council Tax. The annual earnings of an adult on the national Minimum Wage are currently £11,174 (for a 37.5 hour week) and this figure is a useful one around which to construct some idea of how to reduce the tax burden on the less well off. In addition, indirect taxes such as VAT play a particularly strong role in producing a regressive tax system; although we do not explore proposals for reducing them in this document, a thorough overhaul of the tax system would need to address these.

54 Ibid.

55 Byrne and Ruane, ‘The UK tax burden’.

For some years, the UK has been burdened with an inequitable, lopsided and dysfunctional tax system. With a more radical approach to putting fairness centre stage, proposals can be devised which, once in place, would be administratively much simpler than the current tax credit arrangements, would cost far less to administer, and would involve redistribution from the highest incomes to the lowest. The proposed revisions are radical but they would result, first, in the overwhelming majority of people paying either the same or less tax and having more to spend in relation to gross income *and*, second, in an increased resource for government to fund job-creating public and environmental programmes.

## 4. Steps towards a fairer tax regime

The Institute of Fiscal Studies estimates the breakdown of total tax receipts in 2008 to be about £540 billion in total.<sup>56</sup> According to HMRC, the three main components of personal tax account for about half the total and are shown in Figure 7. (Council Tax, which brings in around £22 billion, is not shown because it is collected locally.) Revenue for 2007, 2008 and 2009 falls because of the recession. For this reason, our estimates below of extra tax receipts derived from changing taxation should be treated as typical of the business cycle average rather than relating to troughs or peaks.

‘Our long-term objective would be to replace the 10% band with a personal allowance worth £13,500, so that no-one below the poverty line pays any Income Tax’

What is important is the shares in total personal taxation of National Insurance Contributions (NICs), VAT and Income Tax as shown in Figure 7. The main reason why overall

personal tax incidence is regressive is because the sum of VAT and NICs (plus Council Tax) outweighs Income Tax. This problem can be alleviated chiefly by two sorts of measures: introducing new bands for personal Income Tax on high earners and changing the flat nature of NICs while further banding Council Tax. We examine the impact of such measures below.

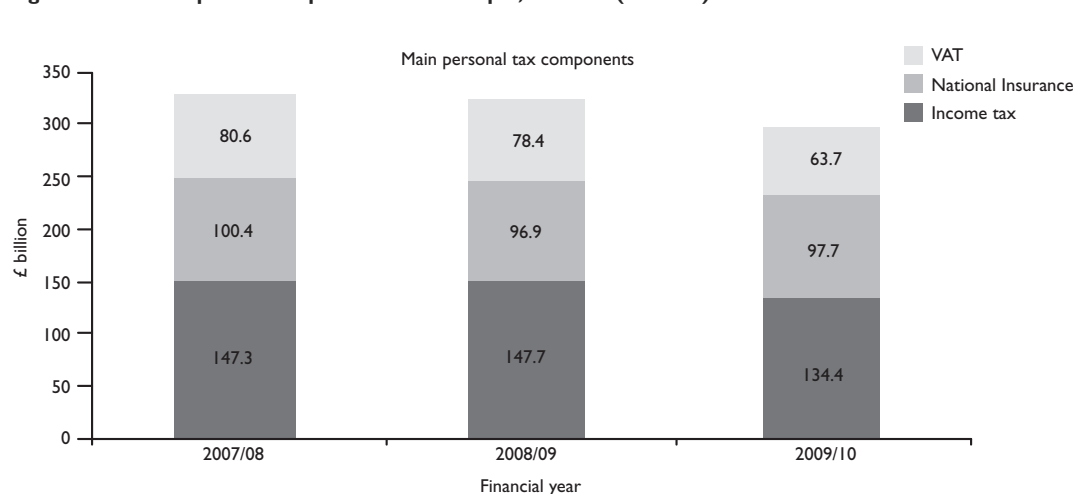
Equally, we look at changes in the tax system which, while falling short of the ‘ideal’ Byrne and Ruane tax proposals outlined above, would move the UK some way towards it and result in a more progressive overall tax incidence. The tax model is a version of that originally built for the Institute for Public Policy Research by Howard Reed and used for micro-simulations of several of the main tax reforms suggested in this document. Unless otherwise indicated, sums are shown at current prices and reforms apply to individual taxpayers (since households no longer count as taxable units).

### Our recommended package of reforms

#### Reform 1: 50% Income Tax above £100,000

This reform introduces a new 50% band of Income Tax for taxable incomes above £94,000 per year (approximately £100,000 a year gross income). This contrasts with New Labour’s April 2009 announcement of introducing a 50% band on incomes above £150,000 per year – we have lowered the threshold by £50,000 per annum.

Figure 7 Main components of personal tax receipts, 2007–09 (£ billion)



Source: HM Revenue and Customs annual receipts; Figure 1.1; this source omits Council Tax.<sup>57</sup>

<sup>56</sup> See Adam, S., Browne, J. and Heady, C. (2008) *Taxation in the UK*, prepared for the Report of a Commission on Reforming the Tax System for the 21st Century, chaired by Sir James Mirrlees, Institute of Fiscal Studies, p.8; their figures are slightly higher than those given by HMRC.

<sup>57</sup> See [www.hmrc.gov.uk/stats/tax\\_receipts/menu.htm](http://www.hmrc.gov.uk/stats/tax_receipts/menu.htm) (accessed 18 July 2009).

Setting the band at £150,000 a year gross income would only raise £2.4 billion (while our measure raises £4.7 billion).

### Reform 2: Remove the upper limit on employee NICs and make NICs payable on investment income

Currently (2009/10), employee NICs are payable at 11% from £100 a week up to £884 per week – and at 1% above this level. (Self-employed NICs have an equivalent structure based on annual profits, paid at 8% up to profits of £43,875 and then at 1% above this.) Also, unearned income (for example, income from investments and savings) is not subject to NICs. This reform removes the upper threshold so that employee NICs are payable at 11% on all earnings above £884 per week for employees and at 8% on all profits above £5,715 per year for the self-employed. Additionally, all investment income above £110 per week (or the annualised equivalent) is made liable to NICs at 11%.

### Reform 3: Introduce minimum Income Tax rates at incomes of above £100,000

This reform introduces minimum average rates of Income Tax above certain levels of gross income, a principle suggested by the TUC in its 2008 report *The Missing Billions*.<sup>58</sup> As gross income approaches each threshold, the personal allowance and other reliefs (for example, tax relief on pension contributions) are ‘clawed back’ at a high marginal rate until the average tax rate – as well as the marginal tax rate – on income above each threshold is equal to the rate shown in Table 6.

Gross income level	Minimum rate
£100,000	40%
£150,000	50%

**Reform 4: introduce a tax band of 10% up to the poverty line of £13,500 per year or roughly 60% of median income,<sup>59</sup> and restore the ‘basic rate’ to 22p (where it was prior to April 2008) to help pay for it** Our long-term objective would be to replace the 10% band with a personal allowance worth

£13,500, so that no-one below the poverty line pays any Income Tax, but this is too expensive to introduce in the short run.

### Reform 5: Increase Council Tax multipliers above Band D to raise the yield from Council Tax on expensive houses (or at least those that were assessed as expensive in 1991)

The revisions are shown in Table 7.

Band	Current multiplier	Reform multiplier
A	0.667	0.667
B	0.778	0.778
C	0.889	0.889
D	1.000	1.000
E	1.222	1.500
F	1.444	2.000
G	1.667	2.500
H	2.000	3.000
I	2.333	3.500

Of course the right will argue that higher taxes will just lead to higher rates of avoidance or the flight of talent. Research by the Work Foundation busts the latter myth.<sup>60</sup> Our view on avoidance is that if the top rate is increased while at the same time reforms are made to the tax system, minimising avoidance and evasion, the taxable income elasticity is likely to be small, if not zero.

Table 8 gives the results from the tax simulations of each of the five reforms we look at. The reforms are modelled cumulatively: reform 2 (R2) contains R1, R3 contains R2, and so on. All revenue is expressed annually.

## Summary of micro-simulation results

The combined impact of the package tax reforms considered here is to raise about £18.9 billion each year in extra revenue. Introducing a 50% marginal rate of tax (MRT) on income above £100,000 pa raises £4.7 billion (reform 1), which is £2.3 billion more than the government’s estimate of £2.4 billion from the 50% rate at £150,000 and above in its budget 2009 report.<sup>61</sup>

58 Murphy, *The Missing Billions*.

59 Our figure is a slight underestimate of 60% of individual median income before housing costs and is based on Brewer et al, *Racing Away*; the latest median figure available is £490 (2007/08), or  $490 \times 50 \times 0.6 = £14,700$ . See Brewer et al, *Poverty and Inequality in the UK*.

60 See Isles, N. (2003) *Life at the Top: The Labour Market for FTSE-250 Executives*, Work Foundation.

61 See HM Treasury (2009) *Budget 2009*, Table A.1, [www.hm-treasury.gov.uk/d/Budget2009/bud09\\_chaptera\\_307.pdf](http://www.hm-treasury.gov.uk/d/Budget2009/bud09_chaptera_307.pdf). Note that the Treasury estimate is somewhat lower than ours because, as the IFS discovered using a Freedom of Information request, the Treasury applied a downwards adjustment to their estimates of yield to capture the impact of tax avoidance (which would reduce the yield from the 50% top rate in the absence of any other reforms, largely due to reclassification of income as capital gains). Because we are recommending a set of other reforms to minimise (and hopefully eliminate) tax avoidance, we have assumed that a downward adjustment is not required here.

**Table 8 Effect of implementing recommended tax reforms: average increase in income of each decile group (%), and effect on total tax revenue<sup>62</sup>**

Reform	Recommended tax reforms				
	R1 50% MRT above £100k	R2 R1 plus uncapping NI	R3 R2 plus minimum tax rates	R4 R3 plus 10p band and 22p basic rate	R5 R4 plus CT reform
Average % increase in income by decile group:	%	%	%	%	%
1 (poorest)	0	0	0	0.2	0.1
2	0	0	0	0.4	0.4
3	0	0	0	0.7	0.7
4	0	0	0	1.5	1.3
5	0	0	0	2.2	2.0
6	0	0	0	2.8	2.6
7	0	0	0	2.9	2.7
8	0	-0.1	-0.1	2.5	2.3
9	0	-0.3	-0.7	1.2	0.9
10 (richest)	-2.2	-6.2	-12.9	-12.4	-12.6
Aggregate impact of policy	Raises £4.7bn	Raises £13.8bn	Raises £28.7 bn	Raises £17.2bn	Raises £18.9bn
Incremental effect	+£4.7bn	+£9.1bn	+£14.9bn	-£11.5bn	+£1.7bn
Cumululative. Impact on Gini (percentage points)	-0.4	-1.1	-2.5	-2.6	-2.6

Adding Reform 2 (uncapping NICs and applying them to investment income) brings in an extra £9.1 billion, raising total new revenue to £13.8 billion.

Applying minimum tax rates of between 40% and 50%, depending on income level, raises an extra £14.9 billion on top of this, bringing total extra revenue up to £28.7 billion. Table 8 also shows the impact on inequality of each reform by decile group.

Reform 1 (50% MRT starting at £100,000 and above) lowers post tax income of the top decile by 2.2% while decreasing the Gini coefficient by nearly half a percentage point. When, in addition, NICs are uncapped and minimum tax rates are introduced, the highest three decile groups are affected with the top decile bearing the weight of the reform (a fall in post tax income of 12.9%) and a reduction in inequality of 2.5 percentage points on the household income Gini coefficient. Further decreases in the Gini coefficient are achieved in reforms 4 and 5, which also offset any loss incurred to deciles 8 and 9 by reforms 1–3.

Reform 4 halves the current basic rate of tax (reduces it to 10%) for incomes below the poverty line – below 60% of median income or approximately £13,500 per annum – covering nearly one-fifth of the UK population.<sup>63</sup> Poverty-level income earners in Britain pay far higher personal Income Tax rates than those in Germany or France, one of the reasons we have higher income inequality than our neighbours.

This reform is redistributive in that almost all decile groups benefit. But such a reform would cost the Treasury about £11.5 billion in revenue foregone, all other things remaining equal. (We assume that reforms 1, 2 and 3 are implemented.) The income band targeted runs from the current personal allowance of just under £6,500 to £13,500; its width is about £7,000. The reason the reform costs so much – and gives so much away to the decile groups above the targeted group – is that every taxpayer, rich or poor, now pays the lower 10% rate instead of 20% on their first slice of income up to £13,500.

<sup>62</sup> Notes: calculations produced using tax-benefit microsimulation model developed for ippr's 'Red and Green Taxes' project, funded by UNISON, Friends of the Earth and the PCSU. The calculations use data from the 2005/06 Family Resources Survey, which is sponsored by the UK Department for Work and Pensions, and supplied by the UK Data Archive.

<sup>63</sup> See Lansley, *Life in the Middle*, p.11.

Because this reform is expensive, we propose to pay for it in part by restoring the basic tax rate to 22%. But this does not mean that all basic rate taxpayers would pay more. *Individual taxpayers earning a gross income of £36,800 or less are better off* under this arrangement, which is why the gains from reform 4 accrue to all decile groups right up to the 9th.<sup>64</sup> But even after factoring in the 22p basic rate, reform 4 reduces cumulative extra revenue generated from £28.7 billion (R3) to £17.2 billion.

Introducing new Council Tax bands (reform 5) raises an additional £1.7 billion. However, this is not a particularly well-targeted reform in distributional terms; the impact on inequality is only one-tenth of a percentage point. Hence we see this as a ‘stopgap’ measure pending wholesale reform of local taxation. It must be borne in mind, too, that the Council Tax multipliers used above apply to property valuations last updated in 1991. In this context, it might be added that CentreForum estimates that a 0.5% annual levy on property worth more than £500,000 would raise an additional £2–3 billion, while Compass has published excellent proposals by Iain McLean and Toby Lloyd for replacing Council Tax with a Land Value Tax.<sup>65</sup>

The only reason the property revaluation update has not been carried out is that the government appears to fear that it will create a lot of losers in the south (because house prices in the south are much higher relative to the north, despite recent falls). Also, reform would create a large administrative overhead and for relatively little gain (from the government’s point of view). So the update has been kicked into the long grass, except in Wales where property was revalued in 2004. Of course, the downside of not revaluing is that the relationship between house price band and current house price value becomes ever more tenuous.

## Tax avoidance

Tax avoidance is pernicious: it means that people and institutions ‘get round’ their obligation to pay tax in ways which tax law did not anticipate and did not intend. Tax avoidance, both corporate and personal, is estimated to cost the UK at least £25 billion a year. Since some effects cannot readily be measured, the true cost is likely to be more.<sup>66</sup>

There is no ethical justification for tax avoidance. Although it is technically legal, it is no more justifiable than those MPs’ expense claims that ‘met the rules’ but were very obviously abusive. The very term ‘tax avoidance’ suggests that this is so since such avoidance is the process of going round the law to ensure a tax saving is achieved. The resulting tax cost is borne by everyone else in society: this is not a victimless activity.

## Capital gains should be taxed as income

The 1980s Conservative government introduced a sensible reform of Capital Gains Tax (CGT). While allowing any person an allowance of tax free gains each year, which has the benefit of considerably reducing the administrative burden of this tax, the reform stipulated that all remaining gains should be taxed as though they were part of a person’s income and their highest personal Income Tax rates should be applied to the gain. This tax was, to some degree at least, progressive. The incentive to re-categorise income as capital gains was dramatically reduced, so eliminating a whole raft of opportunities for tax avoidance.

New Labour removed this link with a person’s Income Tax rate. In 1997 it announced a new CGT rate of 10%; in 2008 the rate was raised to 18% where it currently stands. The government has also dramatically increased the tax free allowance for small businesses (now £1 million) without making an economic case for doing so. These changes make no sense, not least because they provide a massive inducement to re-categorise income as gains, so providing a significant incentive to the tax avoidance industry.

We propose that all capital gains above a certain minimum (exempting ‘once in a lifetime’ gains) be treated as income. If, at the same time, measures were introduced to stop partners in domestic arrangements using artificial transactions to spread capital gains tax liabilities to those with lower rate tax bills and to use two sets of allowances for this tax, it is anticipated that the revenue derived from it would increase significantly. Its annual yield (2007/08) is approximately £3 billion per annum (although this varies widely from year to year), and it is realistic to think these changes might increase that by at least £2 billion per annum.

64 This is because the maximum gain is  $10\% \times £7,000 = £700$  from the 10p rate but an extra 3p on the 20% rate which kicks in at £13,475 is lost; the equilibrium point is given by the expression  $£13,475 + (£700/0.03) = £36,800$  (to the nearest £100).

65 See Wilkes, *A Balancing Act*; also McLean, I. (2006) *The Case for Land Value Tax*, Compass Thinkpiece 2, Compass, and Lloyd, T. (2009) *Don’t Bet the House On It: No Turning Back to Boom or Bust*, Compass, April.

66 See Murphy, *The Missing Billions*.



### Non-doms

The UK has perverse rules for determining whether a person is a tax resident: you are a UK tax resident only if you spend more than 120 nights a year here. The consequence is that some of the wealthiest people in the UK work here for up to four days a week but commute to and from (say) Monaco each weekend and claim for UK tax purposes to be resident in a tax haven, not the UK. As a result they pay little or no tax in this country.<sup>67</sup> The rules also make it very hard for those arriving in and leaving the UK to be sure whether they are liable to UK tax, while allowing those who leave to take up residence in a tax haven and to avoid tax for considerable periods while retaining the right to use UK facilities, such as the NHS, whenever they like.

This system needs simplification and reform to stop abuse. The simplest reform would be the most effective: all UK passport holders should pay UK tax on all their worldwide income whether or not they are in the UK. Their tax position would be very clear, and considerable tax avoidance by those claiming to live elsewhere, but continuing to make frequent visits to the UK, would be eliminated if this rule was adopted.

For those who genuinely leave to take up work or to live in a country which charges tax on an equivalent basis to the UK (which tax havens do not) there would be an exemption from UK tax – but only if proof of paying tax elsewhere was provided. This would mean that those seeking to use tax havens to avoid UK tax could no longer do so.

For those coming to the UK to live, a much simpler objective test than exists at present would be introduced so they knew where they stood. For example, they could be allowed to pay tax in their home country for the first four years lived in the UK, after which they would pay tax in the UK on the same basis as UK passport holders.

As with all measures aimed at stopping tax avoidance, it is hard to estimate the additional tax this change would create, but the TUC has estimated that eliminating the current domicile and tax residence rules (which this reform would do) should raise £3–5 billion a year; we have used £3 billion as a conservative estimate.

### Reforming taxation for small businesses

There is a fundamental flaw in UK business taxation. It is assumed that all companies, from the very largest such as our multinational banks and oil companies, down to the single-person company that many self-employed people use, should be subject to the same basic laws of accounting and taxation. This is an anachronism dating from the Victorian era that needs overhauling.

It makes no sense to assume that all these companies are similar in structure and subject to similar taxation rules. Nor does it make sense to assume that they are subject to broadly similar accounting rules, especially when in both cases the structures that are applied to small business are, in effect, simply scaled-down versions of the rules that apply to large companies.

We suggest that there should be a radical reform of the various entities available to small businesses so that tax laws suitable for the 21st century can be made available to the small business community to replace those currently in use. In particular, it is vital that a small business be allowed to trade with limited liability but without the owner being obliged to comply with all aspects of employment law (given that their sole employee might be themselves). In addition, it makes no sense that employment taxation rules be applied to payments to small company owners when in reality the relationship between those businesses and their owners is fluid, subject to rapid change, and incapable of being forced into the current, rigid taxation regime designed for those in stable, long-term employment.

This reform can be achieved by developing the model of limited liability partnerships (LLPs), a model which currently exists in the UK but which has been too little used. We suggest that all existing small limited companies (approximately 2 million of them) be re-registered in this form unless they want to subscribe a minimum of £50,000 of share capital – which the vast majority would not, particularly if NICs were introduced on dividend income, as should be done for reasons noted above. Limited liability partnerships do not pay dividends; their members are taxed on their share of the profits of the business as if they are self employed.

<sup>67</sup> An annual charge has recently been introduced meaning that some 'non-doms' must pay to make use of this rule.

If, at the same time, new economically justifiable and verifiable standards for splitting income between the members of LLPs were introduced so that the current practice of paying income to those who have not really earned it was eliminated, then a fair basis for paying rewards could be established without risk of serious taxation challenge arising. In addition, senior employees of the business could be made members of the partnership and so be subject to reduced PAYE compliance rules and to the slightly lower tax rates the self-employed enjoy.

If these reforms were undertaken, then:

- the administrative burden for many small businesses would be reduced
- the certainty of the arrangements under which they can operate would be increased
- the rewards that small businesses rightly seek to pay to those who contribute to their management from within domestic relationships would be rewarded, but within appropriate constraints
- the attraction of freelance status in tax terms would be retained
- the current injustice that sees income from labour more heavily taxed in the UK than income from capital would in large part be eliminated
- the incentives for tax planning would be reduced, so simplifying tax administration
- the tax yield would probably not be altered significantly.

## A financial transaction tax

Speculative and high risk trading of financialised products helped create the credit crunch and the subsequent recession; the growth in inequality they lead to stretches the fabrics of society.

In 1977 the ratio of foreign exchange dealings to world exports was estimated to be 3.5. By 2007 this ratio was estimated to have risen to about 86. In 1971, following the demise of the fixed exchange rate system, the economist James Tobin proposed a tax to tackle such currency speculation. The main feature of the 'Tobin Tax' is that it is set at a very low rate (Tobin originally proposed 1% but 0.1% is more typical) it falls on all financial transactions. Because the better part of

London's \$2–3 trillion a day in transactions is speculative, the effective tax rate increases substantially for repetitive transactions, thus reducing the incentive for speculators to trade and so reducing price volatility. At times of significant price change in the market, the effective tax rate rises, thus dampening speculation and acting as a disincentive to the herd instinct.<sup>68</sup>

Despite public campaigns in favour of a Tobin tax, no OECD country has yet introduced such a tax, nor have economists explored the extension of this tax to other markets where speculators fundamentally distort trade. Yet many of these markets are located in London. Such a measure has been urged, among others, by George Soros and Adair Turner.<sup>69</sup>

We suggest that there now has to be active consideration of mechanisms that might limit speculative activity in foreign exchange and commodity markets. Research is needed into the use of Tobin Tax not only in currency markets but also in markets for oil, gas, coal and other energy supplies as well as minerals and foodstuffs that are subject to speculative trade.

A Tobin Tax is simply a special case of a Financial Transactions Tax (FTT), one applied to foreign exchange dealings. The UK already has an FTT: it is called stamp duty. The stamp duty amounts to a fixed rate of tax on certain forms of financial instrument, mainly those relating to share dealing and the sale of land and buildings. It has been successful in generating significant revenue; about £14 billion per annum was raised before the recession began, although the sum is now less.

There are, however, other forms of FTT. A tax could be imposed on all debits – that is payments – in bank accounts. The rate might be very low – say, 0.1%. The GDP in the UK is at present approximately £1.4 trillion per annum. To achieve this level of national income, several times this volume of debits is required in bank accounts (for example, wages paid are a debit, and when those who receive them spend that cash they are a further debit). Speculative activity also creates substantial cash movement for little income generated. If it is supposed that debits run at three times the level of GDP, a tax at 0.1% would raise £4.2 billion, costing the average household less than £20 a year, far less than most households pay in bank charges.

68 Ironically, the orthodox view of speculation in future contracts is that such contracts reduce risk and dampen volatility. While this may be true for small contracts, what we have seen in the recent past is the rise of very large contracts financed by borrowing (leverage); losing a bet under these circumstances can undermine institutions and increase volatility.

69 See Turner, A. (2009) 'How to tame global finance', *Prospect*, 27 August, and <http://uk.news.yahoo.com/22/20090903/tbs-uk-g20-oxfam-sb-b5819a3.html> (accessed 10 September 2009).

## 5. Making the right cuts

We started by arguing that putting Britain's finances on a sounder footing did not mean across the board expenditure cuts. It is clear from the above that ample scope exists to raise more revenue and to do so in a manner which makes taxation fairer. Nevertheless, some expenditure cuts will need to be made. However, talk of ring-fencing NHS expenditure while slashing everything else by 10% is simplistic. What is required is a review of spending priorities. It is political madness to suggest that benefits to the poorest or most at risk should be cut while at the same time spending billions on Trident.

'Our intention is to illustrate the need for changing current spending priorities rather than simply slashing expenditure'

What should be cut? Again, the list below is meant to be suggestive rather than comprehensive. Our intention is to illustrate the need for changing current spending priorities rather than simply slashing expenditure. Britain has travelled the broad-based 'public expenditure cutting' route before, particularly in the years when capital budgets for much needed infrastructure were axed and large number of public services were hived off to the private sector. The results, from overpriced PFI hospitals and underperforming railways to the postcode lottery in education, are generally thought by the public to have been disastrous.

In April 2009 the Institute of Fiscal Studies (IFS) suggested that the Chancellor would need to find an extra £39 billion each year if the budget was to be balanced between 2011 and 2014. Various figures of this magnitude have been bandied about since (as noted above, the IFS has since upped its estimate to £45 billion for the period 2014–18) while leading members of the Monetary Policy Committee (MPC) have warned recently of the need for fiscal belt-tightening. Whether the 'structural budget deficit' is really as high as £45 billion

depends *inter alia* on (a) how soon Britain seeks a 'balanced budget' target, a timeframe which in turn depends on the length of the recession; and (b) the average rate of inflation over the period; for example, a 2% inflation rate over ten years would reduce the above 'hole' by £9 billion.

Quite aside from the question of whether a 'balanced budget' is necessary or desirable even when steady growth resumes – which may be some years off if the recession is indeed L-shaped – consider how this target might be met in ways that do not compromise Britain's social and economic infrastructure, a vital consideration if the country is to regain its competitiveness and find a sustainable growth path.

For the sake of argument, let us assume the target figure is £40 billion, or about 2.5% of today's GDP. Here are some possible cuts:

- ID cards
- Trident, new aircraft carriers and Eurofighter purchases
- Iraq and/or Afghanistan
- mini-Titan prisons
- PFI schemes.

The cost of ID cards is anything between £5 billion and £15 billion, or about £2.5 billion per annum over the relevant IFS period. The cost of Trident and of other 'heavy' military items – two aircraft carriers to be delivered in 2018 at a current cost of £5 billion and the expensive new batch of Typhoon Eurofighter aircraft last estimated to cost £20 billion in 2003 – over the next 30 years is put at £120 billion.<sup>70</sup> The corresponding annual figure would be £4 billion.

ID cards, Trident and other heavy hardware are 'soft' candidates, but more difficult choices must be made as well. The Iraq war in 2008 cost £1.5 billion a year while that in Afghanistan cost £2.2 billion.<sup>71</sup> It can safely be assumed that the full costs of the Iraq war will be shifted to Afghanistan and that Britain will still be there in 2011 (about £4 billion in operations annually). That brings the total to £10.5 billion (2.5 billion + 4 billion + 4 billion) per annum.

The capital and maintenance cost of expanding prisons or building 1,500 'mini-Titans' to accommodate a total of 100,000 prisoners will be about £1.3 billion, so scrapping that project would be a significant saving.<sup>72</sup>

<sup>70</sup> This is a conservative estimate; see Norton-Taylor, R. (2009) 'Revealed: the £130 billion cost of Trident replacement', *Guardian*, 18 September.

<sup>71</sup> See Evans, M. (2008) *The Times*, 26 November; a more recent estimate of Afghanistan cost is £2.6 billion, so we have erred on the conservative side.

<sup>72</sup> See Lord Beith's Justice Committee, [www.alanbeith.org.uk/news/000232/beiths\\_committee\\_asking\\_you\\_how\\_5\\_billion\\_cost\\_of\\_prisons\\_and\\_probation\\_could\\_be\\_better\\_spent.html](http://www.alanbeith.org.uk/news/000232/beiths_committee_asking_you_how_5_billion_cost_of_prisons_and_probation_could_be_better_spent.html) (accessed 29 July 2009).

What about all those hospitals financed under the private finance initiative (PFI)? It is estimated that buying out existing PFI schemes and switching existing and planned schemes back to the public sector could save anywhere between £1.5 billion and £5 billion per annum (call it £3.3 billion).<sup>73</sup> Arguably, having effectively nationalised the key lending institutions in PFI, why should we not re-nationalise the PFI hospitals?

Adding together all these measures gives us total savings equivalent to about one-third of the deficit, or £15.1 billion per annum (10.5 billion + 1.3 billion + 3.3 billion).

As our micro-simulations in an earlier section have shown, abolishing the NIC cap alone would raise a further £12 billion per annum, while placing the 50% tax band at £100k would raise £3.3 billion; the total covers nearly half the forecast IFS deficit. Or again, one could cover between a quarter and half of the IFS deficit merely by abolishing tax havens and reforming personal and company taxation, so that 'tax avoidance' is minimised.

In short, it is perfectly possible to plug the forecast deficit using a judicious combination of saving money on non-essentials and raising revenue through fiscal reform designed to share the burden more fairly. *One could do so and still have money left over for social spending – although we would not recommend the accounting slogan of 'balancing the books'.* The banner headlines in the tabloid press to the effect that every British family will need to pay an extra £1,200 per annum in tax are scare-mongering foolishness, just as is the notion that Britain must accept 10% across-the-board spending cuts.

Cumulatively, Britain has spent a substantial proportion of its annual GDP on plugging the hole in the balance sheets of the financial sector.<sup>74</sup> Relatively little has been spent on stimulating demand, exceptions being cutting VAT by 2.5% and changing the timing of £3 billion in capital spending in the Chancellor's 2008 pre-budget report. Although much of the banking system is now 'owned' by ordinary Britons, there has been no concrete attempt to cap bankers' multi-million pound bonuses, nor to establish a popular bank to stimulate lending or greatly to increase the supply of social housing. The government has spent virtually nothing on accelerating the renewable energy programme.

Britain's social safety nets remain lamentable by EU standards.

At the same time, we are told that public spending after 2011 will rise by less than the rate of inflation: it will fall in real terms. What will suffer? Even if the NHS is ring-fenced, one can reasonably predict that it will be such things as education, unemployment benefit, social services, the probation service, care homes, home helps, Sure Start centres, the youth service, apprenticeships... the potential list is a long one. And none of these cuts are necessary, as we have shown.

73 See for example Edwards, C. (2009) *Private Gain, Public Loss: The Private Finance Initiative and the Norfolk and Norwich University Hospital, a Case Study*, University of East Anglia. But as Edwards notes in private correspondence with the author, these estimates need 'much more work before arriving with any confidence at an annual saving from buying out the [PFI] contracts'. In the same vein, work by Jean Shaoul for UNISON suggests that scrapping PFI might save up to £3 billion.

74 See Stewart, H. (2009) '1MF: fifth of Britain's GDP spent so far on bailouts', *Guardian*, 6 March.

## 6. Conclusions and what next

Somehow, the anger about who caused the crash and how has got turned into a flimsy consensus about public spending cuts. This must be contested. This document shows we can have fair taxes, a sustained recovery and strong public services.

But it is not just tax models and think tank reports we need but the establishment of a progressive consensus for change. The last 12 years of redistribution by stealth has seen some good work done on poverty and public service investment but has ended with a return to mass unemployment and the prospect of years of budget cuts. The Tories call it a broken society – but it won't be fixed by slashing public spending.

Of course we cannot forget that just as we need tax reform we also need public service reform. Compass will continue to work on that; looking to see how services can be modernised and made more efficient not through cuts, targets and markets but by unleashing the incredible productive energies and ideas of public sector workers and users.

The immediate priority, though, is the case for tax reform. As the poor get poorer, the moral base for taxation levels to sustain civilised public services declines and the planet burns – something needs to change and urgently. The proposals outlined here would make a start at reversing these trends and setting Britain on a new course.

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This group of authors was drawn from a wider 'advisory group', which first met in London in September 2008, whose membership includes Robin Blackburn, John Christensen, Chris Edwards, Zoe Gannon, Gavin Hayes, Stewart Lansley, Adam Lent, Neal Lawson, Martin McIvor, Thomas Rixen, Andrew Simms and Stuart White. We should like to thank all of these individuals for their support in making this report possible. Thanks, too, to UNISON, Friends of the Earth and the Public and Commercial Services Union for funding the tax model used for generating many of our quantitative results, and to ippr for allowing the model to be used in our empirical work.

# Glossary

**Behavioural tax model:** a model of taxation that allows for the possibility that higher taxes on labour will result in a reduction of hours worked, an assumption often associated with orthodox neoclassical economic theory.

**Beneficial owner:** the person who has the right to enjoy the income or capital that possession of property might provide. The term is used to contrast with the legal or nominee owners of property and with trustees, all of whom might be recorded as having legal title to property without possessing the right to enjoy the benefits of using it.

**Capital Gains Tax (CGT):** this is tax charged on the profit realised on the sale of a non-inventory asset that was purchased at a lower price. The most common capital gains are realised from the sale of stocks, bonds, precious metals and property. Not all countries implement a Capital Gains Tax and most have different rates of taxation for individuals and corporations.

**Council Tax (CT):** this is a tax levied by local authorities in England, Wales and Scotland on households, and replaced the 'community charge' (aka Poll Tax) in 1993, which earlier had replaced 'rates'. Each dwelling is allocated one of eight council tax bands depending on its capital value, last assessed in England in 1992. At that time, tax on the average band D property was £1,268, and tax for each higher bands was assessed (and still is) using council tax 'ratios' or 'multipliers'. For example, the multiplier for band H property (the highest group whose property is valued at £320,000 and above) is 2.00 times that for band D, so that a mansion owner only pays twice the average amount of Council Tax. Reluctance to reassess property values for tax purposes means that as house prices have gone up, more households have moved into the upper bands. A continuing rise in house prices would mean that eventually everyone would be in band H and pay the same tax, so the tax would be even more regressive.

**Country-by-country reporting:** a proposed form of accounting in which a multinational corporation will be required to report in its accounts in which countries it operates, what the names of its subsidiaries are in each and every

jurisdiction in which it operates, and to publish a profit and loss account of each such jurisdiction, without exception, showing its sales and purchases, both from third parties and intra-group, the number of employees it has and the cost of employing them, its financing costs both third party and intra-group, its profit before tax, its tax charge split between current and deferred tax, and a summary of its assets and liabilities in the location.

**Crowding out:** this is the notion that an increase in public borrowing reduces private investment, mainly through the resulting rise in interest rates.

**Decile groups:** typically, individual (and/or household) incomes can be ranked from lowest to highest, and then cut into 10% (decile) slices. Thus, the poorest 10% of individuals (or households) constitutes the first decile group and the richest 10% the tenth decile group. For convenience, a 'decile group' is often referred to in slightly misleading shorthand as a 'decile'. *Pari passu*, one can slice all income earners into five 'quintile groups', four 'quartile groups' and so on.

**Depression:** a severe (GDP down by 10%) or prolonged (three or four years) recession is referred to as an economic depression.

**Effective tax rate:** the percentage of tax actually paid in relation to the total income of the person paying the tax.

**Financial Transactions Tax (FTT):** a tax used for constraining excessive trading in the financial sector. A modest set of FTTs (e.g. 0.25% on a stock purchase or sale and 0.02% on the sale or purchase of a future, option or credit default swap) would have almost no impact on productive use of these assets, but would discourage speculation. An FTT would make it far more risky to buy a stock with the intention of selling it at a modest gain one hour later.

**Flat tax:** a tax system under which the amount of tax paid remains constant in proportion to total income. Although simple to administer, it is regressive.

**General anti-avoidance principle:** the idea behind a general anti-avoidance principle is simple: it states that if a step is added to a transaction with the aim of securing a tax advantage (which is defined as a saving in tax), but which yields no other material economic benefit, then that step in the transaction is ignored when computing the resulting liability to tax.

**Gini coefficient:** the Gini coefficient is a measure of income inequality within a country. It is usually expressed as a percentage or index where either 1.00 or 100% indicates 'perfect' inequality and 0.00 or 0% indicates 'perfect' equality of income distribution. Britain's current Gini coefficient is approximately 0.34, while Denmark's is 0.23.

**Household income:** in order to measure the income of a household, the pre-tax money receipts of all residents over the age of 18 over a single year are combined. Most of these receipts are in the form of wages and salaries, but many other forms of income, such as unemployment insurance, disability income, child support and so on are included as well. The residents of the household do not have to be related to the householder for their earnings to be considered part of the household's income. The use of household income remains among the most widely accepted measures of income, but does not take into account variations in the household size. Equivalised household income is a measure that adjusts the total annual income of the household to take account of the number of people in the household.

**Income Tax:** a tax charged on the income of individuals. It can also be extended to companies. The tax is usually charged on earned income from employment and self-employment and on unearned income, e.g. from investments and property.

**Land Value Tax (LVT):** a tax on the rental value of a site, assessed as if it were undeveloped and unimproved – in other words, as if it were bare land. It charges tax on an immovable and therefore unavoidable tax base, which is always firmly located within a jurisdiction – the land itself.

**Lorenz curve:** named after the economist Max Lorenz, every point on the Lorenz curve represents a statement like 'the bottom 20% of all households receives 10% of the total income'. A perfectly equal income distribution would be one in which every person has the same income and is represented by a straight line.

**Marginal Rate of Taxation (MRT):** under any progressive system of income tax, after taking the personal allowance into account, the first 'standard slice' of income is taxed at some low marginal rate (e.g. 20%) while income above this

will draw a higher rate (e.g. 40%). The term 'marginal rate' means that only income above a certain threshold draws a higher rate. It is sometimes mistakenly thought that introducing a 50% tax band would mean that all income would draw this higher rate of tax.

**Meidner principle:** named after the Swedish trade-union economist Rudolf Meidner, the principle is that all companies above a certain size pay an annual levy in the form of newly issued new stock shares equivalent to a (small) percentage of their annual profit, the proceeds of which are used to finance social benefits. The advantage of such a levy is that it does not reduce a firm's cash flow; instead, it dilutes share values.

**Micro-simulations:** because tax policy is so complicated and loopholes and allowances (as well as behaviour) change according to income, tax changes must be modelled using sophisticated programs. Such programmes simulate differing rules and behaviours up the income scale, and thus are called 'micro-simulation' models.

**Multinational corporation (MNC):** a corporation with subsidiaries or divisions in two or more nations; also known as a transnational corporation (TNC).

**Recession:** today often defined simply as a period when GDP falls (negative real economic growth) for at least two quarters (three-month periods).

**Regressive taxation:** regressive taxation is the opposite of 'progressive' taxation. The central principle of progressive taxation is that the rich can afford to pay a higher percentage of their income in tax than the poor. All 'flat' or indirect taxes which are levied at the same rate on everyone regardless of income status are therefore considered to be regressive.

**Secrecy jurisdiction (see tax haven):** a 'tax haven' is more appropriately termed a 'secrecy jurisdiction'. Secrecy jurisdictions are places that intentionally create regulation for the primary benefit and use of those not resident in their geographical domain. That regulation is designed to undermine the legislation or regulation of another jurisdiction. To facilitate their use, secrecy jurisdictions also create a deliberate, legally backed veil of secrecy that ensures that those from outside the jurisdiction making use of its regulation cannot be identified to be doing so.

**Structural budget gap:** the budget gap is the gap between public spending and receipts, expressed



as an annual figure (though in practice 'gap' figures in the press often represent multi-year totals). The 'structural' gap is that which exists in normal times and is usually averaged over a 6–8-year business cycle. Because tax revenue falls and government expenditure rises in a recession, the resulting 'gap' is unrepresentative.

**Tax avoidance:** the term given to the practice of seeking to minimise a tax bill without deliberate deception (which would be tax evasion or fraud). The term is sometimes used to describe the practice of claiming allowances and reliefs clearly provided for in national tax law. It is, however, now generally agreed that this is not tax avoidance. If the law provides that no tax is due on a transaction then no tax can have been avoided by undertaking it. This practice is now generally seen as being tax compliant. The term tax avoidance now usually refers to the practice of seeking to not pay tax contrary to the spirit of the law. As such it is synonymous with the term aggressive tax avoidance.

**Tax evasion:** the illegal process of seeking to minimise a tax bill through deliberate deception.

**Tobin Tax:** a suggested tax on all cross-border currency trades (closely related to an FTT, a tax on all forms of short-term stock market speculation). Named after the US economist James Tobin, the tax is intended to penalise short-term currency speculation. The original tax rate he proposed was 1%, but most economists now consider a realistic rate to be between 0.1% and 0.25%.

**Transfer pricing:** a transfer pricing arrangement occurs whenever two or more businesses (whether corporations or not) which are owned or controlled directly or indirectly by the same people trade with each other. The term transfer pricing is used because if the entities are owned in common the businesses might not fix prices at a market rate but might instead fix them at a rate which achieves another purpose, such as tax saving. If a transfer price can be shown to be the same as the market price then it is always acceptable for tax. What are not acceptable for tax purposes are transfer prices which increase the cost or reduce the sales value in states that charge higher tax rates and increase the sales value or reduce the costs in states with lower tax rates. The difficulty for many corporations at a time when up to 60% of world trade is within rather than

between corporations is that there is no market price for many of the goods or services that they trade across national boundaries, because they are never sold to third parties in the state in which they are transferred across national boundaries within the corporation. This gives rise to complex models in which attempts are made to allocate value to various stages within the supply chain within a company, a process which is open to potential abuse. For this reason it is argued that such firms should be taxed on a unitary basis.

**Uncapped NICs:** National Insurance Contributions (NICs) in Britain are levied separately at slightly different rates for the employed and the self-employed. In general, the rate payable is 11% on income of up to £884 per week (£884 is the 'cap') and 1% on higher income. Uncapping NICs would mean paying 11% all the way up the income scale.

**Value Added Tax (VAT):** a tax levied on transactions designed to cumulatively tax value-added within a jurisdiction. National income accounting conventions define value-added as the aggregate of the total value of final consumption and investment goods, excluding intermediate output. Therefore VAT is charged only on imports into, and the sales of registered traders within, a jurisdiction, allowing those same registered traders to make claims for all VAT charged to them for offset against the VAT they collect from their customers. The result is that VAT is only charged to end-consumers within the jurisdiction (exports being exempt from charge). The main advantage of VAT is that, unlike sales tax, it is a tax on the value of gross national product and can be used to raise a lot of money. Its main disadvantage is that it is regressive.

**Wealth tax:** a tax on a person's declared wealth, typically imposed annually at a very low rate. Once commonplace in Europe, wealth taxes are today used less frequently since they are thought to encourage people to hide assets offshore.



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