CENTRE FOR POLICY STUDIES

WHY BRITAIN CAN'T AFFORD ***NOT*** TO CUT TAXES

FIVE TAX CUTS TO MAKE NOW

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Printed by The Center for Policy Studies, 57 Tufton Street, SW1.

CONTENTS

1.	INTRODUCTION	1
2.	WE CANNOT AFFORD NOT TO CUT TAX ON LOW INCOME FAMILIES	3
3.	WE CANNOT AFFORD NOT TO CUT TAXES ON PENSIONS	5
4.	WE CANNOT AFFORD NOT TO CUT TAXES ON SAVINGS	7
5.	WE CANNOT AFFORD NOT TO CUT TAX ON FAMILY INHERITANCES	9
6.	WE CANNOT AFFORD NOT TO CUT TAX ON SMALL BUSINESS	10
7.	CONCLUSION	12
APPENDIX: VALUE OF PROPOSED TAX CUTS		

CHAPTER ONE
INTRODUCTION

A belief in the importance of low taxes is axiomatic for those who put their faith in the power of markets, enterprise and personal responsibility as the foundation of a free society. Yet, today, much of the debate on tax starts by taking the current tax burden as a given. The question most often asked is whether or not the government of the day can afford to reduce taxes.

This approach is the wrong way round. High levels of taxation are damaging not only in their own right – for the impact they have on incomes and incentives – but also because of the high levels of state activity and expenditure that they enable to be funded. An overlarge public sector acts as a break on wealth creation by sucking resources into public sector employment where productivity growth is dismally low; and by sucking resources out of investment and growth in wealth creating enterprises. Furthermore all the evidence suggests that, on the margin, a high level of state spending is hugely wasteful.

Public spending as a proportion of GDP has risen significantly over the last few years – from a low point of 37.1% of GDP in 1999-2000 to a projected 41.9% of GDP in 2005-06.[1] The increase in the burden of taxation, while currently lagging the increase in spending due to the size of the government deficit, will follow the same path unless this trend is changed. And due to the progressive nature of tax rates – the tax take generally rises faster than increases in income and spending – continuing rises in taxation are built in unless tax levels are regularly reduced.

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1 See HM Treasury, *Public Finances Databank*, Table B2, September 2004.

This is damaging. And it is not what the public wants. The electorate is beginning to recognise that big government tends to lead to waste and inefficiency rather than to a better society. A recent YouGov survey found that 71% of respondents agreed that the "welfare state has become too inefficient – with many undeserving people getting too much whilst genuinely needy people struggle to get by." Only 15% thought that the "welfare state is under-funded and poor families need higher benefits in order to help them make ends meet."[2] And a recent ICA poll found that only 12% supported higher taxes while 58% thought that taxes should be reduced.[3]

The starting point must be that Britain cannot afford NOT *to cut the tax burden. Setting an affordable tax level will impose an essential discipline on the further growth of public spending.*

A new approach is needed. The starting point has to be that we cannot afford ***not*** to cut taxation levels. Starting with affordable tax levels will impose an essential discipline on the further growth of public spending. Crucially, it will constrain the size of the public sector to match affordable tax receipts rather than the other way around. And the discipline of growing public spending by just 0.5% a year less than GDP for five years would open up scope for taxes to be £26 billion lower than they would otherwise need to be[4] – and that on top of the huge potential now being revealed by the Gershon and James Reviews for savings in waste and efficiency.

At the macro-economic level, the benefits of reducing the recent ratchet in tax levels would show up in faster productivity growth and wealth creation. As a result lower taxes do not necessarily result in a lower absolute level of public spending over time. If the overall economic 'pie' grows faster, tax revenues will be boosted despite lower tax rates.

However, the most compelling arguments for reducing tax levels come from examining the damaging effect that high taxation is having on incentives and wealth in specific areas of the economy.[5] In this light, and as an initial step, the following five taxes are those that Britain cannot afford ***not*** to cut.

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[2] YouGov survey for the Centre for Social Justice, September 2004.

[3] TaxPayers Alliance/ICA poll, 12 September 2004.

[4] See, by the same author, *Freedom and responsibility: a manifesto for a smaller state, bolder nation*, CPS, 2003.

[5] See Ruth Lea, *Tax 'n' Spend: no way to run an economy*. CPS, 2004.

CHAPTER TWO
WE CANNOT AFFORD NOT TO CUT TAX ON LOW INCOME FAMILIES

The average household income in the UK is roughly £20,600 per annum (£400 a week). For couples with children, the average household income is close to £30,000 per annum. However some families, particularly those with only one earner, have to struggle to make ends meet on incomes well below that – some 20% of couples with two children, for example, have annual incomes below £15,000 per annum. Yet, perversely, with a personal income tax allowance of just £4,700, below average income families start to pay tax on every pound they earn above that level – well below what most people would regard as a minimum income on which to raise a family.

No family with dependent children should pay income tax until they have enough to live on.

These families cannot afford to have their income reduced through income tax deductions – indeed the benefits system already has a whole battery of schemes under which low income families can receive money back from the state, including the highly complex working tax credit. However, as well as being extremely costly to administer, these blunt incentives foster a culture of dependency on the state.

The system must be simplified. No family with dependent children should pay income tax until they have enough to live on. Is the last pound spent by the state more worthy than an extra pound left in these families' pockets?

As a first step, the next Government should therefore raise personal allowances from £4,745 to £7,500. Alongside this, they should introduce a system of transferable allowances between couples with caring responsibilities (i.e. children eligible for child benefit) so that where one partner is not working the unused allowance can be used by the working partner. As a result all couples with children would be able to earn £15,000 between them free of tax.

And it is not only families that would benefit from this tax cut: all working people would of course benefit from the reduction in income tax resulting from higher allowances.

CHAPTER THREE

WE CANNOT AFFORD NOT TO CUT TAXES ON PENSIONS

The UK has a savings and pensions time-bomb on its hands. As the post-war baby boom generation ages, a rising proportion of the population will fall into the post-60 age range where they have traditionally expected to retire from the working population. Current projections suggest the ratio of workers to retired dependents will halve from 3:1 to 1½:1 over the next 50 years. Without adequate savings, the cost of supporting this growing proportion of retirees will become an increasing burden on the remaining population still in work.

Yet the savings ratio has dropped over the last few years – from an average of around 10% in the early 1990s to around 6% over the last year. Latest estimates suggest that company pension funds are already some £100 billion short of the levels required to meet commitments to those they cover, and an increasing proportion of final salary schemes are now closed to new entrants. Further, some 11 million working age individuals – close to half the working population – have no private pension fund at all.[6] Meanwhile the unfunded cost of future state pension commitments on which these individuals will rely – a current liability of over £1,000 billion which will have to be paid for out of future taxation – continues to grow. According to the Government Actuary, if state pensions kept pace with earnings, by 2060

[6] Department for Work and Pensions, *Simplicity, security and choice*; 2002.

it would require an extra levy of almost 10% on the earnings of those in work to foot the bill.[7]

Unfortunately the Government has compounded this problem by a whole series of tax changes that have drained money out of pensions and long-term savings, and reduced the incentives to save – most notably the £5 billion a year tax charge on pension funds from the abolition of tax credits previously received on dividend payments. At the other end of the savings equation, means-tested benefits for pensioners have grown significantly. These effectively act as an additional tax deduction on retirement savings income, with many people being no better off than if they had not saved at all.

Britain cannot afford to continue with this destruction of its pension savings. Nor can it afford to rely on future taxpayers to foot the state pension bill.

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Therefore, as a start, the next Government should commit itself to put back the £5 billion annual tax taken from pension savings, either by reintroducing the dividend tax credit or by providing an equivalent sum to introduce new tax incentives aimed particularly at low income savers.[8] To meet the scale of the pensions problem, however, this will need to be followed by a whole range of other measures, including:

- the reform of the state pension;
- the reform of means-tested pension benefits to reduce the disincentive to save;
- the simplification of the rules and regulations around the marketing of pension savings to low income earners.

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7 See Government Actuaries Department, *Quinquennial Review*, October 2003:

> "If benefit rates are increased in line with earnings growth... the required rate on National Insurance contributions is projected to rise from 19.1% of earnings in 2001/02 to 27% in 2060/61."

8 See the proposals, by the same author, in *Freedom and Responsibility*, CPS, 2003 for a matching tax credit on the first £1,000 of annual pension savings.

CHAPTER FOUR
WE CANNOT AFFORD NOT TO CUT TAXES ON SAVINGS

Incentives to save for retirement should not stop with traditional pension schemes. Increasingly individuals' savings are also being accumulated in other assets – in ISAs and investment bonds, or real estate.

Britain cannot afford not to encourage and support long-term savings. Initially , the amount that can be invested in an ISA should be raised to £20,000 a year – and restrictions on what type of assets held in such funds removed.

At a time when savings levels have fallen and provision for retirement is under strain, the Government followed its raid on private pension schemes with an attack on other forms of savings. In particular, it reduced the limit on annual savings in tax-advantaged ISAs from £7,000 to £5,000; and it removed the tax benefits these funds received from credits on dividend income during their lifetime. Government policy needs to go in the other direction: to encourage and support long-term savings by extending their tax benefits.

The simplest way to do this would be to raise the amount that could be contributed to an ISA substantially – initially, say to £20,000 per year – and to remove restrictions on what types of assets can be held in such funds. That would allow people to put aside lump sums – such as redundancy payments and inheritances – to accumulate tax-free income, and would effectively abolish Capital Gains Tax on savings for most individuals. People who invested in properties to let would be able to transfer those into their funds over a period of years and would benefit from tax-free rental income in retirement – making such forms of saving substantially more worthwhile.[9]

Over time, other taxes on savings should also be removed or reduced. For example, the costs of the stamp duty paid on each share transaction largely comes out of the institutional funds backing individuals' savings and pension plans. It has been estimated that this amounts to a charge of £8,000 on a typical company pension over its lifetime. Eliminating this tax would be another way to ensure those funds grew faster and were able to provide higher benefits.

Every pound reduction in tax that goes into long-term savings represents a future income stream for someone in retirement that does not have to come out of the pockets of tomorrow's taxpayers. Britain cannot afford not to cut taxes on savings now.

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9 See the proposals by the same author, in *Freedom and Responsibility*, CPS, 2003.

CHAPTER FIVE
WE CANNOT AFFORD NOT TO CUT TAXES ON FAMILY INHERITANCES

Future generations will be less dependent on the state if savings can be handed down within families. Inheritance tax was originally introduced as a 'death tax' on large estates. In the last few years, however, the failure to raise the threshold in line with rising household assets – particularly the value of the family home – has meant that many ordinary families are now being brought within the net. The *average* house price in Greater London, for example, is now at the same level as the inheritance tax threshold (£263,000).

This is wrong in principle as well as in practice. In principle, hard-working people should be encouraged to accumulate assets that they can pass on to their children, increasing the wealth and independence of family units in each generation rather than confiscating wealth to enlarge the state. In practice, wealth accumulated in property and passed on to the next generation is an important contributor to providing those recipients with an additional capital sum to help fund their pensions. A lump-sum inheritance, often received when the younger generation are themselves close to or in retirement, can make all the difference to whether or not they have sufficient capital to pay for a decent retirement income.

The next Government should grasp the nettle and abolish inheritance tax. At the very least, it should raise the threshold to a level where the vast majority of families are exempt. Since too few people have adequate retirement savings, this wealth-transfer should be encouraged rather than penalised. And that would mean more income for tomorrow's pensioners that will not have to come from tomorrow's taxpayers.

CHAPTER SIX

WE CANNOT AFFORD NOT TO CUT TAX ON SMALL BUSINESSES

Small businesses are a major driver of employment in the UK – for example, those with under 50 employees account for 30% of the private sector workforce. Since nearly every new generation of leading businesses starts off with small companies, they are a vital source of innovation and wealth creation in the economy.

Yet, over recent years, these enterprises have been particularly badly hit by both the growing burden of red tape and regulations, and by the rising tax and rates burden on businesses. Overall, the CBI estimates that – despite small reductions in headline corporation tax rates – the overall tax burden on business will be £7.6 billion higher in 2006 than it was when the current Government came to power. For many small businesses, these tax payments may make the difference between being able to afford one more employee or not, between being able to invest in expansion or not.

Furthermore the costs of administering new taxes and regulations may be even more severe. The British Chambers of Commerce (BCC), recently revealed that the cost to business of the almost 900 regulations introduced since 1997 has increased to £30 billion, a rise of 46%. In 2003 alone, British business was faced with the bill for an extra £9 billion. These figures exclude the cost to business of the National Minimum Wage Regulations 1999 and subsequent amendments to the rate, estimated to have cost £13.5 billion by

July 2004. [10] Other research has shown that the cost to small businesses of implementing the working tax credit averaged 5% of payroll costs, and for some firms exceeded 10%.[11]

The cost to business of the almost 900 regulations introduced since 1997 is estimated to be £30 billion, a rise of 46%.

One of the most damaging of the 'stealth taxes' on businesses was the increase in national insurance contributions introduced in the 2002 budget. This is effectively a direct tax on employment, costing employers an estimated £4 billion annually.

The next Government should, as a first step, reverse this particular rise. After that, it should progressively reduce the tax burden on small businesses, and reduce the fixed costs of setting up a new enterprise. Beyond this, as well as simplifying taxes, it should look further at the rates and thresholds for national insurance, business rates and corporation tax. It should explore the kind of schemes operated in some US states where small businesses can 'sell' annual tax losses to larger businesses who are able to take advantage of the offset against current profits.

A thriving small business sector is one of the most vital requirements for a high productivity, wealth creating economy in the future. Britain cannot afford to let small businesses be buried under the tax costs of an oversize state.

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10 BCC, *Burden's Barometer*, 2004 and Newsletters.

11 See Dr Colin Lawson and Michael Goodwin, University of Bath, 2004.

CHAPTER SEVEN

CONCLUSION

These are just some of the opportunities to benefit individuals, families and the UK economy from moving to lower levels of taxation. There are many other taxes which are similarly damaging to incentives, to wealth creation and to the chance for families to provide for themselves – to stand independent of the state. Those who advocate more state spending are often quick to point to the benefits they believe they can offer, but blind to the costs of the higher taxes that their proposals bring in their wake.

The argument should not be about whether we can afford to reduce taxes, but about how we discipline state spending to match the tax levels we can afford.

These arguments must be reversed. The state – like every private family – has to live within its means. Given the huge growth in public spending in recent years, the argument should not be about whether we can afford to reduce taxes, but about how we discipline state spending to match the tax levels we can afford.

APPENDIX
VALUE OF PROPOSED TAX CUTS

	£ billion
Raising personal tax allowances to £7,500, and introducing transferable allowances for couples with children (partially offset by eliminating 10% band)	12 to 14
Put money raised from abolition of pension fund dividend tax credit back into pensions	5
Extend ISA tax relief on savings	3 to 5
Abolish inheritance tax	3
Reverse employer's 1% rise in NICs (net of £1 billion cost on public sector employees)	3
Total	**26 to 30**

Notes:

1. The cost of raising tax thresholds will be partially offset by potential savings in means-tested benefits and tax credits
2. Growing public spending by 0.5% less than GDP over five years would open up scope for tax reductions of between £25 billion and £30 billion. Given the scope for savings in waste and inefficiency in current expenditure, this should be a minimum target.