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An overview of the flat tax

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INTRODUCTION

There has been much welcome discussion in recent months concerning a flat tax. In particular, this discussion has had the great advantage of drawing attention to the failings of our current tax system. These failings can be summarised as follows: tax is too complicated; taxpayers start to pay tax on very low levels of income; and the tax system creates unwelcome distortions and disincentives to economic activity. There is also the need to respond to the competitive pressures from the low tax economies of Eastern Europe, and the general fall in tax rates elsewhere in the world. Without significant reform in the UK, these factors could undermine the competitiveness of the UK economy.

A flat tax is intended to meet the twin objectives of simplicity and lower rates. However, the important question is whether a flat tax is the only, or even the best, way to achieve simpler and fairer taxes?

The case for the flat tax is often made along the following lines. It is argued that high rates of tax are at present alleviated and made more politically acceptable by a welter of allowances and reliefs. The complexities thus created are exacerbated by a raft of anti-

avoidance legislation which is required to prevent abuse of these allowances and reliefs.

The solution to the mess that has resulted is to sweep away all the reliefs and substitute a simple tax system with a single low rate of tax. As the rich would benefit disproportionately from lower tax rates, personal allowances should be substantially increased. It is recognised that the immediate result of lower tax rates and higher

personal allowances could be a substantial loss of income for the Exchequer, notwithstanding the removal of the tax reliefs. The debate then moves onto whether increased economic activity stimulated by these changes would be sufficient to make up the tax shortfall over time. Advocates of the flat tax point to the experience of the East European states as providing encouragement in this respect.

However, a more detailed appraisal of UK tax law as it stands leads to a slightly different perspective on the possibilities for achieving tax reform. The question of whether simplifying tax and reducing tax rates are connected, or whether they are independent objectives, needs to be properly analysed, as this impacts on the discussion of possible ways

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forward. Other problems connected with introducing a flat tax, such as what to do about National Insurance Contributions and tax credits for the low paid, also need to be addressed, together with the critical issue of fairness. Finally, the flat tax needs to be discussed in the context of looking at other practical policies to reform the tax system, policies which might have a better chance of achieving reform.

TAX COMPLEXITY

Before deciding how to simplify tax law it is necessary to seek out how and why tax law is presently so complicated.

The point can be illustrated from the pamphlet by Richard Teather on flat tax (*A Flat Tax for the UK*, Adam Smith Institute, 2005). He lists five main tax reliefs:

- those relating to personal savings (eg ISAs);
- employee share schemes;
- age-related allowances;
- exemption for certain state benefits; and,
- capital gains tax taper relief and indexation.

If these were all abolished, there would however be a only a minimal reduction in the thousands of pages of current tax law, (although there would be a noticeable impact on ordinary tax returns for many people). Even if all the minor reliefs mentioned by Richard Teather were also abolished (professional subscriptions, rent-a-room, termination payments, crown servants abroad, relocation packages, business tax credits for research and development, contaminated land, substantial shareholdings for companies, blind person's allowance,

profits averaging for farmers and creative artists and shipping reliefs), it is doubtful that more than about 1% or 2% of current direct tax law would be repealed. The underlying problems of complex tax law would remain, although the savings would enable headline tax rates to be reduced.

What is the current complexity and how did it come about? Governments enact much more new tax law in the annual Finance Acts than is ever repealed by these Acts. They do this in order to achieve a number of different policy objectives. These were analysed in the

Are there other reforms to the tax system that can achieve the same goals of simple and lower tax? And would these be more likely to be achievable?

earlier CPS paper *Tax Simplification – How, and why, it must be done* published in March this year. The objectives of direct tax can include implementing public policy, providing fiscal incentives, preventing tax avoidance, relieving capital expenditure, achieving tax neutrality and symmetry, correcting

earlier shortcomings in tax law and certain other pragmatic objectives for specific situations. These measures have been introduced in a piecemeal fashion over a long period of time, with less regard than one might have hoped to identifying the underlying principles which might have produced a more coherent and a simpler system.

It would not therefore be particularly apt to say that tax law is complicated primarily because reliefs and exemptions have been introduced in an endeavour to make high rates of tax acceptable. It is more complicated than that.

For a more detailed description of what tax law is doing the dedicated reader could be referred to the last 62 pages of the paper *Tax and Accounting: a response to the 2003*



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consultation document on corporation tax reform published in February 2004 by the Tax Law Review Committee of the Institute of Fiscal Studies. The question, however, is whether all these other complicated provisions are necessary, or whether could they be swept away as well.

Tax law can and should be simplified. At least half of it could be hacked away given any priority for simplification on the part of the Government. With a more determined approach to simplification much more could go, probably three quarters or more. The principles for doing this are likely to include:

- refocussing on the primary objective of direct tax to identify and tax profit, using accounting profit as the starting point for working out taxable profit;
- adopting a more purposive approach; and
- combining and aligning a multiplicity of tax rules which are currently used for different situations.

Naturally some rationalisation will carry a cost either for the taxpayer or the Exchequer. The taxpayer, for example, might give up certain reliefs on the one hand; or the government might allow the pooling of losses on the other hand. Each side should be expected to give and take in order to achieve the objective of a more transparent and user-friendly system.

There would remain however, a nexus of provisions whose retention is probably justified, notwithstanding that they stood in the way of complete simplicity.

An example would be group relief, whereby tax losses of one company in a group can be surrendered to eliminate profits of another company in the group. Without such a provision, existing groups would be tempted for tax reasons to conduct all their businesses through one company, which may not be commercially efficient. Another example would be roll-over relief whereby capital assets used in a business can be replaced without an immediate tax liability. Without such provisions, commercial life would be considerably inhibited, even if the tax rate were significantly reduced.

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Lower rates of tax would not, in themselves, remove the desire of taxpayers to minimise their taxes. Neither would lower tax rates achieve a new culture so antipathetic to tax avoidance that it ceased to be an issue. While simpler taxes would need simpler anti-avoidance rules, rules would still be

needed to cover such tax devices as diverting profits overseas, issuing special classes of shares to employees for avoidance purposes, renting clothing and other items to employees and then selling it shortly afterwards to them for their second hand value – to name but a few possibilities.

Some structural tax rules will be required. For example companies do not pay tax on dividends received from other UK companies, because otherwise profits earned by bottom tier subsidiaries would be taxed several times over. If one allows this exemption, however, anti-avoidance rules are required to prevent, for example, the payment of interest tax free by disguising the interest as a dividend.



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Equally, tax incentives may be appropriate where it is to the public advantage for someone to do something but he needs a public grant to make it worthwhile for him to do it. An efficient way of providing a grant is often through the tax system. It should be noted that the ultimate purpose of such incentives is not so much to lighten the burden of higher tax rates on the individual taxpayer but for the common weal.

Substantial tax simplification and rationalisation is not only desirable but it is also achievable. The process of simplification has limits however, and a review of existing law is likely to be helpful in establishing those limits, rather than merely discarding all current law and starting with a blank sheet of paper.

It will further be noted that most of this simplification can be achieved without touching tax rates.

HOW TO SIMPLIFY AND LOWER TAX RATES

There are too many tax rates at the moment, causing much confusion. For individuals there is the nil rate band, the starting rate (currently 10%), the basic rate (currently 22%), the higher rate (currently 40%), the lower rate for certain savings income (currently 20%), and the ordinary and upper rates for schedule F income (10% and 32.5% respectively).

For small companies there is the starting rate, the small companies relief, the non corporate distribution rate and the full rate. For other entities such as trusts further different rates may apply.

The flat tax would sweep away all these different rates and substitute a single rate for

individuals and a single rate for companies (which may be the same rate). This would indeed be simple.

It should be recognised however that there are other possibilities. Two rates for individuals (a basic and a higher rate) and one or two rates for companies would not result in particular complexity. Moving from that possibility to a single low rate would have to be justified on other economic or political grounds, rather than simply the objective of simplicity.

Simplification has its limits. A review of existing law is more likely to establish those limits than the discarding of all current law.

There are two choices facing those favouring lower rates of tax: either to abolish all the different rates and substitute a flat tax rate in one go; or to simplify substantially the rates but only to move them lower over time.

The first strategy seems to be high risk, with few compensating benefits. The second strategy allows policy makers to assess the impact of measures taken and to respond accordingly. Although lowering tax rates from a high level has been shown to increase the overall tax collected, there clearly comes a point where tax rates fall too low for the economy to make up the shortfall. It would take a brave policy maker to identify exactly where optimisation is best achieved without “feeling the way” forward in steps. Furthermore, a staged approach avoids the immediate and potentially huge shortfalls that could destroy confidence in the economy.

OTHER ISSUES

The complexity of the current tax system is aggravated by the complexity of means-tested tax credits.



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If a flat tax were introduced without a simultaneous reform of the tax credit system, many of these poorer households would be little better off than they are today as much of the increase in their post-tax income would be negated by a reduction in the value of their tax credits. This would mean that one of the principal objectives of the flat tax – to increase the final income of poorer households – would not be achieved. So proponents of the flat tax must also show how they propose to reform the tax credit system. And that is no easy task.

The question of National Insurance Contributions, and whether they should be assimilated within the flat tax rate, would also need to be addressed. Equally, some will argue that the flat tax only makes sense, for example, if VAT rates are increased on luxury goods, to combat a perception that the rich would otherwise benefit unfairly. For similar reasons they may argue that the balance of public expenditure would need shifting in favour of the poor. All these issues would need to be resolved when introducing the flat tax, possibly leading to greater uncertainty as to their combined effect.

Further, the practical difficulties of doing everything at once, and the difficulty of building the necessary political and public consensus for this, could actually make it less likely than any substantial reform will be achieved.

George Osborne MP, the Shadow Chancellor, has made the welcome announcement of a Commission to look at simplifying tax and a flatter tax system. He has implied, however, that the Conservatives

might not move immediately to a flat tax if they were elected.

THE WAY FORWARD

Simplification of the tax system is ultimately a matter of political will and conviction. An attractive panacea – such as the flat tax – will not in itself solve the problem of complexity. And proponents of the flat tax must be aware of the danger identified by the American commentator H L Mencken who observed that “for every complex problem, there is a solution that is simple, neat, and wrong.”

The practical difficulties of doing everything at once, and the difficulty of building the necessary consensus for this, could make substantial reform less likely.

Given the political determination to carry through a programme of tax simplification, the first step should be the appointment of a Treasury minister responsible for simplifying and rationalising tax law. The Minister should have agreed guidelines on which taxes or entities to focus attention, and a timetable for doing this. The work of the Commission mentioned above would be very relevant to this. In addition, it would seem sensible that no new tax law is rewritten under the tax rewrite project until it has first been simplified. Specified topics for rationalisation, such as investment vehicles (unit trusts, investment trusts and the like), could be the responsibility of specialised groups, to speed up progress.

Different possibilities for tax rates would need to be addressed. One suggestion is that the various tax rates could be immediately simplified into two rates for individuals (for example 20% and 40%), and a single rate for companies (for example 20%). Under this example a company which earned profits of £100 could pay a dividend after tax of £80, which would count as £100 gross income



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with a £20 repayable tax credit. Thus a basic rate taxpayer would have no further liability and a higher rate taxpayer would have a further liability of £20, producing the same result as if the company profits had been directly earned by shareholders. The combined cost to the Exchequer of reducing the basic rate by 2% and the full corporation tax rate by 10% would be approximately half of the £35bn potential savings in government expenditure identified by the James report, and also less than the savings identified by the Gershon report. The 20% rate for companies would be a tax incentive for business, and attract investment from overseas, and be a measure reflecting the seriousness of the competition now faced from countries such as China. While small companies would have a modest increase in tax, this would be balanced by the savings in accountants' fees.

Over time, the higher tax rate could be reduced, and the level of personal allowances increased, in line with the past and expected future performance of the economy. This tax reduction would be made possible by eliminating allowances and reliefs, and by making progress made on the other issues referred to above which are affected by flatter taxes

It might be objected that this process would lead to constant change over a period, and it would be better to "bite the bullet" up front. It is suggested however that dealing with the objectives over a period of time ought to be acceptable provided the direction of reform is made clear from the start. Much work would need to be done (not least on the impact on tax credits), but the result would be a tax system that removed many economic distortions and disincentives, reduced the scope for avoidance, was much more user-friendly, and which was the envy of our international competitors.



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THE AUTHOR

David Martin enjoyed a career spanning 23 years as a tax lawyer within a large City Law Firm, latterly as Head of the Tax Department, before taking early retirement in 2002. During that time he advised both company and individual clients. He now lives a less pressurised life in Devon with his wife and two daughters but maintains an active interest in tax law. He is a Research Fellow at the Centre for Policy Studies, a member of the Tax Law Review Committee of the Institute of Fiscal Studies, and is the author of *Tax Simplification: how and why it must be done* (Centre for Policy Studies, March 2005).

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