Centre for Policy Studies

THE BAD SAMARITAN

THE WAR OF INDEPENDENCE PART TWO

Maurice Saatchi and Peter Warburton

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CONTENTS

PROLOGUE

SUMMARY

THINGS CAN ONLY GET WORSE? 1

MORE COMPLEX, MORE INEFFICIENT 3

GROWING EXPENDITURE COMMITMENTS 8

THE CHANCY CHANCELLOR 11

THE HIGHER TAX BURDEN AHEAD 17

A BETTER USE FOR THE DIVIDEND 20

CONCLUSION 22

EPILOGUE 23

APPENDIX 1: INDEPENDENCE DAY

APPENDIX 2: THE ADMINISTRATIVE BURDEN OF THE NEW TAX CREDITS ON EMPLOYERS

PROLOGUE
THE PARABLE OF THE GOOD SAMARITAN

A certain man went down from Jerusalem to Jericho, and fell among thieves, which stripped him of his raiment, and wounded him, and departed, leaving him half dead.

And by chance there came down a certain priest that way: and when he saw him, he passed by on the other side.

And likewise a Levite, when he was at the place, came and looked on him, and passed by on the other side.

But a certain Samaritan, as he journeyed, came where he was: and when he saw him, he had compassion on him.

And went to him, and bound up his wounds, pouring in oil and wine, and set him on his own beast, and brought him to an inn, and took care of him.

And on the morrow when he departed, he took out two pence, and gave them to the host, and said unto him, Take care of him; and whatsoever thou spendest more, when I come again, I will repay thee.

Which now of these three, thinkest thou, was neighbour unto him that fell among the thieves?

And he said, He that shewed mercy on him. Then said Jesus unto him, go, do thou likewise.

This is the original Bible story of The Good Samaritan.

The Government – The Bad Samaritan – pays the two pence but then applies a means-test to the donkey and sends you on your way.

Can we do better?

SUMMARY

The purpose of this pamphlet is to focus public attention on 'Independence Day', the day on which people stop working for the government and start working for themselves. In 2000, the tax burden is expected to reach £350 billion, equivalent to 37% of Gross Domestic Product or 41% of Net National Product. On this calculation, people will have worked for the government for all of the first five months of the year. So Independence Day this year falls today, May 30.[1]

Three years ago Independence Day fell five days earlier, on May 25. Next year, it will be in June. We want to move it back to April, (where it was in the 1950s), when tax was only 30% of GDP.

A once in a lifetime opportunity may have arisen to make this possible.

BACKGROUND

In last year's CPS pamphlet, *The War of Independence: a Declaration,* we described how the tax burden is constantly rising, while the tax system itself is also getting more complicated. This complexity increases the tax burden further, by adding to the cost of administration:

There is a massive overlap between tax and benefit payments

[1] If the cost of the Working Families Tax Credit were to be included in the calculations, it would fall on 1 June 2000. The Government treats this benefit payment, however, as a tax cut. See Appendix 1.

First, there is now a massive overlap between tax and benefit payments.

Every year, the Government collects around £30 billion in Income Tax and National Insurance Contributions from 17 million households to whom it also distributes around £30 billion in benefits.

How much better it would be if these households simply retained a larger proportion of their earned income. Higher after-tax incomes would remove the need for millions of minor benefit payments, which could simply disappear.

There are now a mass of 250 complex tax allowances... The Institute of Chartered Accountants recently warned that the tax system was so complicated that it had "spun out of democratic control".

Second, there has been a staggering proliferation of tax rates.

There are now a mass of over 250 complex tax allowances, reliefs, exemptions, credits, indexations, tapers, disregards and so on, which taxpayers have to navigate. According to the latest figures from the House of Commons Library even the number of basic tax rates has more than doubled from 15 to 38 under the present Government.

The Institute of Chartered Accountants recently warned that the tax system was so complicated that it had 'spun out of democratic control'. The Institute of Fiscal Studies says it is now 'extremely difficult' for people to calculate how much tax they are due to pay.

This complexity enables the Government to claim that the "tax burden is falling" while the ONS, the House of Commons Library, the IFS and the OECD, not to mention both Opposition parties, say that tax is rising.

This complexity enables the Government to claim that 'the tax burden is falling', while the Office of National Statistics, the House of Commons Library, The Institute of Fiscal Studies, and the OECD, not to mention both Opposition parties, say that tax is rising.

THE PROPOSAL

What to do? *The War of Independence: a Declaration* proposed a radical reform of the tax and benefit system. The plan was to raise the income threshold, below which people do not pay tax, from its present level of £4,300 to £15,000.

The result of this step would be a loss of tax and National Insurance revenue for the Government of between £30 billion and £40 billion under the present system. In principle, it should be possible to cancel out an equivalent value of cash payments of benefits and pensions, without withdrawing support from individuals and families who are genuinely dependent. In the first instance, this reform would be strictly revenue-neutral, entailing a parallel reduction in cash-paid benefits and Income Tax receipts. However, in time it should be expected to improve the efficiency of the economy and to raise the underlying pace of GDP growth.

By implication, most working individuals with annual incomes below £15,000 would simply cease to be taxpayers. Hardly any income taxpayers aged over 65 would remain. People would typically receive benefits, or pay Income Tax; but seldom both at the same time.

The result would be that 12 million people would stop paying Income Tax altogether, 8.6 million working people with incomes below £15,000, and most of the 3.4 million taxpayers aged 65 and over. The tax burden would be reduced to 33% of GDP.

This simplified, streamlined structure would result in an estimated £5 billion saving in administration costs through the elimination of duplicated tax and benefit assessments, and a more efficient benefit payment system. All of this £5 billion saving could be used to boost investment in health and education.

It was further proposed that Independence Day should be declared a national holiday, a benchmark of progress towards the goal of greater independence for all.

In addition to the auction proceeds of the 3G mobile phone licences, the Chancellor is also the recipient of a second, even more lucrative, stream of revenue – one which in the last fiscal year alone was worth £14 billion.

AN OPPORTUNITY

In the last year, events have occurred which make it possible for the Government to stop being The Bad Samaritan and to start behaving as The Good Samaritan.

The Chancellor of the Exchequer has not only just collected the first instalment of a £22.5 billion bonanza resulting from the auction of 3G mobile telephone licences. He is also the recipient of a second, even more lucrative stream of revenue, one which in the last fiscal year alone was worth as much as £14 billion.

The UK, like the US is reaping a global "Financial Markets Dividend" (FMD). This dividend is in two parts:

- Buoyant financial markets have swelled the earning and capital gains of a sizeable number of individuals, bringing significant additional Income Tax and Capital Gains Tax revenues. Increases in stock market turnover and levels have also increased Government tax receipts from Stamp Duty. As a result, total tax receipts rose by 9% last year, three times the rate of inflation and GDP growth.
- At the same time Government expenditure on debt service has fallen dramatically as a result of historically low interest rates.

The income from this dividend is extremely capricious. It is not prudent to use exceptional items such as these to fund recurring expenses. Yet the Chancellor of the Exchequer is using them to pay for the permanent public spending commitments he has made for the next four years.

This income stream is capricious. If for any reason it fails to materialise, taxes will have to increase substantially.

If for any reason the FMD fails to materialise at the assumed level in the coming years, other taxes will have to increase. Independence Day will move back even later in the year.

Would it not be better to use this dividend to smooth the transition to a permanently lower tax burden and a greatly simplified tax system – for the Government to become The Good Samaritan?

Instead, what better use could there be for the FMD than to smooth the transition to a permanently lower tax burden, and a greatly simplified tax system, with all the long-term benefits that will bring to Britain's growth and competitiveness? For the Government to become the Good Samaritan.

With the help of Dr Roger Cockfield, reader in taxation at De Montfort University, we hope to develop these ideas into a practical proposal which will show in detail how the FMD could be applied to a reform of the current system. This will be published on Independence Day 2001.

CHAPTER ONE
THINGS CAN ONLY GET WORSE?

New data for the tax year 1998-99 indicates that the tax and benefit system is becoming ever more complicated.

The overlap between cash-paid benefits and direct tax payments (even after deducting tax credits and housing rebates) has risen to £37 billion for the aggregate of UK households (£27 billion for non-retired households and £10 billion for retired households).

Take the example of a typical non-retired household in the 4th decile with original income (wages, salaries, occupational pensions and investment income) of £16,600 per annum.

TABLE I. EFFECT OF TAX & BENEFITS ON BELOW AVERAGE INCOME FAMILY 1998-99

	£ per annum	% of original income
Original Income	16,629	100.0
Minus Income Tax, NIC & local taxes	3,604	21.7
Plus cash benefits	2,990	18.1
Minus indirect taxes	3,975	23.9
Plus benefits in kind	3,591	21.7
Final income	15,631	94.1

Source: *Economic Trends*, ONS, April 2000.

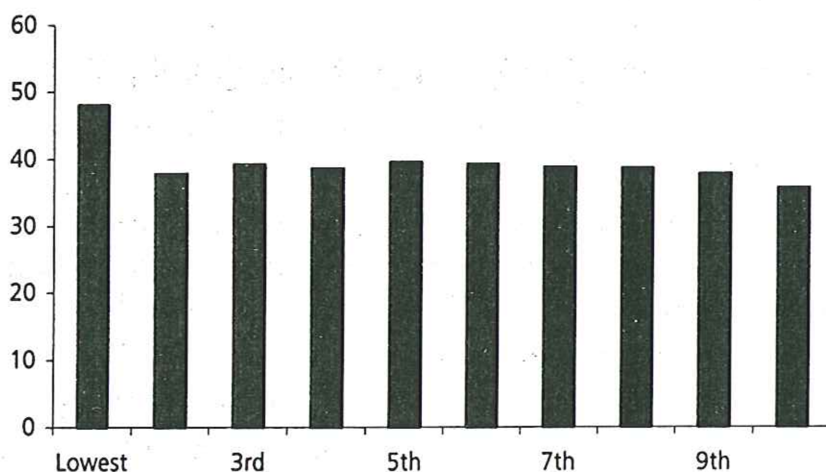
Out of this modest amount, Income Tax, National Insurance contributions and local taxes (usually Council Tax) of £3,600 per year is levied – equivalent to 21.7% of original income. But almost £3,000 per year is handed back in the form of cash-paid benefits, some dependent on age, some on health, some on hours worked per week, some on family

size and most on the determination of individuals to discover what are their entitlements. After some immensely complicated calculations, the typical household in the 4th decile (containing two adults and one child) emerges with £600 less per year – £12 per week.

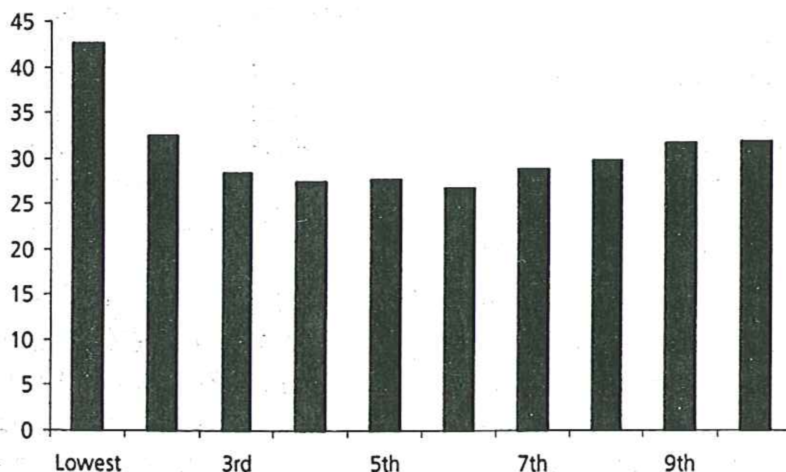
This, however, isn't the end of the story. The same household pays another £3,975 of indirect taxes (on VAT, excise duties on fuel, tobacco and alcohol and business taxation passed on through higher prices). This makes the total tax take 45.6% of original income, or 38.6% of gross income including benefits. Lastly, the household receives benefits in kind provided as public goods – mainly the provision of state education and health services – of almost £3,600 per year. In the final reckoning, this below-average income household has a lower final income than original income by £1,000.

The following charts show how the tax take varies across the income distribution for non-retired and retired households.

TOTAL TAX TAKE AS % OF GROSS INCOME FOR NON-RETIRED HOUSEHOLDS, 1998-99



TOTAL TAX TAKE AS % OF GROSS INCOME FOR RETIRED HOUSEHOLDS, 1998-99



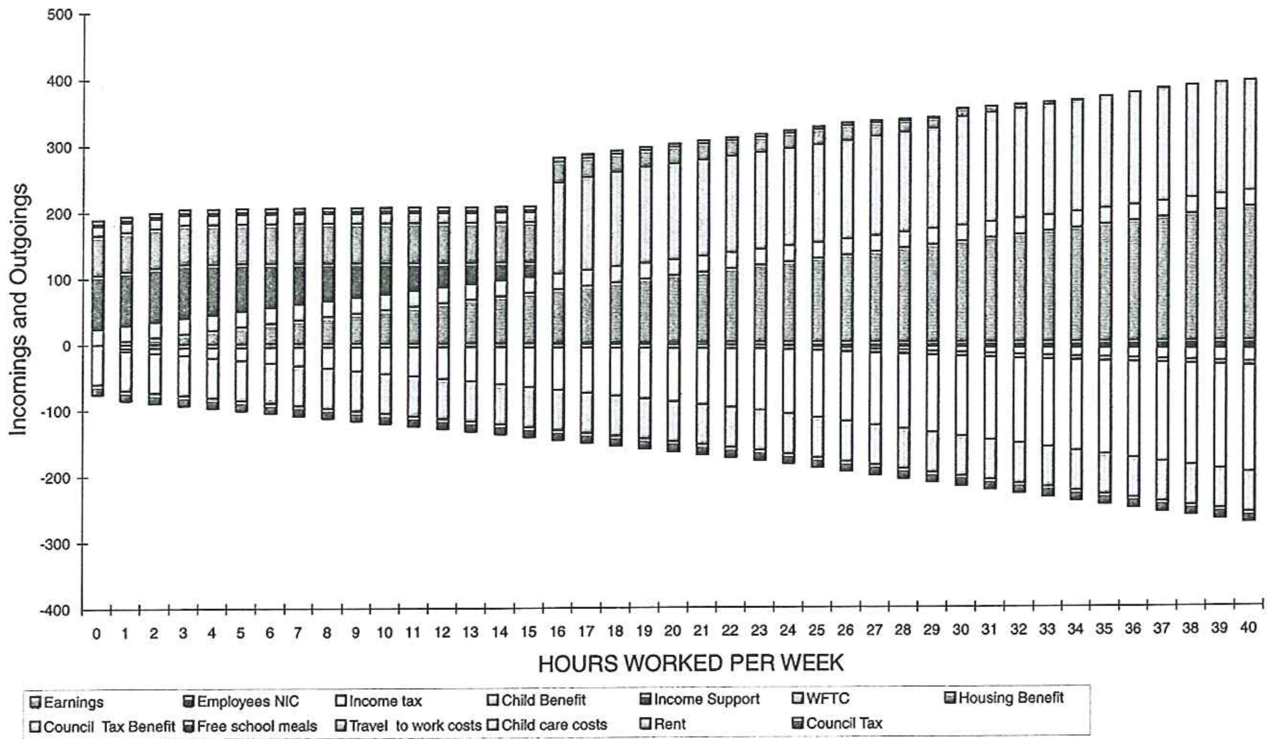
CHAPTER TWO
MORE COMPLEX, MORE INEFFICIENT

The bewildering complexity of the current system imposes hidden costs on the operation of economy. These include:

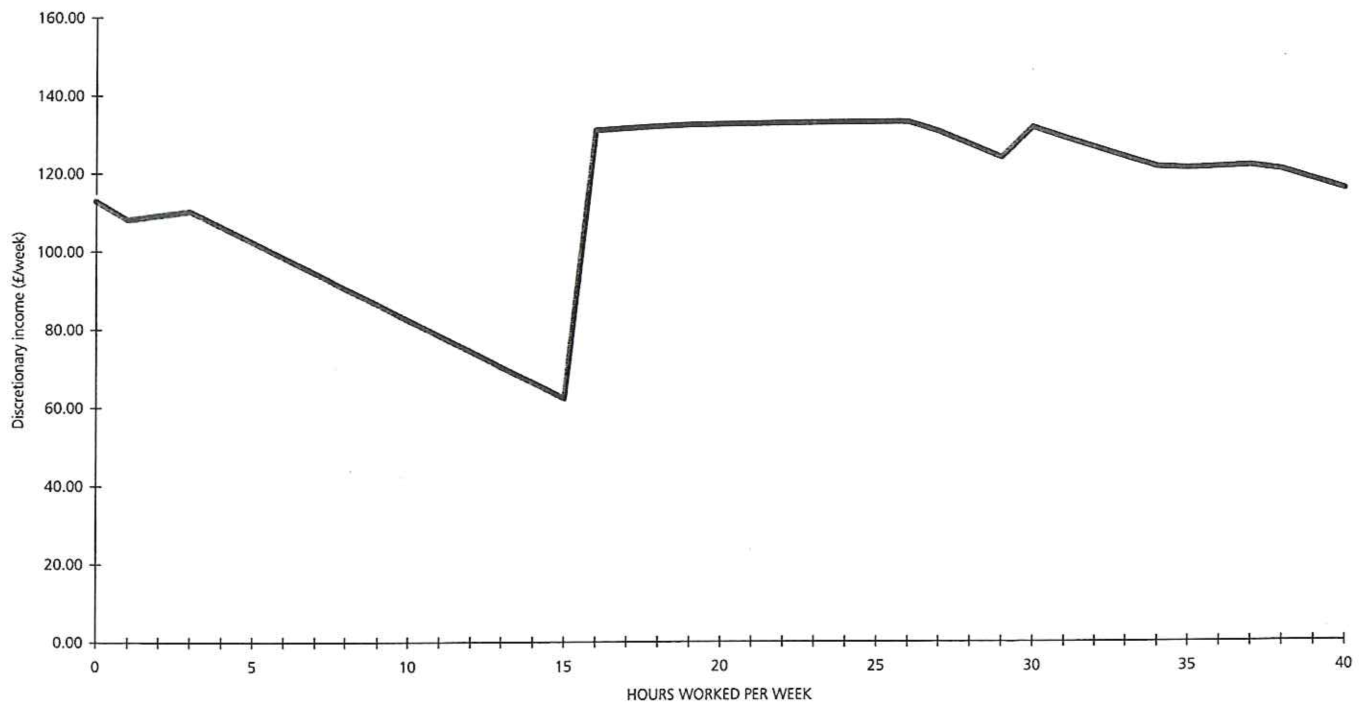
- the costs of administration of a disintegrated system;
- the public sector costs of enforcement of petty regulations;
- the private sector costs of compliance;
- and the costs associated with the demotivation of the workforce.

Consider the wide range of methods by which taxes and benefits are assessed: some benefits are income means-tested, some are capital means-tested and others neither. Income Tax is based on the income of the individual, while benefits are based on the income and capital of household units, defined simply as individuals living in the same accommodation and sharing at least one meal together each day. The low initial thresholds for Income Tax and National Insurance ensure that the low-paid and the growing number of part-time employees quickly become entangled in the tax system. Hours per week restrictions on certain benefits create further complications.

Tax and benefit interactions for a lone parent family with 2 children
(Discretionary income is positive minus negative amounts)



Discretionary income of a lone parent family (2 children)



This unnecessary complexity can best be understood graphically. The charts opposite show the effect of the tax and benefit system for a lone parent with two children, earning £5 per hour, paying £60 per week rent and £15 per week Council Tax. The fact that 13 colours are required to represent the interaction of taxation and benefits for this simple example can only be an indictment in itself.

13 different colours are needed to illustrate the interaction between tax and benefits on the income of a lone parent with two children, earning £5 an hour.

But the reality is worse: this lone parent must solve a complex "optimisation problem" (at least every six months) in order to decide how much work – if any – is worthwhile. The second of the two charts shows that the lone parent's discretionary income fluctuates wildly and illogically according to the number of hours she works. The fact that her earnings will more than double if she works 16 as opposed to 15 hours per week is extraordinary. But more so is the fact that her earnings will fall if she works 27 hours as opposed to 26 hours per week.

Her income will double if she works 16 hours a week instead of 15 hours. It will fall if she works 27 hours as opposed to 26 hours a week.

Effective taxation of benefits is subject to irrational and inconsistent decisions within the system. For example, Child Benefit is not charged to Income Tax at the basic or higher rates, but for those on Income Support (IS) or Job Seekers Allowance (JSA) it is taxed at 100%. A family with total earnings of £100,000 per annum pays 0% tax on Child Benefit, but an unemployed household pays tax at 100%. For those working 16 hours per week or more, Child Benefit is taxed at 65% for Housing Benefit (HB), and 20% for Council Tax Benefit (CTB). This is because it forms part of the income calculation which triggers the taper restriction when resources exceed the relevant threshold. Incidentally, each benefit has a different sufficiency threshold. The taper tax operates more drastically than an Income Tax rate in that it eventually wipes out the whole of the benefit. The chart overleaf shows how the most recent model used by the Treasury fails to recognise the effective taxation of Child Benefit.[2]

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[2] *Supporting children through the tax and benefit systems*, HM Treasury, November 1999.

The poverty and unemployment traps for recipients of social security benefits were explored many years ago by John Kay and Mervyn King.[3] More recently, the work of the Review of the Tax and Benefits Task Force, headed by Martin Taylor, has resulted in some slight alleviation of the traps.[4] For example, the Working Families Tax Credit (with a 55% taper) replaces Family Credit (taper: 70%). However, the interaction of WFTC, HB and CTB still creates a marginal tax rate of 95% for hundreds of thousands of households. The Taylor reforms have failed to tackle this anomaly. In almost all other respects, the effects of the WFTC are detrimental to work incentives and economic efficiency. Specifically, the WFTC extends the range of incomes over which tapering exerts a strong disincentive to work. A double earner couple with four children (two under 6, two over 14) in which the mother earns £3,000 per annum, is entitled to WFTC until the father earns more than £34,000 per year. Throughout most of this range, the marginal deduction rate (Income Tax and benefit tapers combined) is just under 70%. Additionally, WFTC benefits for lone parents are significantly more generous than for double-earner couples, providing a powerful financial incentive for lone parents not to combine as two-adult households. Another problem area is the effect of capital means-testing for the WFTC, whereby households with savings are heavily penalised if they confess to holding them in deposit accounts.

The huge public expense of the WFTC (around £6 billion in 2000-01, which is over £2 billion more than would have been spent on Family Credit) and its undesirable side-effects are bad enough. What aggravates the system is the burden it places on employers to operate the scheme through the payroll. This imposes an extra burden of £103m each year, on top of the estimated £43m in one-off set-up costs.[5]

Nor does the WFTC appear to work. The Institute for Fiscal Studies (IFS) has published a simulation of the labour participation effects of the introduction of the WFTC, and found a two percentage point increase for single mothers offset by a fall in participation rates for married women.[6] On any objective cost-benefit analysis, the WFTC emerges as a costly and confusing addition to an already incoherent system. Plans to extend the use of tax credits, splitting the WFTC into a Children's Credit and an Employment Tax Credit threaten to compound the folly.

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[3] J. Kay and M. King, *The British Tax System*, Oxford University Press, 5th edition, 1990.

[4] See their report, *The Modernisation of Britain's Tax and Benefit System*, HM Treasury.

[5] See Appendix 2 for details of how the burden falls on employers.

[6] R. Blundell, A. Duncan, J. McCrae and C. Meghir, "The Labour Market impact of the working families' tax credit", *Fiscal Studies*, March 2000.

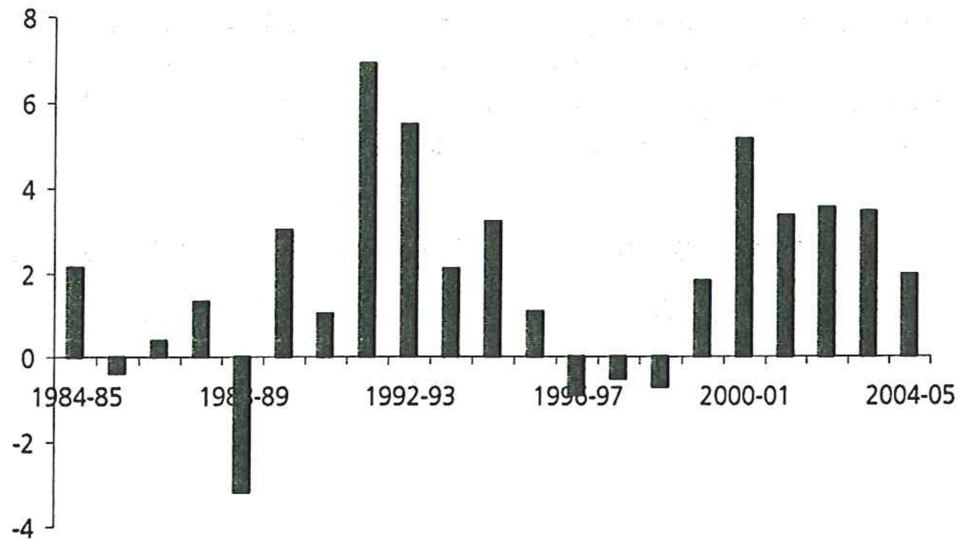
CHAPTER THREE
GROWING EXPENDITURE COMMITMENTS

In his 2000 Budget, the Chancellor of the Exchequer significantly raised the planned level of public expenditure for the next four years. Whereas previously the Government had made a virtue out of the flat real spending profile that it had inherited from the Conservatives, the 2000 Budget plans show a sequence of increases of more than 3% per year in real terms, beginning in 2001. The following chart sets these plans in the context of the past 15 years.

In the last Budget, the Chancellor announced plans to increase public spending by a total of 3% p.a. from 2001.

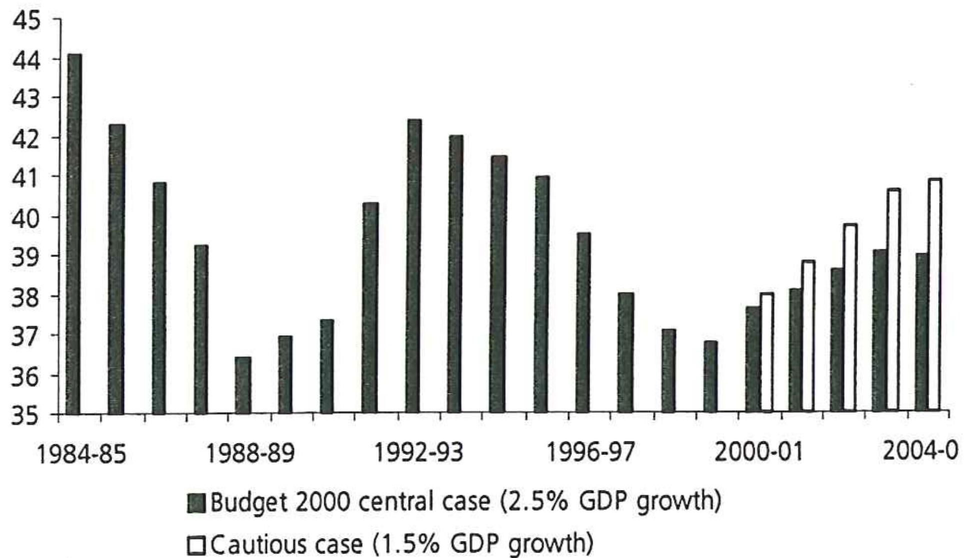
Specifically, National Health Service spending was lifted on to a 6% real growth trajectory, such that planned NHS spending in 2003-04 is £62.4 billion in 1999-00 prices as compared to £49.3 billion in 1999-00. Assuming that the average real growth in the education budget for the coming two years (5.5%) is continued in the following two years, then this would add another £10 billion to the real cost by 2003-04. However, real spending increases totalling a further £18 billion would remain to be allocated to other departments by the Comprehensive Spending Review in July.

REAL GROWTH OF PUBLIC EXPENDITURE (%PA)



The next chart illustrates the significance of this quickening of the pace of public spending. If the economy grows on average by 2.5% per year, then public current and net capital expenditures will rise from 36.8% in 2000-01 to 39% in 2003-04 and 2004-05. If, on the other hand, the Treasury's cautious case assumption of 1.5% annual GDP growth is used, then the 36.8% becomes 40.6% in 2003-04 and 40.8% in 2004-05. These percentages are some way adrift from the four-year Budget projections of a steady 37% of GDP for net taxes and social security contributions, which themselves are sensitive to a slower GDP growth rate.

PUBLIC SPENDING AS A PERCENTAGE OF NOMINAL GDP



The Government has ratcheted up its spending commitments for the next four years on health (and presumably education) on the assumption that the present buoyancy of tax revenues and low funding costs for government debt will persist indefinitely into the future. Is it safe to make these assumptions, especially in the light of what is already known about the reasons for the prevailing fiscal abundance?

The Government has ratcheted up its spending commitments for the next four years on the assumption that the present economic conditions will persist indefinitely. Is this a safe assumption?

CHAPTER FOUR
THE CHANCY CHANCELLOR

The rude health of the public finances, especially in the fiscal years 1997 and 1999, owes much to the buoyancy of global financial markets. This has effectively given the Chancellor a second, less well-known, even more lucrative dividend – the global Financial Market Dividend (FMD) – in addition to that he has already received from proceeds of the auction of the 3G mobile phone licences (with another £2 billion expected to be raised from an auction of broadband wireless fixed-access technology later in the year).[7]

The financial markets have given the Chancellor a second dividend – one even more lucrative and no less unexpected than the one he got from the auction of the G3 mobile licences.

The FMD can be considered in two parts:

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[7] The FMD is not be confused with the wealth effect. The effects of financial wealth accumulation through the revaluation of the equity markets (which apparently accounts for virtually all of the financial wealth gain by UK private investors) undoubtedly has a positive effect on total consumption. This has been estimated by others as adding around 0.25% to 0.5% per annum to real consumer spending in recent years. In its own way, this will make some small contribution to VAT and excise duty receipts. However, it is not an important contributor to the FMD.

- First, the enhancement to exchequer receipts of Income Tax, social security contributions, capital gains tax and stamp duty resulting from the extraordinary growth of personal incomes and share price-related benefits in the finance, technology and communications sectors and from abnormally rapid turnover in financial securities by retail investors.
- Second, the reduction in gross debt interest paid by central government as a result of extremely low long-term interest rates and a lower debt stock than would have occurred in the absence of the revenue enhancements of the first part.

TABLE II. ESTIMATED VALUE OF THE FMD

	1996-97	1997-98	1998-99	1999-00	2000-01F
Contribution of taxation	4.1	5.3	3.3	6.7	5.0
Contribution of debt service savings	0.8	1.1	3.6	7.0	4.2
Estimated size of the FMD	**4.9**	**6.4**	**6.9**	**13.7**	**9.2**

See Tables IV and V below for full details of calculations

The calculations are necessarily tentative and indicative. However, they encapsulate an authentic story about the evolution of the public finances in the context of unusual global capital market conditions. The dividend is also clearly present in the USA and in other European countries, to greater or lesser extent. The calculations are based on the extent to which tax and duty revenues have exceeded Treasury forecasts in successive Budget documents, after taking account of revenue increases that can be attributed to structural tax changes.

The chart below provides a visual justification for the notion of the FMD. It is inconceivable that Gordon Brown expected the average burden of Income Tax and CGT on gross primary household incomes to rise from 11.7% to 14.2% in little more than two years.

EFFECTIVE AVERAGE RATE OF INCOME TAX AND CGT ON GROSS HOUSEHOLD INCOME (%)

Source: Datastream

This is not to infer that the Treasury has been unaware of the dividend, for otherwise the Chancellor could not take credit for maximising it through the 'painless' tax increases on pension funds, residential and commercial property transactions over £250,000, the introduction of Self-Assessment for Income Tax and, prospectively, the punitive new tax on contractors known only by its press release number, IR35.

Table IV below presents a straightforward analysis of revenue projections contained in the past five Budget statements. At the point of delivery, the Budget forecasts include the anticipated effects of all announced measures. For this reason, the out-turn for 1997-98 is more accurately compared with the forecast in the July 1997 Budget, since its measures superseded those in the Conservative Budget of November 1996. The resulting increases (with the exception of 1997-98) are a crude estimate of the extent to which Income Tax, social security contributions, capital gains tax and stamp duty revenues have consistently outstripped the initial forecasts.

A relatively small, but significant, group of employees working in the "hot" sectors of the economy – the knowledge-based employees and contractors in finance and technology-based industries – have prospered disproportionately to those in other sectors. Their earnings and capital gains have triggered this unexpected boost to government revenues. As an example of the increasing concentration of the UK Income Tax liability, the Inland Revenue estimates that the top 10% of Income Taxpayers contributed 50% of the total liability in 1999-2000. As recently as 1995-96, the proportion was only 44%.[8]

Another piece of evidence comes from the official calculation of income inequality, commonly summarised by the Gini coefficient.[9] The top 20% of the income distribution received 52% of original income in 1998-99, as compared to 50% in 1995-96 and 47% in 1984. In terms of after-tax income, the top quintile received 45% of the total, compared to 43% in 1995-96 and 38% in 1984. It is particularly noteworthy that the tax and benefit system has had no material impact on recent trends in income inequality. The Chancellor has collected the FMD without making significant changes to the tax structure.

The following table shows how the Chancellor has benefited from a huge surge in Capital Gains Tax payments.

TABLE III. CAPITAL GAINS TAX RECEIPTS

	1994-95	1997-98	1999-2000 (e)
No. of CGT taxpayers*	73,000	172,000	220,000
Total revenue from CGT	£745 million	£2,038 million	£3,000 million

*Individuals and trusts combined

Source: *Inland Revenue Statistics 1999*, Table 14.1, TSO.

[8] *Inland Revenue Statistics 1999*, Table 2.4, TSO.

[9] *Economic Trends 2000*, ONS.

The figures have been boosted for a number of reasons, but the realisation of stock market gains on employee share options is likely to have played an important role. These options have become significantly more valuable over the past five years.

Stamp duty rates on conveyances and transfers of land, buildings and property other than financial assets have been raised from a standard 1% for all transactions above £60,000 before July 1997 to 3% for considerations above £250,000 and to 4% for those above £500,000. Stamp duty receipts on real estate transactions have dutifully bounded ahead from £1.1 billion in fiscal 1996 to £2.1 billion in the fiscal year 1998 and around £2.6 billion in 1999. Much of this additional duty has been collected from Greater London, south-east and south-west England where there is the greatest density of hot sector workers and the highest concentration of residential property valued above £250,000. However, there has been a massive increase in turnover for financial transactions where the rate of duty has remained constant. Stamp duty on financial transactions raised £1.4 billion in 1996-97, £2.5 billion in 1998-99 and an estimated £4 billion in 1999-2000.

TABLE IV. ANALYSIS OF BUDGET PROJECTIONS OF SELECTED TAX REVENUES (£ BILLIONS)

		1995-96	1996-97	1997-98	1998-99	1999-00	2000-01
Nov-96	Income Tax	68.0	68.1(f)	71.8(f)			
	Social security contributions	44.5	46.7(f)	49.1(f)			
	Capital Gains Tax	0.8	0.9(f)	1.1(f)			
	Stamp duty	2.0	2.4(f)	2.7(f)			
Jul-97	Income Tax		69.5	76.5(f)			
	Social security contributions		47.4	49.5(f)			
	Capital Gains Tax		1.1	1.3(f)			
	Stamp duty		2.4	3.3(f)			
Mar-98	Income Tax*		71.5	79.4(e)	86.1(f)		
	Social security contributions		47.1	50.5(e)	53.7(f)		
	Capital Gains Tax		1.1	1.4(e)	2.2(f)		
	Stamp duty		2.5	3.4(e)	4.6(f)		
Mar-99	Income Tax*			79.8	87.5(e)	90.8(f)	
	Social security contributions			51.1	54.9(e)	55.7(f)	
	Capital Gains Tax			1.5	2.4(e)	3.2(f)	
	Stamp duty			3.5	4.7(e)	5.7(f)	
Mar-00	Income Tax*				88.4	98.9‡	101.0(f)
	Social security contributions				55.1	56.6	58.8(f)
	Capital Gains Tax				1.8		3.4(f)
	Stamp duty				4.6	6.6(e)	7.2(f)
	Uplift from first forecast (£bn)						
	Income Tax		3.4	3.3†	2.3	4.9‡	
	Social security contributions		0.4	1.6†	1.4	0.9	
	Capital Gains Tax		0.2	0.2†	-0.4		
	Stamp duty		0.1	0.2†	0.0	0.9	
	Total		**4.1**	**5.3†**	**3.3**	**6.7**	

Source: *Budget reports 1996-2000*, HM Treasury.

* Gross of Income Tax credits

† Uplift from July 1997 forecast

‡ Combined figure for Income Tax and CGT

Finally, considerable savings have been made on central government debt service charges.

The FMD reached almost £14 billion last year. But even this is probably an underestimate.

The table below attempts to quantify these savings. The assumption made is that, over a full economic cycle, the government should expect to pay RPIX plus 4.5% – that is, a total of 7% – as an average cost of debt service. Obviously, the value of the dividend in one year diminishes the likely extent of financial liabilities in the next. The accumulation of the FMD is the main reason why actual debt service costs have stayed broadly constant in recent years, but the distortion at the long end of the gilt market relating to the rigidity of the Minimum Funding Requirement for pension funds, has clearly contributed to the situation in fiscal years 1998 and 1999.

TABLE V. ANALYSIS OF CENTRAL GOVERNMENT GROSS DEBT INTEREST AND CALCULATION OF THE FMD (£ BILLIONS)

	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01F
November 1996	25.6	27.2(f)	29.9(f)			
July 1997		27.0	29.6(f)			
March 1998		27.2	29.4(e)	29.1(f)		
March 1999			29.7	29.5(e)	26.0(f)	27.6(f)
March 2000				29.5	25.5(e)	27.8(f)
Most likely outturn	25.6	27.2	29.7	29.5	25.5	27.8
Total financial liabilities of CG (mid-yr)	362.1	394.9	428.4	458.4	438.9	425.0
Average cost of debt service (%pa)	7.1	6.9	6.9	6.4	5.8	6.5
Adjusted financial liabilities	362.1	399.9	440.4	473.4	463.9	457.0
Assumed average cost of 7%pa	7.0	7.0	7.0	7.0	7.0	7.0
Adjusted gross debt interest	25.3	28.0	30.8	33.1	32.5	32.0
Estimated contribution of debt service savings	-0.3	0.8	1.1	3.6	7.0	4.2
Estimated contribution of taxation		4.1	5.3	3.3	6.7	5.0
Estimated size of the FMD		**4.9**	**6.4**	**6.9**	**13.7**	**9.2**

In aggregate, it is estimated that the FMD reached almost £14 billion last year. But even this is probably an under-estimate. The much lower dividend for the previous year is readily explained by the global financial markets crisis of autumn 1998, which depressed securities market turnover for three months and significantly diminished the bonus element of financial sector earnings in respect of calendar 1998. The projection of the dividend in the fiscal year 2000 as £9 billion is an estimate.

The Chancellor appears to be treating the FMD as a structural and permanent change. It is the opposite. By identifying the true source of the dividend, a more accurate assessment of its size in future years can be considered.

The Chancellor appears to be treating the FMD as a structural and permanent change. It is the opposite. A severe storm in the financial markets could well remove it altogether. The Chancellor is being anything but prudent

A severe storm in the financial markets could well remove it altogether. In this light, it appears extremely foolhardy of the Chancellor to have committed the FMD more fully in the later years (2002-04) when its very existence – let alone its size – is least dependable.

CHAPTER FIVE
THE HIGHER TAX BURDEN AHEAD

Once announced, a commitment to raise public expenditure in real terms is, politically, next to impossible to withdraw. In the absence of a sizeable FMD, additional revenues from other forms of taxation will be needed to compensate for their loss. In this event, the framing of the Government's fiscal rules, which may appear uncontroversial, will have some unpleasant consequences for the UK tax burden.

Should the FMD evaporate, the Chancellor's golden rule will have unpleasant consequences for the UK tax burden.

The "golden rule" requires that, on average, public sector current spending is matched or exceeded by current revenue over the economic cycle. The sustainable investment rule insists that public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level, which has been set at 40% in the current parliament. In making the level of taxation the free variable in the fiscal arithmetic, rather than the public sector's net borrowing requirement, a subtle but devastating transformation has occurred. The rules imply that all favourable out-turns in government revenues are available to be allocated as additional expenditures, while all unfavourable outcomes must be financed from fresh impositions of taxation.

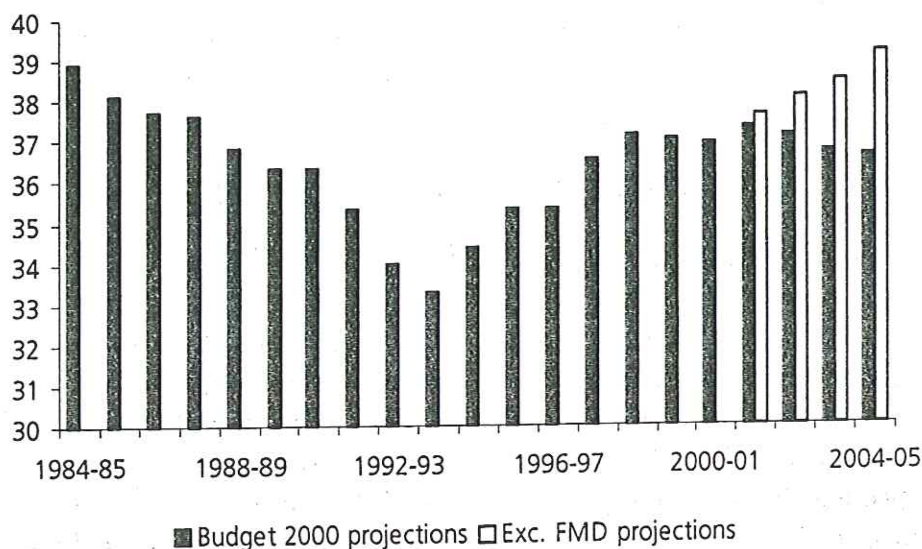
The chart overleaf illustrates the consequences of a dislocation of the global financial markets on the UK's overall tax burden. It assumes that

the Budget 2000 spending plans are irrevocable. No allowance has been made in these calculations for the effect of replacing Family Credit (which was counted as a social security benefit) with the Working Families Tax Credit (which is scored as a reduction in the tax liability). The effect in 2000-01 is to reduce the tax burden by 0.6% of GDP in comparison with the years before WFTC was introduced.

For the sake of argument, it is assumed that the FMD halves to £7 billion in 2000-01 and disappears altogether in later years.[10] However, this would not be the end of the matter. Because of the deflationary forces that would accompany a financial markets slump, other tax revenues would also be liable to decelerate from the rate of 5% per annum rate used in the Budget. Using the second assumption of a gradual deceleration to 2.5% per annum growth of all other source of tax revenue, then the balance on the current budget would move from a surplus of £8 billion to a deficit of £30 billion in 2004-05, thus shattering the golden rule in that year.

Under this scenario, £30 billion would have to be recovered from other forms of taxation.

NET TAXES AND SOCIAL SECURITY CONTRIBUTIONS AS A PERCENTAGE OF GDP



Since every year after 2000-01 is a deficit year on this scenario, it is assumed that the full £30 billion must be recovered from other forms of taxation in order to fulfil the golden rule. As a consequence, net tax and social security contributions as a percentage of GDP must rise to more than 39% by 2004-05.

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[10] The FTSE-100 Index has made little progress in the last 12 months so scope for immediate growth in CGT revenues is limited.

History offers countless examples of countries in a seemingly balanced fiscal position falling victim to recession or natural disaster, with the result that the tax burden ratchets sharply higher. In Sweden, in 1974, it was not a democratic decision to raise the overall tax ratio to climb from 42% to 50% of GDP in three years – it was a recession. And in Italy, in 1990, there was no vote to raise the ratio from 39% to 44% in three years – it was a recession.

The March 2000 Budget, already criticised as irresponsible by international organisations and domestic institutes, will come to be regarded as a serious and costly blunder.

The structure of the UK's fiscal rules offer no protection against an upward trend in the tax burden. It is only when the "easy" revenue evaporates that the "hard" revenue must be sought – the increases in the VAT rate, the non-indexation of tax bands, the increases in the Income Tax rate and so on. Then, the rising tax burden becomes universally visible and the strength of public feeling about taxation reasserts itself. The March 2000 Budget, already criticised as irresponsible by international organisations as well as domestic institutes, will come to be regarded as a serious and costly blunder.

CHAPTER SIX
A BETTER USE FOR THE DIVIDEND

The chapters above have shown that:

(a) the current tax and benefit system has become so complicated and onerous on individuals that it is a significant cause of confusion, frustration and dependency; and,

(b) that the FMD is not a secure stream of income but the result of extraordinary conditions in the global financial markets.

Would it not therefore be wiser to use the FMD to reform the present tax and benefit system?

In *The War of Independence*, a radical reform of the tax and benefit system was proposed. It involved raising the initial threshold for Income Tax in stages to around £15,000 per annum. Most working individuals with annual incomes below this level would simply cease to pay Income Tax. As a result, millions of people would no longer qualify for means-tested benefits because their net incomes would be that much higher. By separating the ranges of benefit withdrawal from those of Income Tax and National Insurance payments, the incidence of punitive marginal deduction rates would be greatly reduced. Most people would either receive benefits or pay Income Tax; but seldom both.

The overall tax burden would fall as a result of eliminating much of the wasteful and unnecessary overlap between direct taxation and benefit payments. Also, many simplifying measures could be adopted, including the standardisation of qualifying income levels for all means-tested

benefits – Income Support, Housing Benefit, Council Tax benefit and Working Families Tax Credit. While the means-tested benefit system would remain under the new regime, its relative attractions would be diminished.

Most working individuals with annual incomes below this level would simply cease to pay Income Tax. As a result, millions of people would no longer qualify for means-tested benefits because their net incomes would be that much higher.

Over the next year, we plan to carry out a detailed simulation of the proposed tax and benefit system compared to the existing one. But a range of £2 billion to £5 billion per annum would appear to encompass most reforms of the type outlined above.

CHAPTER SEVEN

CONCLUSION

There is much talk of investing in a "New Britain". What better investment can be made than one which returns income, independence and responsibility to its citizens? Within five years, the UK could restore fairness, transparency and simplicity to the financial affairs of millions of households, and reduce the overall tax burden from 37% to 33% of GDP into the bargain.

EPILOGUE
A GROWN-UP CONVERSATION

Government: Come on, what's up? You don't seem happy.

Citizen: I'm not happy. I have money worries.

Government: *You* have money worries. How do you think *I* feel? I give you a strong economy, millions of new jobs so you can afford cars and TVs and computers and holidays in Florida and still you complain, making me spend all my money on benefits for you... I mean, what do you think I am, made of money? Where's it going to end? I just can't keep going on like this. Don't talk to *me* about money worries.

Citizen: Who else can I talk to? You're the Government, you're in charge.

Government: I know, and I've had enough of your endless moaning and whinging. Leave me out of it: just talk to an independent financial adviser or something.

Citizen: But I'm not independent, that's the point. What's the use of an independent financial adviser? I have real issues here. What about health care and my parents' old age? What about the kids' university fees? And what about the mortgage if taxes keep going up? And I don't even want to think about the pension and whether that'll be worth anything by the time I retire. I'm genuinely worried and I don't know what to do.

Government: How many times have I told you, you don't have to do anything, I'll take care of all that for you. You worry too much. Relax, I've got it all under control.

Citizen: That's the problem, that's exactly the problem. How do I know it's going to be OK unless *I'm* in control?

Government: It's going to be OK precisely because you're not in control. Imagine if everybody was in control of their own little lives! Then where would we be? Chaos. Anyway, you couldn't possibly afford to take control of everything and look after all these things for yourself. Have you any idea how expensive health care is? And education? And all these benefit payments I hand out? Where would you get the money?

Citizen: The same place you get it. From me.

Government: What do you mean, "from me"?

Citizen: Well that *is* where you get your money isn't it? The only place you *can* get it. From me.

Government: OK, OK, but I always give it back.

Citizen: I know, so why take it in the first place?

Government: Well, because… because that's how it works. That's the way I've always done it. No one's complained before.

Citizen: Oh come off it, everyone's always complaining. And, by the way, you haven't always done it like that. Fifty years ago you didn't take half as much money from us.

Government: Yes I did, I've got the figures here. Actually, I took two thirds as much.

Citizen: Well… whatever. It's a lot less than now. And in any case, I thought you believed in doing things differently than in the past?

Government: I do.

Citizen: So don't take so much of my money in taxes.

Government: But then, how could I afford to pay for all the things you say you're worried about?

Citizen: You wouldn't have to. If you didn't tax me so much, you wouldn't have to pay me so much in benefits. I'd have the money to pay for things myself, which is what I asked for in the first place. A bit of independence.

Government: So you don't mind looking after yourself?

Citizen: No! Not if you don't take so much of my money in tax. Then I could pay for things myself, and you could concentrate on doing the things people really can't do for themselves.

Government: And then I won't have you complaining the whole time?

Citizen: Exactly.

Government: Sounds good to me.

Citizen: Me too. Thank you and goodbye.

APPENDIX 1
INDEPENDENCE DAY

Independence Day expresses the overall tax burden in terms of days per year.[11] It calculates how much of the year the average income earner spends in financing the government's budget. When Independence Day is reached, individuals have fulfilled their obligations to the government and for the remainder of the year they enjoy full discretion over their earnings.

Independence Day represents the total tax revenue, including indirect taxes, local taxes and National Insurance contributions, paid annually by a taxpayer with average income, as a percentage of total income. For practical purposes, it is calculated as general government tax revenue with the Net National Product (NNP). NNP differs from the more familiar Gross Domestic Product in two ways. First, NNP adds in net property and entrepreneurial income of UK citizens from abroad (which totalled £15 billion in 1998). Second, NNP subtracts capital consumption (i.e. depreciation of fixed capital assets), which amounted to £88 billion in 1998. NNP is therefore smaller than GDP, making the ratio of tax revenue to NNP slightly larger than that to GDP. For 1998, the percentage tax to NNP was 41.1% as compared to the 37.1% of GDP reported in the March 2000 Budget report.

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[11] To avoid confusion, Independence Day has now been aligned with the Adam Smith Institute's Tax Freedom Day.

The rationale for using a net rather than a gross national income measure is straightforward. Since depreciation is an expense – expenditure which must be set aside in order to replace worn-out fixed assets if the economy is to function properly – it should be deducted when calculating the tax burden. The only difference between depreciation and other, mainly corporate, expenditures is that it is not an immediate drain on corporate cash flow. An invoice for depreciation does not arrive each 31 December, but whenever companies replace fixed assets, they are implicitly drawing on the cash reserves represented by the annual depreciation charge.

The use of multi-year Budget changes and the replacement of Family Credit (which was recorded as benefit expenditure) by the Working Families Tax Credit (which is recorded as a negative tax) have muddied the waters in terms of comparability of the tax burden from year to year. Last year, the Adam Smith Institute decided to average out the changes over the 1997-99 period in order to create a clearer comparison with previous years. The average tax burden for those years equated to 151 days, as against 146 days in 1996. The use of so-called stealth taxes, tax changes made other than at Budget-time or pre-announced changes that have an impact in distant years, has continued in the 2000 Budget. The pre-announced abolition of Married Couples Allowance (MCA) and Mortgage Interest Relief took effect in April 2000, but the Children's Tax Credit which replaces MCA will not be introduced for another year.

After adding back the WFTC effect, the tax burden is projected to rise from 37.1% in 1999-2000 (on the Treasury's calculation of the tax burden) to 37.5% in 2000-01 and 38% in 2001-02. The stage is set for Independence Day to slip into the beginning of June, even if the UK economy performs well.

APPENDIX 2
THE ADMINISTRATIVE BURDEN OF THE NEW TAX CREDITS ON EMPLOYERS

In December 1999, the Inland Revenue issued a 20-page document entitled *An employers' guide to tax credits – Working Families' Tax Credit (WFTC) and Disabled Person's Tax Credit (DPTC)* in order to prepare employers for the introduction of the new system from April 2000.

In its introduction, the document explains:

> The tax credits are worth more than the old benefits and aim to tackle both the unemployment trap and the poverty trap, which can sometimes put people off getting a job or increasing the number of hours they work.

The following extracts from the document give some idea of the complications, extra work and expense, which its implementation involves:

> If you have a manual payroll....
>
> In order to pay tax credits to an employee you will have to use some or all of the PAYE tax, NICs and student loan deductions that you have deducted from your employees' pay. You therefore need to make sure that you have cash flow checks which will tell you in good time if you will not have enough money on hand to pay tax credits. If your tax credit payments are more than the deductions you make, you may apply to us for advance funding.

The reader is then referred to Section 6 of the document, which helpfully addresses the following questions:

> In what circumstances can I ask for Inland Revenue funding?
> How do I apply?
> How soon do I apply for funding?
> How far in advance can I apply?
> What information will I have to provide in order to get advance funding?
> How will I know that my funding application has been accepted?
> Will I receive all the funding I have applied for at once?
> What if the Inland Revenue disagrees with my calculations?
> How can I appeal?
> How much notice do I have to give if I want funding?
> What happens if I have met these conditions but the funding has just not arrived?
> What happens if I find that I am going to be short of funds on payday?
> Can I apply for funding even if I don't have a bank account?
> Can I reduce or increase my initial funding application?
> What happens if I no longer need funding?
> How will my payroll system have to change?
>
> You will have to be able to
>
> - calculate the tax credits for the period from a daily rate
> - pay the tax credit through the payroll
> - enter this amount on the employee's payslip
> - record the total tax credits paid in a tax year
> - enter the total tax credits in the year for the employee on the P14 and P60
> - enter the total tax credits for all employees in the year on the P35, together with the total amount of Inland Revenue funding for that year, and
> - complete Certificates of Payments when you stop paying tax credit earlier that the end of your period of responsibility.

These procedures apply to all employers from the smallest of small businesses to multinational corporations.