Agenda for a reforming government

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Twenty four years ago Margaret Thatcher inaugurated nearly two decades of reform, designed to restore Britain economically to the low-inflation and dynamic economy it once had been. In 1997 a ‘New’ Labour government obtained power; the distinguishing ‘new’ was added to indicate that Labour would continue along that reforming path. It would, so its leaders proclaimed, use the free market to pursue efficiency while also striving for ‘social justice’. In a number of areas that has been true. In monetary policy the Bank of England was made independent; in fiscal policy the government proclaimed various new rules to buttress fiscal responsibility, though this now looks rather tarnished; in the labour market the tough approach to benefit eligibility inaugurated by the Conservatives was made bipartisan. Thus some progress has been made.

However, in key areas no progress has been made; indeed we have slipped back.

In taxation and benefits- now renamed ‘tax credits’- complexity has proliferated, with a stress on special incentives and special penalties; this has created a complex patchwork of high marginal tax rates.

In the labour market there has been a series of concessions to renewed union power and workers’ rights, which have raised the cost of labour and increased labour market rigidity.

In public spending the trend to greater decentralisation, competition and privatisation was reversed. In the NHS the internal market was abolished and centralised planning system restored, with new layers of bureaucracy. In schools local authorities were given new powers. The result has been a massive increase in public sector inefficiency and a rise in taxation to pay for the extra cost. Recently, it is true, the government has talked of reviving market forces in the public services and made some initial steps in that direction, with private provision of selected operations and changed management of some schools. But this late reversal has caused confusion and demoralisation among core service providers; it is also unclear whether it will survive Mr. Blair’s departure.

In pensions the trend towards greater personal responsibility has been reversed. Private pensions are now in retreat, after a variety of regulative and tax interventions, most notoriously the abolition of the ACT (Advance Corporation Tax) reclaim. Meanwhile state pensions are in confusion, with a Minimum Income guarantee and the Pension Tax Credit undermining the incentive to save.

In this short paper we look at how the reform of Britain could be put back on track. In the first section we look at the tax, benefit and regulative system, including its effects in the labour market. In the second section, we go on to consider the provision of public services, especially health and education. In the last we turn to pensions.

I. Tax, benefits and regulations

It is useful to recap on just what, from the viewpoint of economic efficiency, is the best tax system. The key principle is due to Ramsey and is known as the Ramsey Principle of equalising tax across groups, commodities and time. (Ramsey was a brilliant student at Cambridge in the 1920s and this comes from an article in the Economic Journal of 1927). The basic idea is that as you raise the tax rate the extra cost becomes steadily higher (call it the law of increasing dysfunction); the formal reason is that the state is driving a bigger and bigger wedge between what things (eg labour) are worth in the market and the (net-of-tax) return to the people producing them; the latter is the true cost of the effort being expended, the former is the true value to the economy. So as you raise taxes and so lower output the loss of that output is more and more damaging because the loss of value to the economy is ever greater while the reduction in effort gained is ever smaller. Per contra where you lower the tax rate and so raise output, the gain from that higher output is getting steadily smaller because the extra value is getting closer and closer to the extra cost. The corollary of this principle is that when the output responses are the same (a natural benchmark) tax rates should be equalised; because at this point there is no gain from switching tax burden from e.g. one commodity to another, as the extra gain on the one would be just equal to the extra loss on the other. The three practical implications are a) the celebrated 'tax neutrality' (across goods and different activities, methods of finance etc) principle of the Lawson years- alas much resiled from since-; b) the flat rate tax (the same rate across all groups of people regardless of eg their earnings); and c) the less well-known idea of 'tax-smoothing', which is keeping the tax rate for the economy constant over time (and by implication tax consumption not income so that consumption is taxed equally over time). The aim of reform should be to reintroduce a), to move the system towards b) and to use c) for a shift the tax base to consumption and as the foundation for policy towards public borrowing.

a) Neutrality across sectors and activities:

Under Nigel Lawson’s chancellorship a determined effort was made to achieve neutrality so that different activities should as far as possible attract the same marginal tax rate. Capital allowances were reduced so that they reflected economic depreciation rates; stamp duty was largely abolished as were preferential rates of tax for privileged activities such as ‘development zones’. Gordon Brown has reversed this thrust in a bout of unprecedented activism. We now have capital allowances back again, to ‘encourage investment’. Stamp duty on houses (a tax on mobility) has been raised sharply, with a top rate of 4%. Tax privilege is back for ‘derelict zones’. There are special low rates of tax, both income and capital gains, for small and medium-sized enterprises, ‘SMEs’, on the grounds that their activity is particularly fruitful. Saving in various forms has been penalised, notably by the abolition of ACT-relief for pension funds but also by the sharp raising of the level of the old age benefit threshold (now called a minimum) and the introduction of pension tax credits for those with pension incomes above this threshold; previously the philosophy was to relieve saving of income tax in most approved (long-term) forms, thus moving the income tax in the direction of a tax on consumption, again in line with the Ramsey principle- in that future consumption is thereby taxed at the same rate as current consumption (strictly part of principle c).

The aim of reform should be to get rid of special treatment. The concept that should underlie the taxation of commodities and services should be that of taxing consumption however it is carried out, at a standard percentage rate. In principle the VAT should be extended as far as possible across all categories of spending, so making possible a reduction in the standard rate of VAT. At the same time income tax should be adjusted onto a consumption tax basis: this means that all saving is deducted from income before it is taxed. This would abolish the mass of saving exemptions as redundant, so also simplifying the system; since these exemptions have much the same value as the total relief of savings via the consumption tax, there is no extra cost in the switch from income basis.

The consumption tax base would enable us to get rid of capital gains tax, which is most unsatisfactory in principle (because it taxes saving) and also complicated in application. Consumption is equal to income (including capital gains) minus the difference between end-period and beginning-period asset values. Since the change in assets includes capital gains, this amounts to income (excluding capital gains) minus any new asset acquisition. The simplification, incidentally, of tax returns would be huge: instead of the present mass of detail it would be just income less any new assets.

One may note in passing that stamp duty, which is a tax on transactions not on any consumption value, should be abolished. The same applies to a number of recently-introduced taxes such as airport tax and insurance tax. Only if such taxes are related directly to charges for services rendered do they have a justification; in this case it would be better for them to be levied explicitly as charges and then passed on to the customer in whatever way the commercial operators feel is best; airport charges for example should be levied on airport operators.

b) The flat rate tax, benefits and regulations:

The flat rate tax

It turns out that the total tax system (NI and indirect included) produces a top marginal tax rate of about 60% (this is the percent of the wage paid by an employer taken by the state in NI, indirect tax and income tax; i.e. employees get £40 worth of goods and services valued at their true cost for an extra £100 paid for their labour by the employer). For the average worker it is about 50%. The average tax rate of the economy is 40%. In this the average yield of income tax is about 20% - this is the result of an average of bands from 10-40% with presumably some slippage in the theoretical yield on this taxable income. So a flat rate tax of the same yield, assuming none of the indirect effects on revenue discussed later, would be some 25% against the current mixture. (All figures in this discussion are inevitably approximate given the complex detail of the tax system.)

However, under the flat rate principle personal allowances are strictly unjustifiable because they imply a rise in the necessary flat rate tax- in effect personal allowances can be thought of as a zero tax band for people on very low earnings which violates the flat rate optimum. Abolishing personal allowances would increase the tax base by about another fifth, allowing the flat rate to drop to 20% for the same yield.

We will consider later the possible ways in which the flat rate might be introduced in practice. But first we consider other parts of the reform agenda.

The benefit system

There is a complication in that families with children obtain working families tax credit and many more also obtain housing benefit; as the personal allowances go, they pay more tax but they are refunded with more benefits, essentially pound-for-pound; the effect of this is to draw more people into the 'poverty trap' where they are on these means-tested benefits. This is a qualification to the gain from the overall lower tax rate you get by abolishing personal allowances; but it also means that people on the lowest incomes barely lose by the allowance abolition.

A further element in reform involves this very benefit system, now renamed as tax credits. The problem with the system is the very high marginal tax rates created by the means-testing of tax credits- currently the withdrawal rate is 37% which added to other taxes and NI implies a marginal rate of around 70%. We will deal with pensioners in detail below.

These benefits have various purposes. Family tax credit is intended to increase work income relative to unemployment benefit, so as to make work worthwhile. It is also designed to help poor people with children, to reduce the poverty of families. Housing benefit is intended to help poor people pay for housing with rents set by market forces; thus the idea was to shift subsidies from bricks and mortar (council housing), which stopped people moving to find jobs, directly to the people intended to be helped. Finally other classes of benefit are explicitly designed to help with particular situations, such as disability; provided these benefits are dependent on these situations and not on income, they do not create disincentives to acquire income by work.

In themselves, these purposes are worthy; the problem is that they are expensive in taxes- which drags down the welfare and efficiency of the general taxpayer- on the one hand and on the other they create serious disincentives (via those high marginal tax rates) to work and retrain for the very poor people they are helping. Hence it is important to try to find ways of reducing both their tax cost and their disincentives for the ppor.

The calibration of unemployment income is designed to reach socially-acceptable minimum levels of consumption. Therefore by implication this is the level we should aim to achieve as a minimum for families with working heads; they should be no higher than this in order to reduce their cost to the taxpayer. Such an idea does of course mean that there is no extra income from working; no monetary incentive therefore to work. However, the whole idea of unemployment support is that it is only to be paid to those who cannot yet find a job; after a period of search they are meant to take a job and then this support is withdrawn. This conditionality ('no fifth option' in Labour parlance, in Conservative terms the Job Seeker's Allowance concept) is now being enforced in a bipartisan manner, as it is generally accepted that people should take available jobs rather than stay on benefits for extended periods. If so the monetary incentive is irrelevant, as once the time is up the unemployment support is withdrawn. Thus we can easily justify this minimum or meanness in the provision of welfare benefits to those in work by the argument that in fact it creates no disincentive to work when benefits are administered toughly so that work must be taken.

This then leaves the question of how rapidly, as incomes rise, support of the working poor should be reduced. There is an age-old dilemma associated with such in-work benefits. If one ‘targets’ them on the poor, withdrawing them rapidly by means-testing as income rises, the poor face a ‘poverty trap’ in which the marginal tax/withdrawal rate is high and so the incentive to retrain for better-paid work is small. At the same time the cost to the state is greatly lowered by such targeting so that the marginal tax rate on the general populace is reduced, with consequent gains to their incentives. In short, here the Ramsey principle of equal marginal tax rates cannot be applied because it only applies for the distribution of a *given* tax burden; here the size of the tax burden is being traded off against the marginal tax rates on the working poor.

In fact one can argue with some plausibility (I did some calculations to this effect some years back**,** in 'The Poverty Trap after the Fowler Reforms' Improving Incentives for the Low Paid, edited by Alex Bowen and Ken Mayhew, NEDO, London, p 121-139. 1991, and plainly similar calculations informed UK Treasury thinking for many years before this current government) that it is best to have a short range of income over which the withdrawal rate is very high. The idea of this is that though technically incentives in this range are very bad, nevertheless the range is small enough that most serious retraining would allow trainees to ‘leap over’ it , in the sense that their income after training would be well above the range and hence the marginal tax rate would be moderate across the leap. This argument would therefore be that the poverty trap does not cause very much damage to retraining plans but does bring the cost of Family and related credits down considerably for the taxpayer. The latter, cost, element in the calculation arises from the shape of the working population distribution; as support is extended up the income range the number of people involved rises disproportionately.

A further principle originally enunciated by Sir Norman Fowler in his review of benefits in the mid-1980s- that the state should only support *families with children*- is now adopted by the main parties. The idea is that single people can help themselves, as can childless couples since both can work. Thus the concept of poverty as the concern of the state essentially relates to families with children. By eliminating a large class of recipients, this again validly avoids both the cost to the taxpayer and the disincentives to those assisted.

With the aid of this analysis we can see that the latest moves on Credits by Labour have been misguided. The withdrawal range for them has been stretched virtually up to average earnings. Also, in order (mistakenly as we have seen) to create an ‘incentive to work’ they have been raised in amount to some 10% or so above unemployment support levels. Our principles suggest that the support should be cut back to the unemployment level and that withdrawal rates should be fast, as they were before 1997.

Housing benefit is in essence, or should be, another Credit. It can be treated similarly. Currently it is paid to benefit recipients in respect of their actual housing bills, hence creating no incentive to economise on housing. It would be better instead to pay them an amount to the value necessary to reach the same level of housing; this should be withdrawn as above, fast. Families will then all shop around for housing just like ordinary unsupported families do today.

Regulation

Finally, what are we to do with the increasingly intrusive amount of regulation, whether in labour markets or in product markets? The principle of regulation is that it should add value to private activity by preventing undesirable behaviour that cannot easily be policed by private agents. An example is safety in the workplace in respect of non-transparent dangers such as inhaling poisons: workers do not have the information or time to check such a danger. One could imagine a union taking up the issue, paid for by workers, on their behalf; this would be a market solution if the state did not regulate. Alternatively intermediaries could set themselves up and sell such a service to workers. There may be certain basic practices that the state could enact via regulation, thus taking them out of such market bargaining. However, very often the market is more flexible and accurate in setting standards than the state.

What this suggests is that the state should get involved in regulation late in the day, once all parties agree on some basic practice and as it were call the state in to force its adoption, more cheaply than the private market could do. However, this is a limited recipe for regulation; the general rule is self-regulation within the industry.

In particular in the labour market there is now an overwhelming degree of state intervention. However, the basis of UK labour law lies in the private contract negotiated between employer and worker, even if it is only implicit. The role of courts should be to adjudicate over these contracts. A minimum wage (widely flouted anyway, surveys indicate) is an unwarranted intrusion by the state into such private contracts, as is much of current health and safety regulation of workers' environment, not to speak of a variety of other worker rights such as maternity/paternity/minimum redundancy payments/minimum notice periods. They should go and normal law of contract allowed to develop in their place.

Such indeed was the philosophy of the Thatcher/Major governments and in those parts of the law where the UK was the dominant authority some progress was made in shifting regulation towards a private sector-led basis. The Blair governments have reversed this to some degree, especially in the labour market. But the biggest incursions from state-dominated regulation have come from the EU under all these governments. This problem is now being examined widely within the UK as a result of the debate on the draft EU Constitution, recently rejected in the Dutch and French referendums. There is a clash between essentially protectionist regulation favoured by several continental governments- most notably France, Italy and Germany- and a framework of competition favoured by the UK and some other countries such as Ireland and Netherlands. So far the dominant coalition in the EU has been the protectionist group; the effects are to be seen in the preservation of the Common Agricultural Policy, in the high degree of protection of manufacturing trade, in the rejection of the Commission's proposed Services Directive which would have liberalised consumer access to services, and finally in the latest EU directives for regulating financial services which could seriously damage the City of London. Hence the UK regulative environment is currently most severely threatened by the EU and this raises quite worrying questions about the economic viability of the UK's treaty relationship with the EU (discussed at some length in my book with Vidya

Mahambare and Eric Nowell 'Should Britain leave the EU?', Edward Elgar and IEA, 2005)

c) 'Tax-smoothing' and the appropriate size of public borrowing:

The constant tax rate calculation

What would be the constant tax rate that would be expected to finance the commitments to spend and service debt? It turns out that it would be:

Tax Rate= (average planned spending)/GDP plus debt/GDP x(the real rate of interest minus the real growth rate of the economy) or

$T=GOV + D(r-g)$

A simple explanation of this would simply be that tax/GDP must be sufficient to pay for average government spending as a proportion of GDP and also to keep government debt from rising as a proportion of GDP. This last implies that taxes must cover debt interest adjusted for inflation and also less an allowance for growth (because growth reduces debt as a proportion of GDP).[1]

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[1] This formula can be explained more thoroughly as follows. If we could forget debt, then obviously taxes as a fraction of GDP (T) would have to be equal to government spending as a fraction of GDP (GOV). GOV is the 'average' annual spending implied by spending plans; to be precise, we compute this by project spending plans into the future, discount them to their 'present value' (ie the sum the taxpayer would have to pay once and for all in order for its interest only to pay for actual spending) and then calculate the steady fraction of GDP that would have the same present value.

On top of this there is the cost of debt to the government. Governments never need to pay off their debts, essentially because it is convenient to market institutions like pension funds to have government debt to hold in their portfolios. In fact governments can naturally allow their debts to rise at the same rate as GDP for this same reason, since the need to hold debt will be related to the size of the economy. Furthermore the ratio of debt to GDP can vary quite flexibly according to circumstances, at least within a wide range. The key point is that it is there so that governments can 'smooth' their spending and tax rates to avoid severe instability in private sector plans when revenues are scarce; for example it would be a nuisance if in recessions roads went unmended and taxes soared so debt is run up in these circumstances to avoid such bumps. It follows that a government should calculate the tax rate so as to keep debt constant in normal times as a fraction of GDP. This will imply that there is no pressure in the longer term to change the tax rate- hence the tax rate will be 'smoothed'. Were debt rising steadily relative to GDP future taxes would eventually have to be raised; if debt was falling steadily relative to GDP they would have to be lowered. Only if debt is going to remain on average constant relative to GDP can the tax rate be expected to be constant. We can therefore calculate the amount extra that needs to be added to the tax rate to keep debt constant relative to GDP.

This consists of interest payments on the one hand. But GDP will be rising by both growth and inflation, reducing the debt/GDP ratio by this proportion. Hence the rise in debt/GDP without higher taxes equals D times (the rate of interest minus inflation and growth= r, the 'real' interest rate, minus g, growth. Thus T must rise also by D(r-g).

To find out finally what deficit/GDP ratio the above formula for a constant tax rate and constant debt ratio implies we do some simple manipulation:

deficit/GDP= rise in debt/GDP=(growth rate of real debt)x(debt/GDP)=Dg {=gov -t +Dr)}

We can now spell out some implications of this formula for the desirable tax rate.

Tax rate reaction to public spending blips and reforms

First consider what will happen under this formula if there is some unexpected shock- say a recession or a public spending crisis (a war perhaps)- which raises spending or lowers the yield of taxation. Then the implication is that the tax rate should only change by the implied permanent worsening of the finances. What is this? Suppose taxes fall by £20 billion for a year and then are expected to recover completely. Then debt will rise by this amount; interest costs will rise by £20 billion times the real interest rate (3%, say) minus the growth rate (2.5% say) of 0.5%, ie £0.1 billion p.a. This is then how much the flat tax rate should be raised to yield- ie roughly 0.1% (on our assumed income tax base). The implication of tax-smoothing is that public debt fluctuations are used to 'smooth tax rates'- and that it should NOT be an objective of policy to pay off debt for its own sake (indeed public debt is necessary for the proper working of the private savings and pension markets.) In practice, one may want to qualify the tax-smoothing principle a bit over the business cycle- for demand or supply reasons- but as a basic benchmark for long periods of time in considering where one should be pushing tax rates, it is highly robust.

A further important conclusion is that the cost of public spending relevant to setting tax rates today is the *whole future stream of spending* not just the amount being spent today. There is a technical way to get at this: one discounts the whole future stream to present value and then calculates what constant share of GDP would generate the same present value. Call this the government's 'permanent' spending share of GDP. We can then set the tax rate so as to meet that permanent share plus interest on the current debt. The implication is that say reform is instituted with the effect of causing economies over a fairly long period of time, then these economies can be counted today in setting tax rates by this discount method; of course delayed economies in this do not count as much as immediate economies because of discounting. But they do count to some extent. What this means is that borrowing can rise to take the strain of lower taxes until the benefits of spending reforms work through.

The 'scope' for tax cuts- the Laffer Curve and growth effects

Another important implication of the formula is for the extent of tax cuts that can be afforded. Since the formula looks forward to the full path of foreseeable spending and tax revenues as a fraction of GDP, plainly the effects of any policy change on that whole future path is of vital importance to the calculation. It makes no sense to

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This is the deficit measured with real interest costs- in other words it is the rise in real debt (excluding the extra debt corresponding to the erosion of the existing stock via inflation). The conventional deficit or PSBR is measured with nominal interest costs, or

PSBR/GDP=D(g+inflation)=D(growth in nominal GDP)

{=gov-t+D(r+inflation) = gov -t + D(nominal interest rate)}

This is the rise in nominal debt as a fraction of GDP. Plainly if inflation is 2.5% and growth is 2.5%, and as now the net debt/GDP ratio is 30%, it implies an appropriate normal PSBR/GDP ratio of 1.5%- ie it is what is appropriate when spending is normal (=gov) and the tax share of GDP is also normal (=t).

exclude from it anything other than the current situation minus the obvious ‘direct’ effects of the tax cut, as was Conservative policy in the run-up to the last election. It would only do so if there was no theory or evidence available on such effects. However since the Reagan and Thatcher periods in the US and the UK a mass of work has been done on these effects and the consensus has changed within the economics profession to one of cautious acceptance that there are significant effects both on net revenues in the short to medium term and on the growth rate of the economy.

The first, or ‘Laffer effects’ (after Professor Art Laffer, their proponent to the Reagan administration, while at Chicago University), are the fairly rapid (i.e within 2-4 years) effects on the supply of work, effort and tax avoidance of lower marginal tax rates. These effects create a ‘net revenue recovery’ or ‘back flow’ partially offsetting the loss of revenue from cutting tax rates. For example in a study for the UK ('The Poverty Trap and the Laffer Curve - what can the GHS tell us ?' , Oxford Economic Papers, 43, 1991, pp. 245-279) Paul Ashton and I found that the response to the top tax rate of higher earners’ labour supply was approximately 1% for a 1% cut in the top marginal rate. Using this response we were able to replicate the effect on tax revenues of Nigel Lawson’s cut in the top rate from 60% to 40%. Further down the income distribution the proportional response fell- the average response was about half of 1%. Using that would imply that for example cutting the top overall marginal tax rate by 10% would cause a net loss of revenue of only half the ‘direct’ amount.

The second set of effects, on growth, are potentially more important still. These have come into focus from research in the past decade into ‘endogenous growth’ (i.e. the study of how government policy on spending and taxation can affect growth). A large number of empirical studies have found an effect of tax rates on growth. Empirical evidence alone might be questioned on the grounds that other mechanisms might have raised growth and reduced taxes. However economic theory too has made progress in identifying the causes at work. One is the interaction of the effect of lower tax rates in stimulating labour supply with the effect of higher employment on learning by doing (the more people work the more they learn); this extra rate of knowledge acquisition raises productivity growth. Another effect is on risk-taking and entrepreneurship; lower taxes mean that individuals and firms will take more risks to get extra income which will mean more innovation and so higher productivity growth at the level of the economy (at this level individual risks cancel out; rather like competition which causes individuals to lose out to others while benefiting society as a whole).

If we turn to the quantities involved, the typical response found in empirical studies (for a survey and discussion of these results see my ‘Public Spending and growth’, with Jiang Wang, available on my webpage) is for the growth rate to rise by one third of the proportional cut in marginal tax rates. For example if the marginal tax rate fell by 10% on average across the economy (from 40% to 36% say) then the growth rate would rise by 4% (from 2.5% to 2.6% per annum say). This may not sound much; but of course it is compounded from year to year, steadily raising revenue. Or one may look at it from the viewpoint of spending: if government spending programmes are kept the same as before, this higher growth implies that they will fall steadily as a fraction of GDP, thus enabling tax rates to fall. The exact amount can be found from manipulating our formula. Thus initially we have that

$$T0/(r-g0) = GOV0/(r-g0) + D$$

where g0 is the initial growth rate; GOV0/(r-g0) is in fact the present value of future government spending programmes under initial plans expressed as a fraction of GDP. The formula as manipulated says that the present value of taxes (left hand side) equals the present value of spending plus debt, all as fractions of GDP.

Now if we keep government spending programmes as initially planned, their present value as a fraction of original GDP will be the same. But the present value of taxes will be T1/(r-g1) where g1 is the new growth rate and T1 the new tax rate. Hence the formula becomes

$$T1/(r-g1) = GOV0/(r-g0) + D$$

so that the permissible new tax rate is:

$$T1 = GOV0(r-g1)/(r-g0) + D(r-g1)$$

To illustrate the importance of this quantitatively take the following numbers close to current UK values- GOV0=0.4; D=0.35; r=0.03; g0=0.025; T0=0.0.40. Now suppose the average marginal tax rate is cut by 10% so that the growth rate rises to g1=0.0258. The average tax rate as a proportion of GDP can now fall, without reducing planned government programmes at all, to 0.34. Such a 6% of GDP drop in tax revenues is no less than £60 billion per year! One can think of this as the permissible initial deficit after the tax cut; by implication this will be whittled away by growth until eventually the higher revenues would be sufficient to keep the debt/GDP ratio steady again.

Now of course one might well wish to be more cautious than this but the point remains that there is substantial scope to run deficits prudently in the context of cuts in marginal tax rates.

Taxes other than income

Suppose one accepts the flat rate consumption tax in principle. What should be done about taxes other than income taxes? National Insurance? VAT, Customs and Excise? Capital Gains tax? Inheritance? Corporation tax? Miscellaneous like stamp duty? Let us consider these in turn.

National Insurance is not actually in its entirety a tax but a payment in return for an entitlement, viz the second supplementary pension and insured unemployment benefit. Furthermore one may ‘contract out’ of part of it in respect of this second pension- as we have seen all those over average earnings should logically do.

It is nevertheless in respect of what cannot be contracted out of in essence a tax since it is a compulsory payment in exchange for general government spending. Notice however that it is very close to flat rate on ‘earned income’. There is a ceiling on the amount of contributions the employee pays but none on what the employer pays. There are thresholds to both. Not much will be lost on the flat rate principle if it is left alone. But equally it would not be difficult to roll it up with the general flat rate consumption tax.

VAT, Customs and excise are all consumption taxes. Excise taxes are large imposts on items in highly ‘inelastic demand’ (i.e where higher prices cause little reduction in demand); as such they do not violate the Ramsey principle because this refers to items with the same general elasticity of response. In fact it makes sense to levy taxes on inelastic items because they yield extra revenue without much altering people’s spending patterns, which is what causes economic costs. As for VAT it is not all-inclusive at the same rate which it ought to be to match up to the flat consumption tax principle. It would be best if it could be extended and the rate levelled. However it is not that far from matching up.

Capital gains tax is part of the income tax that would essentially disappear on moving it to a consumption basis, as explained earlier. Only if capital gains were partly spent would they be taxed.

Inheritance taxes would go. Only if inherited wealth was spent would it be taxed just like other consumption. The reason is simple: the fact that wealth is inherited makes no difference to the point that taxing it implies overtaxing consumption of it, just as the taxation of income on savings does. Taxing assets on the accident of death is in some ways an even worse tax than taxing the income of savings because it is unpredictable. Uncertainty can be a severe disincentive to investment and enterprise.

Corporation tax was, before the abolition of ACT, a rough approximation to an ‘imputed tax’ on dividends. This meant that when profits were distributed to shareholders any corporation tax paid on them that year was returned to those shareholders. The main exception was foreign shareholders whose treatment varied with double tax agreements. Since the abolition of ACT, corporation tax has become simply a tax on company profits, with foreign companies being able to claim back certain amounts via double tax agreements. Because of these agreements this tax has become a lawyers’ paradise. However the tax itself is economically damaging because it penalises the return on capital. Because capital is free to flow nowadays across borders without exchange controls this in practice means that it has to recover this cost from consumers and so it is passed on in prices. But the relative cost of capital and labour is distorted by the tax, creating a wasteful incentive for firms to use less capital and more labour. So corporation tax can be thought of as like an inefficient sales tax.

Lawyers mesmerised by the sums they get back for companies via double tax agreements from foreign Treasuries argue that corporation tax should be kept in order that the Treasury can obtain corporation revenues from those foreign Treasuries instead of their clients paying. This is a doubtful argument. True; eliminating corporation tax would eliminate these receipts from foreign Treasuries. But it would also stimulate activity by withdrawing a distorting tax. One way forward would be to keep the tax as one paid by corporations and thus eligible for double tax agreements; but to levy it as a value-added tax which would retain its revenue qua consumption levy while eliminating its distortionary impact.

Finally, those miscellaneous taxes like stamp duty and airline tax. We discussed these above. Taxes on transactions are in general poor taxes since they do not correspond to consumption values. If they caused no change in behaviour patterns they could be justified on the same basis as excise duties like the beer one. If they corresponded to economic costs (as with the environment), that could be another justification. However in the absence of these they should be converted into consumption-based taxes- e.g. to tax housing consumption the imputed rent value of housing could be incorporated into VAT in place of stamp duty.

What we have seen in this review of the tax system is that existing taxes can be made to conform with the flat rate consumption principle with some modest 'tweaking'. We have also noted that some could be left alone without much damage to the flat rate principle.

II. Public spending reform

We now turn to the issue of spending reform. The UK public sector programme grew to its present huge size largely as a result of decisions taken immediately after WWII by the Attlee government, that the state should be the primary provider of education and of health care services and that it should provide these services free at the point of consumption to all UK citizens who would thus pay through general taxation. The general idea was the socialist one that such services are a matter of need and should be provided equally to all according to their need.

This idea is deeply flawed for such complex services as health and education where the decision about what is needed is highly subjective. For something quite simple like a general vaccination one can see that general provision to all, free, has much to recommend it. It is simple, it can be easily monitored, and so the state can effectively do it, saving the resources involved in charging.

It is helpful to think about another complex commodity such as food. Clearly food is a need. But no-one would think of having the state provide some 'equal amount' to all at taxpayers' expense. (Of course the Soviet State did precisely this with the dreadful results and, ironically, huge inequalities that we all now know about.) Instead we enable people to have the means to acquire a minimum amount of food- as in our last section on benefits- and then suit themselves in the market-place.

So it should be essentially with health and education. Somehow we should ensure that everyone is enabled to reach minimum acceptable standards of consumption and then stand away, letting individuals suit themselves.

To attempt to clarify what occurs when the state provides services free at the point of consumption I jokingly formulated 'Minford's Law'. This states that a free public service creates excess demand (because it is free and the alternatives carry a money price); if a price cannot somehow be created for the service (such as by a black market) this can only be removed by some equivalent to a price, such as a deterioration in quality, sufficient to persuade people to move to the costly alternative. This fall in quality acts as the effective price deterrent clearing the market, rationing the product in other words in a manner akin to a black market.

For example the relevant quality loss in healthcare is the time one has to wait for NHS attention. This waiting time is the equivalent of the price of private care which can be obtained at once. It follows that all ministers' efforts to reduce NHS waiting times are completely in vain. The more resources they pour in, the more they simply transfer work from the private to the public sector until NHS resources can no longer be provided. At this point the waiting time is the same; however waiting lists, ironically, (ie the number of people waiting) will have grown because there are more operations etc to queue for. It is like a beach where first one ice cream seller comes and a queue forms until it gets to the point where it takes 6 minutes say to reach the front- this is the time people are willing to take off from sunning themselves. Suppose it takes half a minute to serve each person so there are 12 in the queue. Then another ice cream seller arrives and so a second queue forms; it too will have 12 people in it, each waiting 6 minutes. So with the NHS, the more operations are made available the more people will join the queue until the waiting time is the same.

School education

Now consider schools. In fact with state schools because each has a catchment area, the best schools drive up house prices in their area and this house price premium acts as the price of the school. So there is a market price in effect for the state school places. The problem in the market is that the supply of state school places in inefficient; poor schools do not close, good schools do not expand because of bureaucratic controls. On the demand side there is also the problem that one cannot buy the school without the house and so demands are not as flexibly catered for as if the two things could be bought separately- there is an unsatisfied demand (for the school and a house somewhere else) that cannot be expressed in the market. Hence the state schools market is inefficient but at least there is a market.

Therefore the problems of reforming healthcare and reforming schools, the two major issues of the present time in the spending debate, are rather different. As for other public services, in general it is now widely accepted that they should be subject to normal market disciplines; this latterly has come to include higher education thanks to the bravery of the Blair government in adopting top-up fees which are a few steps away from a proper market for undergraduate education (postgraduate education is already a full market and a thriving part of UK higher education). So our focus here is exclusively on schools and healthcare.

Take schools first. Since there is already a market, one approach to reform would be simply to try to improve the supply side of state schools, which is the major source of inefficiency here. Thus schools could be made independent of local education authorities and simply provided with a set resource unit per student. Then competition could be allowed in the running of schools, with schools managers being given the contract for a period of years, with periodic rebidding.

More radically one could introduce the well-known voucher proposal where every student would have a voucher covering the cost of a state education but the voucher could be switched from the state system to the private system. This would create more savage competition on the supply side because now it would come from private schools as well as other state schools. However it would also be very expensive in state funds because of the number of people in private education who would get the voucher.

Notice that it would not deal with the imperfection of the demand side because there would still not be a separate price for each state school; effectively they are all priced at the same, viz the value of the voucher, as if you go to any of them you spend that voucher on it. Again the house market will have to discriminate between them. It does not seem possible however to allow state schools to charge differential fees without creating the need for another benefit to ensure access for poor children to good schools; there are considerable practical difficulties with organising such a system in which the government allows the private sector free rein in supply and simply pays for all children's education. Apart from the huge cost, the main difficulty is in ensuring the education content meets the taxpayer's requirements; this would mean extra regulation of private schools which would not probably be acceptable to these schools. Hence if the taxpayer wishes to ensure that all children go to some acceptable school and pay for them to do so if they will not pay themselves it will have to have a state sector acting as provider of last resort- more or less the system we have on the demand side.

Hence the reform of state schools is in many ways a relatively easy one of generating market pressures on the supply side within the state sector.

Healthcare

The reform of state healthcare is much harder in the UK because the private sector is so small (around 10% of the total market) and there is no price mechanism rationing NHS supply. There is no way that a proxy price can be charged as with schools because access to a UK hospital or other healthcare facility is not restricted to an area. Anyone can turn up to any doctor or hospital provided they reside in the UK. Instead as we have seen the 'price' is waiting time.

Therefore one can think of reform as having to design mechanisms to generate supply-side efficiency and also to ration demand efficiently (ie not by the wasteful and indeed damaging device of waiting).

Let us begin with the supply side. Here much work was already done by the Conservatives from the late 1980s onwards- through the 'internal market' development. This idea had been implemented to quite a good degree when it was dismantled by Labour, with apparently disastrous results for NHS efficiency. The idea of the internal market was to 'let the money follow the patient' wherever treatment was prescribed by the doctor; hospitals (including private ones) would then compete for patients (and their accompanying money) from doctors as the primary 'gatekeepers'. The implementation was incomplete by 1997; around half of doctors refused to cooperate as 'fundholders' so that much of the funding for the NHS continued to go through the Local Health Authorities who were never too enthusiastic about the process, involving as it did the reduction in their control of local hospitals. These LHAs allocated funds in a way that did not always allow the proper play of competitive forces. Another, related, problem was that the private sector was also not able to compete on equal terms with the state hospitals for two reasons. The first was that the latter had access to this LHA funding, especially for capital projects. The second was even more subtle: the doctors and consultants, having been trained at government expense in UK medical schools, faced a monopsony government as employer; terms of work in the NHS are consequently well below market rates for professional manpower (as eg in accountancy or law) but in a clever deal the NHS allowed medics to operate part-time in the private sector at pay rates that made their income up to market rates overall (all this was uncovered in a reference of UK consultants to the Monopolies Commission in the early 1990s). Thus private hospitals had to pay over the odds for UK consultants, in effect subsidising the NHS.

Getting the supply side of healthcare to work properly therefore involves a lot of unravelling of uncompetitive practices, starting with medical schools, through NHS contracts, LHAs and finally doctors' full participation as fundholders. As it happens the last has already been made possible by Labour's coalescing of doctors into subregional groups of 50 or more. From here the logic or restoring the internal market is much easier; doctors would become the sole recipients of funds, which would go with the patient. Hospitals would compete and would be forced by competition to draw up fair, market-based contracts. The medical schools would charge fees under the proposed loan scheme for university top-up fees. The LHAs would be abolished.

What then of the demand side and those waiting lists whose attempted reduction by politicians has so bedevilled the often selfless efforts of doctors to provide decent medical care?

One possible route, that has been widely canvassed by free market economists, is that of vouchers: give everyone a voucher entitling them to a healthcare service defined so as to match some 'basic standard' of care and then let medics charge for their services quite normally. This standard would need careful definition so that it excluded frills but somehow included very expensive necessities such as open-heart surgery for people with heart conditions. Unfortunately such a definition has so far eluded governments such as the US one where the concept is accepted. In the US there are state hospitals which act as last resort providers of such 'basic care' on a no-charge basis to those without funds. The US does not provide a voucher for such care at any hospital, only in effect at its own, where it can control both what is done and its cost. There is a parallel here with state schools discussed above: again in the US state schools provide basic education at no cost, rather than the government giving everyone a voucher which can be spent anywhere on fee-charging schools.

This leaves ways, as with schools, of getting a market by proxy device or at least of limiting the size of the waiting list problem.

At root the long waiting lists arise from the fact of general access to state healthcare. Thus people with funds have a choice: spend them on private medicine or keep them and take state medicine after a wait. Inevitably they will join the waiting lists until waiting time reaches a deterrent level.

One way of curbing the lists would be to stop ordinary moderately well-off people from using the NHS except in exceptional circumstances (like very expensive treatments). Then the NHS would only in general treat poor people, a bit like what happens in the US where state hospitals only treat the poor and indigent. This could be done by giving poor people on Family Credits (only) a 'passport' to free healthcare, much as currently occurs with dental care. Once they come off the credits they have to pay like anyone else; note that this adds to the marginal withdrawal rate but the same argument as above would be used that it would not impede serious retraining that ‘leapt over’ the relevant income range.

However this idea has little hope of acceptance by floating voters who have paid their taxes, as they see it, largely to entitle them to the NHS etc. It might be possible to put together a ‘big reform’ in which taxes were cut simultaneously with such a ban. But the politics of it look forbidding.

Many successful reforms involve bribery (‘buying off’) of those with a vested interest in opposition. This idea is entirely respectable in economics; ‘compensation’ of losers enables changes that produce general benefit to be enacted without much controversy. Examples are UK rent reform in 1988 when sitting renters were allowed to keep their privileges while still alive; and the privatisation of British Telecom with a large subsidised share allocation to BT workers. There are many more from the Thatcher period; reform is only possible with such realism.

In the case of healthcare we are looking for ways to improve the gross waste on the demand side involved in waiting lists as a rationing device.; this comes about because middle class (often floating) voters are able to use the NHS without charge. The middle classes for their part are indifferent between going private and waiting for NHS operations- in line with our earlier argument that the waiting time is driven (in terms of psychological and other costs) to equality with the price of private treatment. Thus some payment to these middle classes to go private should induce many to do so. When they go private, they will also save the NHS resources. At the same time they will reduce the waste of waiting time. Against this the payment will also go to those 10% or so who already get private treatment- this ‘revenue deadweight’ effect costs the government revenue which in turn causes some cost to the economy due to higher taxes. However it is rather plain that there are net economic gains to be made by pitching the payment somewhere between zero and 100%. (Remember the sum is to be done not in terms of net revenue to the government but in net resource gains to the economy, a quite different matter given that the resource cost of the revenue deadweight is some fraction of that revenue, the fraction lost through the costs of reduced incentives for taxpayers.) A reasonable guess is that it is something like two thirds of the cost of private treatment.

We note at this point that if private treatment continues to be distorted in cost by the monopoly state arrangements discussed above, then this percentage will be distorted downwards. The way to deal with this is to introduce the supply-side reforms we set out above at the same time as these state refunds of private treatment/insurance.

What this state rebate does is to place a price on the NHS, in the sense that by giving up the NHS service you acquire two thirds of its cost, available to be spent in the private sector. It is not as good as full pricing, such as would be achieved by the passport scheme above, but it would go a long way towards eliminating the waiting time/lists problem. What is more, once most people had got used to going private, further progress towards full pricing (with a passport for the poor) could become politically possible; for example certain forms of healthcare, such as going to the doctor, could be fully priced much as dental care is.

So by a combination of restoring the internal NHS market, extending the market to medical schools, and giving people some rebate for opting into private treatment, reform could make huge inroads into the problems of the NHS. Ultimately these changes could make it possible to turn healthcare in the UK into a properly functioning market into which the poor in fact had the sort of access originally envisaged in the Attlee project but alas subsequently unrealised in a morass of inefficiency and bureaucracy.

III Pensions

From the viewpoint of economic efficiency state pensions are a bad idea. They reduce the incentive to save both because the state provides pension income anyway (the 'income effect') and because any means-testing done by the state reduces the return on any extra private saving. They also reduce the incentive to work because they must be paid for out of taxation and hence the marginal tax rate on work must rise. Without state pensions people would invest in fixed capital (the equity market) to obtain their private pension via the nation's own creative efforts; they would work to obtain it; and they would fix their own retirement age in the light of their work/income needs. There would no 'problem of aging'; as people grew older they would automatically invest more and work for longer to provide for their longer old age.

However state pensions redistribute income from rich to poor, so providing a sort of insurance in old age, 'social insurance'. This differs from normal insurance which only protects the insured person from risks in return for his own contribution; social insurance protects someone from poverty in old age by redistributing money not from his young earnings but from other people. There is in a democracy a demand for such insurance though it is not clear how deep-rooted it is: if for example it was understood that this could undermine prosperity the demand could well be greatly attenuated.

In practice there is a group of people- in the UK it is around 6 million- who do not make sufficient contributions for their old age, by contributing either to the state supplementary pension scheme (which gives a pension proportional to wage income) or to a private scheme. For them the only old age income is from the state pension which in the UK is a fixed amount in real terms (indexed over time to rising prices only). Yet this amount is declining relative to average wages; by 2030 it will be some 8% of average wages. This has created concern.

The basic reason for these people's failure to contribute is from their lack of participation in work. They may be women with a patchy employment record because of child-rearing or caring for elderly relatives. They may be other unemployed with poor skills and perhaps disabilities. They come into a variety of categories but their unifying feature is their lack of continuing work income.

The question therefore is whether we can deal with this concern without a pension system that badly damages incentives.

The system now put in place by the Labour government will consist in 2006 of two layers.

First, there is a state earnings-related pension to which entitlement comes through NI contributions made at work. This will wrap up the current state basic pension with the recently introduced supplementary pension. It will deliver 25% of national average earnings to all contributors. People may however opt out of this scheme and have their relevant NI contributions paid instead into a private scheme. Those on above average earnings will find it in their interest to do so. Those on average earnings or below will be better off in the state scheme.

The curious thing about this new Labour set-up is that it is in some ways a continuation of Conservative policies. The Conservatives were proposing to allow people to contract out of the basic pension just as they already could opt out of SERPS, the previous version of the state earnings-related pension. They are now proposing that the state basic pension be linked to average earnings. What Labour has done is to increase what people below average earnings would get- previously it was the basic pension plus any SERPS they had accumulated which would have paid out in relation to their own earnings. Now it is related to national average earnings. Therefore Labour's scheme's difference is that it is much more redistributive, as one might expect.

The second tier of what Labour has done is to introduce a minimum old age benefit related to earnings; as income in old age rises above this level this state old age tax credit is withdrawn at 40% of extra income. The hope is that the vast mass of people will be at work and by qualifying for the state earnings-related pension will obtain a pension well in excess of the tax credit range; also that those currently out of the labour market, such as single mothers, will get back into it once their children reach school age. However all this plainly depends on full employment continuing, which in turn depends on whether labour market policies, as discussed earlier, are appropriate.

The Labour set-up has merit in that the better-off half of the population will contract out of the state pension; it also deals with the concern that those with low earnings on the margin of the labour market should get an adequate pension. One question is whether it is not excessively redistributive in extending a pension only earned by those on average earnings to the whole of the population below average earnings; by being less generous more people would be encouraged to contract out. Another question is whether the retirement age, currently 65 for both men and women, is too low for an ageing population. These questions are a matter of arithmetic and calibration in the light of changing economic prospects.

A more pressing question is the role of pension tax credits and the minimum old age income. Labour's idea here is to have a safety net for those who for some reason fall through the work-related pension arrangements of the state, while at the same time putting support sufficiently below the state scheme to encourage people to work and save through that scheme. (For those with reasons for non-participation such as single people with caring responsibilities the Labour system is to give them a full NI contribution record; so those getting the Minimum would be those who did not participate for other reasons.) The alternative suggested by the Conservatives currently is simply to abolish the state supplementary scheme and to turn the Labour earnings-related minimum into a basic earnings-related pension available to all by virtue of citizenship. People would then have full incentives to save in private schemes on top of this basic pension.

Essentially this issue comes down to a trade-off between the extent of redistribution needed in state pensions and the overall cost in taxation (hence distortions) of the system. (Probably we can neglect the distortions created for saving among the working poor, as of minor order- their savings are small anyway.) The Conservative proposal involves the least redistribution on this trade-off; but it certainly solves the problem we noted at the start, that some 6 million would be under-provided for by the state basic pension. It addresses this issue head on by providing a state basic pension calibrated to what is today regarded as a 'decent minimum' and indexed to earnings, so maintaining this minimum in relation to society's average incomes. As far as one can tell voter opinion supports this, as against the earlier tougher Conservative position that the state would only provide a basic pension indexed to prices. It may be doubted however whether floating voters actually support the much greater generosity of Labour's proposals to those below average earnings- a rough estimate suggests the cost to the state would be 10-15% higher than the Conservative proposals. In effect the average voter is being asked to vote for this sort of tax burden to insure himself with the state against an earnings drop; yet he can insure in other ways (by investing privately, by being willing to work longer etc) which may seem less costly. As this discussion implies this is something that will be, and can only be, decided by the ballot box. As such, it is not possible to make confident proposals for reform, rooted purely in efficiency considerations as we have attempted to do in the other areas.

Practical steps- how do we get from here to there?

The set of proposals we have been discussing are long and elaborate. Some- like pensions- require a great deal of numerical work projecting aspects of demography, work decisions and so on. This paper cannot attempt to do these calculations which are in effect a research project in themselves. The experience of the Thatcher government in reform may however be instructive on how to proceed. In retrospect it is possible to discern a reform strategy in the Thatcher governments, even though at the time actions perhaps often seemed chaotic and ad hoc.

This strategy had three main features:

1) It was piecemeal, gradualist, step by step. There was no grand interlocking mass change of everything at once.
2) It involved (as noted earlier in our discussion of healthcare) a large amount of 'buying-off' of opposed vested interests- some examples were the privatisation of gas and telephones (the first was allowed to keep its monopoly initially ; the second was allowed restricted competition for a time and special shares were issued for employees), and the deregulation of private rents (sitting tenants were exempted for the lifetime of their own tenure).
3) There was compromise on the contents provided the essential economic gains could be made. The biggest example was union law which moved gradually to reduce and qualify the powers of unions to strike, without ever repealing the 1906 Act that conferred the basic immunity of unions from tort proceedings for inducing their members to breach their employment contracts.

These three elements gave reform considerable robustness to the potential dangers from political economy. A grand change is vulnerable to failure in one aspect; it can then be condemned because the concept was interlocking, hence any broken link could be argued to destroy the whole chain. Buying-off has always been recommended by economists employing the ‘Pareto compensation’ principle- that if losers are in practice compensated all can gain (if some gain, some lose, there is no unambiguous gain to all). Compromise on economic inessentials reduces opposition and so the cost of buying-off, since people have to change less.

How can we apply these principles to the reform agenda sketched out here?

Our proposals fall into several categories:

a) Health and education where we argue for more private supply in competition with public service supply, and more pricing of the ‘free’ public service.
b) Pensions where it is a matter of costing different ways and degrees of the redistribution involved.
c) Regulation where the main problem comes from the EU- a whole complex of issues in itself.
d) Benefits where we argue for unemployment support to be reduced to basic support, for a return to much sharper means-testing and for a housing voucher.
e) Taxation where we argue for the creation of a flat consumption-based tax to replace the whole hotch-potch of existing taxes.

Plainly it is quite impossible to propose a simple set of moves whereby ‘with one bound’ the UK would leap free of its problems. It can be reasonably argued that the Blair government is by now fairly well-seized of the problems set out under a)-c) above. Possibly if Gordon Brown becomes the next Prime Minister his government’s approach could differ but again a reasonable case can be made that it would continue in the same vein. Nevertheless there is scope for a Conservative opposition to carve out a clear and consistent approach on these issues that is informed by distinct and consistent free market principles as espoused here.

The main areas where ‘blue water’ can be created are on d) and e). The benefit system needs to be rowed back from the extensive set of people now covered by the tax credits system created by Gordon Brown. There is no need to change the new theoretically-streamlined administration Mr. Brown has created in the Inland Revenue for both benefits and Customs/Excise; though unwieldy it was a logical effort ot cut out duplication and it should be mad to work. Nor is the use of the tax credit mechanism a bad idea. The only issue is the rates, notably the level and the withdrawal rate. These can be changed as discussed above.

On e), taxation, comes the main thrust of this paper. We wish to see the application of the flat rate consumption principle. However this can be done by a process of successive approximation hinted at in our earlier discussion. Existing taxes can be tweaked or left alone. The main effort can be directed to reforming income tax. Probably the most important element in the flat rate tax is the shift to a consumption base which includes the elimination of capital gains and inheritance taxation and the inclusion of imputed consumption of owner-occupied housing. The second most important concerns the abolition of the top rate; this could at once be cut from 40% to 22%. Equally important is a rise in thresholds to cover the existing lower rate band, together with the reform of tax credits; the main impact on the incentives of poor people comes not from taxation but from benefits discussed above.

There will plainly be an immediate loss of revenue from the cut in the top rate from 40% to the standard rate of 22%. According to the standard 2005/6 tax ready reckoner (IFS Green Budget, January 2005) the cost of this would be £21 billion, about 2% of GDP. However there would be large offsetting gains in revenue from bringing imputed owner-occupied housing into the tax base. In addition the Laffer effects discussed earlier are likely to recover much of the lost income tax revenue, if we remember that top rate taxpayers had the highest elasticity. Furthermore, to calculate the growth effect we note that this cut in the top marginal tax rate of about a half would reduce the top marginal rate from overall taxation by about a third. Top rate taxpayers contributed 55% of total income tax revenue and 37% of income in 2005/6. This in turn implies that the effect on the (income-weighted) average marginal tax rate is a cut of about 12%. The permitted fall in revenue due to the growth effect would therefore very easily cover even the direct loss of revenue as discussed earlier.

The sticking point for discussions of tax reform has invariably been: how can we pay for it without upsetting numerous people? However, as this discussion reveals, it turns out to be far less problematic than is usually made out. The following table sets out the key changes and their costs in revenue.

Table of key changes in revenue

	£ billion
Switching to a consumption tax base	
Abolition of CGT, IHT, stamp duty	-15
Tax at 22% on 6% yield from owner-occupied housing (0.22x 0.06x £2500billion)	+33
Reduce income/consumption tax rate to 22%	-21
Raise income tax threshold to cover 10% band	-6
Uncap NI employee rate	+8
Cuts in tax credits	+1
Subtotal	**-**
Laffer effect	+12
Growth effect (equivalent cut in average tax as percent of GDP of 6%)	+60
Cut in standard (consumption) tax rate (by 7%) to 15%	-25
Total	**+47**

(permitting gradual further reductions in flat tax rate
and other taxes over succeeding years)

Source: IFS Green Budget January 2005, ONS statistics, and author calculations

The main point that comes out of this is that tax reform would be extremely popular in all social groups. It would be paid for effectively by the rise in employment rates and in growth. These reforms would bring, at a 15% flat rate tax, the overall marginal tax rate down to 45%. With the flat rate tax in the long term permitted by growth to fall to 2% that overall marginal tax rate would fall to 35%.

In politics there is a well-respected principle: there should as far as possible be no losers. With these proposals, the overall cut in taxation implies an absence of any major class of losers- the vast majority of those who lose from paying tax on owner-occupied housing or from the uncapping of the employee NI rate will benefit more from the cuts in tax rates. However inevitably there will be some individuals for whom there is a serious loss; notably anyone (probably retired) who has a valuable house (bought out of taxed income) but small current income. To avoid injustice to these people, I propose an indefinite transitional provision, guaranteeing that anyone who pays more tax under the new system may opt to be taxed under the old system. Since there will be few such people, and since this option will only be available at the time of the cross-over, no explicit provision is made for the small cost involved. (A precedent lies in the 1988 reform of the housing market when existing tenants were given exemption until they vacated, for their lifetime.)

Conclusions

Principles of reform can suggest quite clear paths ahead for improving the functioning of the UK economy in so far as the state's actions directly affect it. Tax can be simplified, made neutral across time and activity, and turned into a flat consumption tax. Public services can be subjected to competition on the supply side and more consumer choice on the demand side. Benefits can be targeted closely to those in need at much reduced cost to the general taxpayer and so to the workings of the economy. Regulative intrusion can be reduced especially that proceeding from the EU. Proceeding down such paths would complete the supply-side work begun by the Thatcher governments in the 1980s to which the UK's economic revival can be traced. What is more it can be done without exposing the government to damaging opposition from vested interests if rather simple steps are taken that achieve the main elements in the programme.