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Flat Taxes

(An Essay)

Disclaimer: *Although this document is published under the auspices of Isitfair, it does not necessarily represent Isitfair's views or policies with regard to flat taxes.*

Isitfair is an organisation campaigning for the reform of the Council Tax. As such it recognises that this will only be practicable if alternative sources of funding can be identified. Flat taxes are merely one of the many options that have been investigated as possible alternative sources of funding. This document is one of a series of documents illustrating the depth of Isitfair's thinking about these alternative sources

Since Isitfair is not a political party in the conventional sense, it believes that it would be dishonest to "smuggle in" any tax changes that are not essential to its aim of reforming Council Tax. In particular we believe that any change to the regressiveness or progressiveness of the overall taxation system is an entirely separate matter that ought to be debated separately. Since the introduction of flat taxes would impact on the progressiveness of the current tax system, flat taxes do not form part of Isitfair's proposed solution at the present time.

1. INTRODUCTION

A flat tax is simply a tax where there is one tax rate and everyone pays it. For example, if we were to have a pure flat tax on our income we would all pay, say, 20 percent on everything we earned: £2k if you earn £10k; £20k if you earn £100k and so on.

The idea of a flat tax has been around for a long time. However, it is only since 1994 that any European country has actually implemented a flat rate of income tax. This was when Estonia started to tax personal and corporate income at the same rate of 26% - with no schedule of rates and no deductions. Latvia and Lithuania, Estonia's Baltic neighbours were the first to follow Estonia's lead. Later, in 2001, Russia too moved to a flat 13% tax rate on personal, (but not corporate), incomes. Three years later, Slovakia introduced a single rate of 19% on personal incomes, corporate incomes and VAT as well. So far, eight countries have followed Estonia's lead - as shown in figure 1.

Country	Flat Rate Income Tax	
	Rate	Date Introduced
Estonia	26%	1994
Lithuania	33%	1994
Latvia	25%	1995
Russia	13%	2001
Serbia	14%	2003
Ukraine	13%	2004
Slovakia	19%	2004
Georgia	12%	2004
Romania	16%	2004

Fig.1

Whether it is due to its flat tax or to something else, Estonia's economic performance has been impressive. Growth reached double digits by 1997 and has since settled at around 6%. From a revenue raising perspective, Russia's experience is also impressive. In 1997, revenue arrears were said to be of the order of 34% of the amount due. By 1998, government revenues had fallen to just 12.4% of GDP. However, after introducing its flat rate tax, Russia collected 26% more revenue from personal income taxes! This is exactly what one might expect.

2. OPTIMUM TAX RATES - THE LAFFER CURVE

At first sight it might appear that the higher the rate of tax imposed on any asset or activity then the greater would be the amount of revenue that would be raised. Actually a moment's reflection shows that this can not be true. An income tax levied at a rate of 100% would yield virtually no revenue at all. People would not bother to earn incomes or, more likely, they would do everything in their power to keep them hidden. Likewise it is obvious that a rate of 0% would also yield no revenue. Clearly there must be a rate of tax somewhere between zero and one hundred per cent at which the amount of revenue raised would be maximised. This rather obvious statement now goes by the fancy name of the Laffer curve.

This is not mere theory. On both occasions when the last Conservative governments lowered the top rate of income tax, (first under Howe and then under Lawson), the total amount of income tax collected from those who were liable to pay tax at the highest rates increased. Other countries that have tried similar "experiments" have had similar results.

At first sight there is no obvious connection between the Laffer curve and flat taxes. The Laffer curve merely points out that there is an optimum rate of tax. However, with several rates of tax, it is obvious that, at the most, only one of them can be at the optimum rate - and it would be foolish to charge taxes at above the optimum rate from a revenue raising perspective. Doing so can only be either the result of ignorance or the desire to engage in class warfare.

However, levying tax at below the optimum rate from a revenue raising perspective is perfectly justifiable. If the government does not really "need" the extra revenue, then why raise it in the first place? It is only the top rate that should not exceed the optimum rate. However, from a social engineering point of view, it would seem to be more sensible to levy tax at a single rate, (either the optimum rate or some lower one), and use any surplus to fund non means tested **cash** benefits. This point is developed further in this paper.

Most people believe that Estonia’s flat rate of income tax is too high. In fact Estonia is planning to reduce its rate from 26% to 20% by 2007. In contrast with Russia’s lower rate of 13%, tax revenues as percentage of GDP in Estonia have hardly grown at all. In 1993, general government revenues were 39.4% of GDP whereas by 2002 they had only grown to 39.6%. In revenue raising terms this is not particularly impressive. Russia’s corporate tax rate of 35% also appears to be too high. Tax evasion is rife. The recent Yukos affair is just one high profile example. The optimum rate of tax does seem to be quite low - but nobody knows for certain where it is.

3. TAX AVOIDANCE

As the Laffer curve points out, any tax increase always has the effect of reducing the size of the tax base on which it falls - whether through disincentives to transactions or through avoidance and evasion. The lower any tax is, the less is the incentive to avoid it. With very high tax rates, quite expensive schemes of avoidance become worthwhile from the individual taxpayer’s point of view. Such schemes serve no economic purpose and often destroy wealth - even if it is only the valuable time of the tax consultant whose brains could be more usefully deployed elsewhere.

Tax avoidance is also assisted by complexity. The more that government tries to encourage or discourage certain activities through taxes or subsidies and the more that it tries to discriminate between earning income in one way, (say wages), and others, (like capital gains, dividends or whatever), the greater is the opportunity to exploit "loopholes" which make a pound of highly taxed income of one sort look like a different pound of more lowly taxed income of a different sort.

Flat taxes are the simplest possible taxes - and therefore the hardest to avoid. Flat taxes also tend to be **low** taxes - which removes much of the incentive to avoid them. This is not only because the optimum rate of tax is usually quite low, it is also that any tax tends to be unpopular with those who actually have to pay it. High rates of tax are only popular when **somebody else** is footing the bill!

The key to cutting tax avoidance is simplicity and low tax rates. If a government needs to raise a lot of revenue, it should have several taxes - such as taxes on spending as well as taxes on incomes - with each tax on its own being levied at a low rate.

4. TYPES OF FLAT TAX

Technically, a flat tax is simply a tax charged at the same rate across the whole of the taxable base on which it relies. There are many sorts of taxable bases. Possible bases include a person's income, his spending, his wealth or even his very existence. For example: a poll tax is a flat rate tax charged at the same rate to all who live in a particular area, (essentially for the right to live there); a flat rate income tax would apply the same rate of tax to every pound of income from the first to however many millions one actually receives; a flat rate sales tax would apply the same rate to all goods sold of whatever value and so on.

By definition a flat rate tax is neither regressive nor progressive. Under a regressive system, the rate of tax charged falls as the size of the taxable base increases. This does not mean that the **amount** of tax chargeable falls as well. A progressive tax is simply the reverse of this. One pays a higher rate of tax as the size of the taxable base rises. By way of illustration, the council tax is a regressive tax. Although the total **amount** payable rises as the value of a property rises, tax also falls as a **percentage** of the property's value. On the other hand the present form of income tax is progressive. Those on higher incomes pay a higher **proportion** of their incomes in tax than do those on lower incomes.

There is nothing inherently right or wrong, with progressive, regressive or even flat taxes. However, it would be difficult to argue that anything other than a flat tax would be "fair" in the sense of being **non discriminatory**.

Taxes are really the price that we pay for having certain public services. Nobody suggests that the rich should pay more than the poor for the same groceries at the supermarket. Why then do we wish to treat public services differently? Technically, there is very little difference between taxing incomes and taxing expenditure. Politically though, the differences are enormous. There would almost certainly be real opposition to raising basic rate income tax without raising higher rate income tax as well. However nobody has ever seriously proposed that "the rich" should pay a higher rate of VAT! VAT is the nearest thing that we currently have to a flat tax. Other taxes like road fuel duty, (one pays the same per litre however many litres one consumes), and television licences, (which gives one the right to watch television at a particular address regardless of how often it is watched or how many televisions there are there), are also essentially flat rate taxes.

4.1 Income tax

At the simplest level a flat rate **income tax** is an income tax raised at the same uniform rate on all slices of all income from the very first pound to the very last. There are no higher or lower rates and no allowances. All types of income, including corporate profits, rents, interest, dividends and pensions as well as earnings are taxed, and to the same extent, by a true flat rate income tax.

> *In practice, all the countries that have introduced a flat rate income tax have exempted the first tranche of an individual's income.* ***This is not necessary and is probably a bad idea, (see below).***

It should be emphasised that under a flat income tax the rich would still pay more than the poor. For example, someone on £100,000 p.a. would pay five times as much tax as someone on £20,000 p.a.

4.2 Value added tax

Again at the simplest level a flat rate **VAT** is a tax levied on (the value added element of) all purchases at a uniform rate. No items are exempt and there are no lower, zero or higher rates. Under a pure flat rate VAT children's clothing, domestic fuel, newspapers, books and so on, all of which currently enjoy special favours, would be charged the same rate of VAT as everything else.

4.3 Other taxes

Although most discussions about flat taxes are limited to VAT and income tax, there are many other taxes that could be subject to a flat rate approach. Two examples are local property taxes and inheritance tax.

4.3.1 Local property taxes / council tax

Under a flat rate council tax, banding would disappear with the tax being raised on any one of:

— A fixed percentage of the **rental value** of the house or business premises, (like the old rates);

— A fixed percentage of the **market value** of the premises, (similar to, but not identical with), the present council tax;

— A fixed percentage of the site value of the premises;

— A simple flat rate tax on each **household** which takes no account of the actual premises that the household occupies, (business rates would need to be different).

Complete abolition of the council tax would in fact be nothing more than a special case of a flat rate tax of any of the above types with the rate being set at zero.

4.3.2 Inheritance tax

Under a flat rate of inheritance tax all inheritances would bear precisely the same rate of tax.

> *As it happens we have almost got such a regime at the moment. However the situation has been complicated to deal with gifts made in the seven years before death, complex issues relating to trusts and a very high threshold before the tax applies.*

5. THE ADVANTAGES OF FLAT RATE TAXES

The principal advantages of a flat rate tax regime are:

— Administrative simplicity. Such taxes are much cheaper to collect and administer. For example, with a true flat rate income tax, it does not matter to the taxman how many pounds are going to whom. He could, in principle, simply impose a flat rate tax on a company's total payroll! In the USA, for example, this would mean taxing something like 8 million enterprises instead of taxing 130 million employees. Estimates put the cost of compliance, administration and enforcement at around 10% to 20% of the total tax collected in the USA, (a sum nearly half the American government's current budget deficit!) In Britain the 2005 Finance Act is the longest ever and the official (Tolley's) handbook has increased to over 11,000 pages. The time and cost of the effort to produce, legislate for and generally get the nation complying before next year comes round, is mind-boggling.

— They do less economic damage than other taxes - whether or not those other taxes are progressive or regressive.

— They are manifestly "fair" - i.e. they are non discriminatory

— They are harder to avoid or evade - because it is harder to exploit any "special cases".

Unless you are old fashioned class warrior, then there are really no disadvantages to a flat rate tax regime if it is properly implemented.

5.1 The case for a flat rate income tax regime

There will never be complete agreement on what the appropriate rates of income tax on different slices of income "should" be. Some people, (usually those on lower incomes), would like income tax to be more progressive than it currently is. Other people, (often those on higher incomes), would like it to be less progressive. Leaving such selfish considerations aside, probably the only income tax regime that can be **rationally** defended on the grounds of "fairness" is a flat tax regime in which every single pound of anybody's income from the first pound to how ever many millions they might actually earn, is taxed at exactly the **same** rate. Insofar as incomes from work are concerned, then if (say) the rate were to be set at 20%, this would be equivalent to everybody working one day a week for the common good and four days a week for themselves. Being non discriminatory, (as between one pound and another), this is manifestly "fair".

By using the **work** argument, we inevitably raise the question as to how pensions and investment income should be taxed. To the extent that pensions represent deferred income from work, (as virtually all occupational pensions do), they should be taxed in just the same way as earnings. Equally to the extent that any pensions, (whether occupational or private), are paid for out of schemes which have been more or less tax exempt, they too should be taxed like earnings. Virtually all pensions would be caught by one or both of these two provisions. Investment income, particularly investment income that arises from savings that have already been taxed, should not be taxed in the hands of the **recipient**. Business profits, which represent income from work, should be taxed just like earnings. The taxable profits would calculated **before** deduction of any **net** rents, interest, (or dividends), paid out. This would have two advantages over the current system for business taxation:

- The current in-built bias in favour of debt finance and against equity finance would be removed. Businesses would then be able to choose the balance that is right purely from a **business** perspective. This would inevitably be good for the economy.

- The economically illiterate bias in favour of retaining profits for reinvestment over distributing them would disappear. Most of the businesses that produce high profits, the so-called “cash cows”, (the terminology is taken from the BCG matrix for portfolio management), are to be found in mature or even declining industries. These are the very last places that any investment should take place! On the other hand the so-called “stars” are businesses with strong competitive positions in growing industries. These are cash hungry and the ideal places for investment. What could be more stupid than encouraging investment in the wrong places and discouraging it in the right ones?

Using a scheme such as the one just described the yield from **existing** income tax payers would be (slightly) **increased** by a flat rate tax of just 20%. The overall yield would of course be higher still. Virtually all those people who currently pay no income tax would be drawn into the income tax net and end up making **some** contribution. Actually of course we would almost certainly choose to impose a higher tax rate than 20% in order to fund the increased benefits, without which the impact on the poorest people in our society would become intolerable.

There are currently 30.6 million people in this country who pay income tax. If we were to have a flat rate of income tax above the 20% necessary to be revenue neutral, we could redistribute the surplus equally amongst each of these 30.6 million taxpayers in a form of negative poll tax. Figure 2 shows how people on different levels of pre tax income would be affected by just such a scheme for different rates of a flat income tax. A positive number means that the person concerned would be better off by the number of pounds shown and a negative number means that he would be that much worse off. For simplicity we have ignored people who don’t pay any income tax at the moment - effectively assuming that they would be treated in exactly the same way as they are now. Again for simplicity we have also assumed that those who only pay savers rate taxes would not have to pay any higher rate than they do now, but would nevertheless receive the negative poll tax that would make the whole scheme revenue neutral. For the purposes of these calculations we have left all other taxes unchanged

Gross Income	Flat rate of income tax % - no thresholds; no personal allowance							
	22.00%	25.00%	27.50%	30.00%	32.50%	35.00%	37.50%	40.00%
£5,000	-538	-20	412	843	1275	1706	2138	2569
£10,000	-754	-373	-55	262	580	898	1216	1533
£15,000	-754	-510	-306	-102	102	306	510	714
£20,000	-754	-646	-556	-466	-375	-285	-195	-105
£25,000	-754	-783	-806	-830	-853	-877	-900	-924
£30,000	-754	-919	-1056	-1194	-1331	-1468	-1606	-1743
£35,000	-754	-1056	-1307	-1558	-1809	-2060	-2311	-2562
£40,000	-311	-749	-1114	-1479	-1843	-2208	-2573	-2938
£45,000	508	-66	-545	-1024	-1502	-1981	-2459	-2938
£50,000	1327	616	24	-569	-1161	-1753	-2346	-2938
£100,000	9518	7442	5712	3982	2252	522	-1208	-2938
-ve poll tax	454	1108	1654	2199	2744	3289	3835	4380

Fig. 2

It is immediately apparent from figure 2 that it is the relatively poor and the relatively rich who would do best from a flat tax of the sort being discussed. This demonstrates the hypocrisy or ignorance of those on middle incomes who argue for progressive taxes in order to help the poor. The real beneficiaries of a progressive income tax system are actually those on middle incomes!

The particular form of flat rate income tax illustrated in figure 2 is a rather extreme version. Most of those countries that have actually introduced a flat rate tax have only applied it after some fairly generous tax free allowances at the bottom end. Figure 3a shows the gainers and losers relative to the current system from adopting a personal allowance of £7,500, £10,000, £12,500 and £15,000 before applying a flat rate income tax. Figure 3a also shows the flat rate tax that would be necessary to be revenue neutral with respect to the current situation.

Figure 3b shows what would happen if we were to apply the same flat tax rates calculated in figure 3a to a zero personal allowance coupled with a negative poll tax regime. The gains and losses are once again calculated with respect to the current situation.

Gross Income	Personal Allowance £				Flat rate tax - no allowances			
	7500	10000	12500	15000	28.21%	32.38%	37.26%	42.44%
5000	10	10	10	10	534	1254	2096	2990
10000	152	794	794	794	35	565	1185	1844
15000	-131	322	947	1795	-248	93	491	913
20000	-413	-151	253	865	-530	-380	-204	-17
25000	-696	-623	-441	-65	-813	-852	-898	-947
30000	-978	-1095	-1136	-995	-1095	-1324	-1592	-1877
35000	-1261	-1568	-1830	-1925	-1378	-1797	-2287	-2807
40000	-1100	-1597	-2081	-2412	-1217	-1826	-2538	-3294
45000	-564	-1250	-1957	-2523	-681	-1479	-2413	-3405
50000	-27	-904	-1832	-2634	-144	-1132	-2289	-3516
100000	5338	2564	-585	-3744	5221	2335	-1042	-4626
Flat rate	28.21%	32.38%	37.26%	42.44%	-	-	-	-
-ve poll tax	-	-	-	-	1809	2718	3782	4912

Fig. 3a **Fig. 3b**

It is immediately obvious that the poor do substantially better under the negative poll tax model. The rich are, by and large, in much the same situation under either model. It is those on middle incomes who do better under the allowances model than under the negative poll tax model.

It would seem that the main effect of **any** plausible flat rate income tax model would be to tax middle incomes more heavily and low and high incomes more lightly. There are of course good arguments for doing this - as well as good arguments for not doing so. Nevertheless it does seem to be worthwhile to investigate whether some sort of **national** flat rate income tax, used as a **supplement** to the existing income tax could possibly be "the answer" to the Council Tax problem.

It is almost impossible to work out the yield from a flat rate income tax in which everybody paid tax from the first pound of their income to the last - the Inland Revenue does not collect or publish statistics on non tax payers! Indeed, as we have already noted, we have ignored people who don't currently pay income tax when performing the calculations that produced figures 2 and 3.

Following this line of reasoning, if we were to disregard that portion of anybody's income below £5,000 p.a. and charge a supplementary income tax at a flat rate of 4.7% on all income above that level, then we would raise £25.2Bn. extra from income tax. This is very close to the £25Bn or so that we have used as being the right sort of figure needed to abolish the Council Tax altogether.

Figure 4 shows the gains, (positive numbers), and losses, (negative numbers), for a household with one earner but at least two adult occupants that would result from a change of this sort. We have based our calculations on the average Council Tax of £1,214 for a band D property.

Gross Houshold Income	Council Tax Band							
	A	B	C	D	E	F	G	H
5000	809	944	1079	1214	1484	1754	2023	2428
10000	574	709	844	979	1249	1519	1788	2193
15000	339	474	609	744	1014	1284	1553	1958
20000	104	239	374	509	779	1049	1318	1723
25000	-131	4	139	274	544	814	1083	1488
30000	-366	-231	-96	39	309	579	848	1253
35000	-601	-466	-331	-196	74	344	613	1018
40000	-836	-701	-566	-431	-161	109	378	783
45000	-1071	-936	-801	-666	-396	-126	143	548
50000	-1306	-1171	-1036	-901	-631	-361	-92	313
100000	-3656	-3521	-3386	-3251	-2981	-2711	-2442	-2037

Fig. 4

As can be seen, such a spurious "flat rate" tax would be more progressive in its overall effect than the Council Tax that it was designed to replace. Since we are seeking tax changes whose overall effect is, as near as possible, neutral from a progressivenes or regressiveness point of view, this particular idea does not form part of Isitfair policy.

It is not widely appreciated just how "unfair" our current progressive / redistributive income tax system can actually be in practice. We all know that things like a pint of beer, a haircut or housing are considerably more expensive in some places than they are others. A person in an expensive place living on a given income is considerably worse off in real terms than a similar person on the same nominal income living in a less expensive place. Both however currently pay the same amount in income tax. It is easy to see that people in expensive places can, (and do), easily end up subsidising people elsewhere who in real terms are better off than they are themselves. One doubts whether many of the advocates of income redistribution or progressive taxes would regard this as "fair".

Our current system of income tax is also "unfair" in its taxation of interest received. In an inflationary climate, part of any interest is merely a compensation for the loss of capital value. It seems unfair, as well as economically ridiculous, to tax this portion of interest at all. It only makes sense to tax any remaining portion of interest on a real added value basis.

At one time it was widely recognised that interest was really a transfer payment. It only makes sense to tax., at most, **one** side of the transaction - certainly not both. In more sensible times, interest used to be taxed in the hands of the recipient but the payer was given income tax relief. This is the origin of tax relief on mortgages. All such loans used to be treated as tax deductible whether they were for house purchase or any other purpose. Eventually tax relief on mortgages were retained but the relief on loans for other purposes was removed. It was then argued that special treatment for mortgages was "unfair" - which it was. However it was the unfair treatment of **other** loans that made it so! Our proposal to tax interest paid rather than received in effect merely removes the economic nonsense of the present system.

A flat rate income tax would be much simpler than the current complex system. As a result it would be cheaper to administer, there would be fewer mistakes in its administration, and it would be much harder to avoid.

5.2 The case for a flat rate VAT regime

Just about everybody spends money so that just about everybody also pays VAT. The virtues of VAT are very similar to those associated with the old community charge. Everybody who has the right to vote has to bear some of the consequences of their views on public expenditure.

At present, because of the plethora of exemptions, reduced rates and so on, VAT is fiendishly complicated and expensive to administer, (for businesses as well as for government). Such complexity facilitates avoidance. VAT is also widely evaded, (the cash in hand black economy). VAT is only levied on **part** of consumer expenditure. If we were to charge a uniform rate of VAT on **all** consumer expenditure then, at the current rate of 17.5%, we would have raised approximately an extra £35.5Bn in the financial year 2003/04. This would allow us either to cut the standard rate of VAT or else to cut other taxes. Today there are many things that are zero rated, exempt or subject to rates lower than the standard rate. Such special treatment is hard to justify

- It is difficult to understand why, (other than for reasons of administrative convenience), there is a lower limit on turnover at which businesses, or the self employed, have to register for VAT. This gives an **economically** unjustifiable advantage to the little man. The social advantage is not clear either. It certainly costs substantial revenue!

- It is somewhat difficult to defend the exemption of children's clothing from VAT - at least on the grounds of "fairness". Children of the same age vary enormously in size - and what is or is not classified as children's clothing for VAT purposes is determined by size. At present many people start paying VAT on their children's clothing much earlier than others. We are aware of some small adults who still pay no VAT - at least on their underwear!

    — Any increase in VAT on children's clothing could be offset by an increase in child benefit. The overall effect on revenues is likely to be small but still positive. Much depends upon how much child benefit is paid for each age range of child and how many people currently pay VAT on their clothes at too young or too old an age.

- At one time it was proposed to charge the full rate of VAT on domestic fuel / heating. There is little doubt that this would do more to reduce carbon dioxide emissions than taxing road fuel. The amount of carbon dioxide produced is greater and domestic heating is more price sensitive. There is also no doubt that such a move, on its own, would hit pensioners very hard. However, it is a sad fact of life that if you want to reduce the consumption of something by taxing it then you have to hit those consumers whose budgets are stretched most! The millionaire will simply carry on as before

    — Any increase in VAT on domestic fuel / heating would probably have to be offset by an increase in the basic state pension and / or the winter fuel allowance, (which is really only part of the pension in disguise). This would not negate the effects of the VAT increase on either revenue or the environment - although it would of course reduce them. In the first place only pensioners would benefit. Others would have to pay their full whack. In the second place pensioners would probably choose to spend some of their extra money on things that do not add carbon dioxide to the atmosphere - such as better home insulation, more holidays in the sun or even woolly jumpers!

5.3 Corporation Tax

Corporation tax is little more than an income tax paid by businesses but subject to different rates and reliefs from those that apply to individuals. We can see little justification for this on any of the grounds of revenue yield, economic performance or "fairness". So far as we can see there is no real fiscal or social justification for the small company allowances. It seems a little odd that one can obtain advantages from a taxation point of view according to whether one is an employee, self employed, a sole trader or a limited company. This is an open invitation to tax avoidance and does not produce the sort of level playing field for competitive markets that most economic theories would prescribe. If corporations and individuals are to be treated in a similar way, then it would seem that only a flat tax of the type described in sub section 5.1 would be appropriate.

6. THE CASE AGAINST FLAT RATE TAXES

The case for all taxes being flat is by no means overwhelming. All taxes need to be tested against the criteria of "fairness", affordability, their efficiency at raising revenue, and their economic effects. In particular, flat taxes do not **always** yield the most revenue. This is particularly true in the case of taxes on consumption.

6.1 The case against flat rate consumption taxes

VAT is by no means the only tax on consumer expenditure. We also have excise duties on alcohol, road fuel, tobacco and so on. Unlike VAT these taxes are based on volume not on value. Some of these taxes have now become self defeating. It has been estimated that somewhere between one quarter and one third of all the cigarettes smoked in Britain are smuggled. With lower excise duties, (say equal to those in France), there would be much less smuggling and probably more revenue collected. Similar remarks apply to taxes on alcohol. What could be more economically ridiculous than the "booze cruise"?

However, all that this shows is that the taxes on tobacco and alcohol are probably above their optimum rates. It does not demonstrate that those optimum rates are the same as they would be for other goods from a revenue raising perspective. In days gone by, before the "links" with cancer, global warming or whatever were "established", finance ministers knew that high taxes on petrol, alcohol and tobacco had very little effect on consumption - thereby making them an excellent source of revenue. This still seems to be the case today. It is just that they have overdone it.

In fact the price elasticity of demand for different goods varies considerably. A rational, albeit highly complex, consumption tax designed to raise the maximum revenue would take this into account. Goods with a low price elasticity of demand, (like tobacco, alcohol and road fuel), would be taxed more highly than would goods with a high price elasticity of demand.

If we were to subsume all customs and excise duties into VAT raising the same amount as all of the customs and excise taxes, (including VAT), do through a single flat rate of VAT applied to **all** purchases, then a VAT rate of 19.7% would be sufficient - and would then be the only tax raised on consumers.

Many people might find this approach unattractive believing that we ought to tax “bads” like road fuel, tobacco and alcohol in order to discourage their consumption. The trouble is that taxation is almost totally ineffective in this respect. We still buy; we just buy in lower tax regimes.

On the other hand, a single uniform rate of consumer tax seems to be “fairer” than demanding that smokers, drinkers, motorists or whatever should finance the rest of us.

Classical economic theory would suggest that **all** taxes designed to encourage or discourage particualr activities are bad for the economy. Actually, where goods have a low price elasticity of demand, the harmful effects tend to be small - but only because the subsidies or taxes are largely ineffective!

6.2 The case against flat rate local property taxes

In the technical sense, Council Tax in its present form is a regressive tax. Some proposals for the reform of the Council Tax involve turning it into a flat tax where the amount payable would be proportional to the average valuation of a house within each band. The effect of any such change would vary widely from region to region. Those living in high value properties are penalised the most where they are rarest whereas those living in lower value properties gain the least when they are the most common. Figure 5 illustrates these points and shows the percentage by which council tax bills would have to change if it were to be made a flat tax in order to raise the same revenue locally as at present.

A glance at figure 5 immediately shows us that introducing a flat rate property tax of this type, where the amount payable is proportional to the average valuation of a house within each band, will tend to make those who are house asset rich but income poor suffer **even more** than they do under the present system. These are just the sort of people that Isitfair are aiming to help.

	Band A	Band B	Band C	Band D	Band E	Band F	Band G	Band H
NE	-11.0%	-11.7%	0.8%	16.4%	26.6%	44.2%	115.1%	138.6%
NW	-15.6%	-16.3%	-4.4%	10.3%	20.1%	36.7%	103.9%	126.2%
Y&H	-14.5%	-15.2%	-3.1%	11.8%	21.7%	38.6%	106.7%	129.3%
E Mid	-15.5%	-16.2%	-4.4%	10.4%	20.2%	36.8%	104.1%	126.4%
W Mid	-17.4%	-18.1%	-6.5%	7.9%	17.5%	33.8%	99.5%	121.3%
E of E	-23.7%	-24.3%	-13.6%	-0.2%	8.6%	23.6%	84.4%	104.5%
Lond	-30.4%	-31.0%	-21.2%	-9.0%	-1.0%	12.8%	68.2%	86.5%
SE	-29.0%	-29.6%	-19.6%	-7.1%	1.0%	15.1%	71.6%	90.3%
SW	-21.9%	-22.5%	-11.5%	2.1%	11.1%	26.6%	88.7%	109.3%

Fig 5.

This raises the question of whether it might be better to have a different sort of flat tax where all houses were charged the same amount of local tax, regardless of their value. This would certainly solve the problem of our asset rich but cash poor individuals. Figure 6. shows what would happen in the different English regions if we were to adopt this strategy on a revenue neutral basis. A positive number means that people would be worse off.

	Council Tax Band							
	A	B	C	D	E	F	G	H
NE	17.1%	0.4%	-12.2%	-21.9%	-36.1%	-46.0%	-53.2%	-61.0%
NW	24.9%	7.0%	-6.3%	-16.8%	-31.9%	-42.4%	-50.1%	-58.4%
Y&H	23.4%	5.7%	-7.5%	-17.8%	-32.7%	-43.1%	-50.7%	-58.9%
E Mid	26.2%	8.1%	-5.4%	-15.9%	-31.2%	-41.8%	-49.5%	-57.9%
W Mid	29.6%	11.1%	-2.8%	-13.6%	-29.3%	-40.2%	-48.2%	-56.8%
E of E	43.2%	22.8%	7.4%	-4.5%	-21.9%	-33.9%	-42.7%	-52.3%
Lond	58.3%	35.7%	18.7%	5.5%	-13.6%	-26.9%	-36.7%	-47.2%
SE	53.7%	31.7%	15.3%	2.4%	-16.2%	-29.1%	-38.5%	-48.8%
SW	40.1%	20.1%	5.1%	-6.6%	-23.6%	-35.3%	-44.0%	-53.3%
Eng	37.9%	18.2%	3.5%	-8.0%	-24.8%	-36.3%	-44.8%	-54.0%

Fig 6.

Again we see the same disparity between the regions that we saw in the case where we adopted a strategy at the opposite extreme. This option looks particularly unattractive when we realise that all that we would be doing is shifting the burden from those in more expensive houses, (usually the richer segment of our society), onto those living in cheaper housing, usually the poorer segment). We need to bear in mind that it is a relatively small **minority** that we are trying to help. We certainly don't want to place hardship on a **greater** number of people!

6.3 "Fairness" and "Social Justice"

Most of the opposition to flat taxes arises from considerations of "social justice" and "fairness" - although these terms are usually left undefined. Many people appear to believe that taxes whereby they end up paying more are less "fair" than those which end up with their paying less. However they can only all be right if taxes are virtually zero. It is mainly because taxes are burgeoning that people are so concerned about finding other backs on which to place the burden.

Of course all taxes which involve an element of subsidy are inherently "unfair", (whether it be the "rich" subsidising the "poor" or *vice versa*). Is it not unfair that the Irish now enjoy one of the highest standards of living in Europe as a result of subventions from Brussels which are largely paid for by German and British taxpayers? Is it not unfair that the Scots are able to treat their students and their old people in care better than the English because central government spends more, (and collects less), per head in Scotland than in England, (the Scots' privileges being paid for from English taxes under the Barnett Formula)? Even if one thinks that the rich owe some sort of duty to the poor, why should this duty be restricted to national boundaries? Why is it a moral duty for us to help the poor of Birmingham and Manchester but not the much more needy poor of Bombay and Madras?

To us "fairness" is a question of **symmetry** - "what is sauce for the goose is sauce for the gander". As we have already argued, a flat rate income tax is manifestly "fair" from this perspective. Everybody spends the same proportion of their working **time** working for the common good. A poll tax is also manifestly "fair". Everybody is taxed the same **amount**. Flat rate property taxes are also "fair". The problem is that unless the rates of poll or property taxes are very low, some people will quite literally find them unaffordable. This does not mean that they are bad taxes. It simply means that if we are to have them at all, then their rates need to be relatively low.

In fact one of the strongest cases for a flat tax is that everybody contributes **something**, however little to the common "pot". This will tend to make them vote responsibly. Nothing is more conducive to irresponsibility than the right to vote for taxes that are only paid by somebody else! If "one man, one vote" is OK, what is wrong with "one man, one tax unit"? Perhaps we should even consider "one vote, one tax unit"!

It is a sad reflection on our society that people don't vote to pay taxes. They vote for other people to pay taxes. If we want more of our own money to be spent on (say) the NHS, then all that we have to do is to write out the appropriate cheque. We only need to resort to the morally dubious expedient of coercion through the ballot box if we want to force others to pay more for our own pet projects.

Taxes that are paid by the many, like the poll tax or petrol fuel duty, tend to be very unpopular whereas taxes that are paid by the few, like higher rate income tax, tend to be much more popular with the selfish majority. For some reason Inheritance Tax now appears to be unpopular. One suspects that this is indeed purely selfishness. It was OK, and even popular, when only a small number of other people's estates were hit. Now that house prices have risen to the point where the many are faced with the prospect of paying the tax for the first time it suddenly becomes "unfair". Similarly as more and more "ordinary" people like policemen and schoolteachers are having to pay higher rate tax through the effects of so-called "fiscal drag", opposition to it is growing.

Many people believe that the "rich should pay more". In fact, under most flat taxes they do. Whilst it is easy to see why the poor should **sometimes** pay less, (on grounds of affordability), it is not obvious why the rich should **always** pay more. Is there no limit to how much they should contribute? Any practical implementation of the rather meaningless slogan that "the rich should pay more" needs to answer questions like: more than what; more than whom; how much more, and, most importantly, **why**. If there is such a thing as a "right" level, then, if we happen to be above it, shifting the burden from the rich to the poor would actually be the right thing to do! Of course if we are below the "right" level we would do the opposite.

One wonders how many of our inveterate class warriors have ever asked themselves what would happen if all those people with highly paid jobs in the City of London were to decide to take six months unpaid leave. They could easily afford it. But could the rest of us cope? Remembering that these people are responsible for a very significant proportion of our total foreign exchange earnings, (approximately $19Bn net), and also that this country can not grow enough food to feed itself, might not the rest of us starve? The exchequer would also be faced with a difficult problem. More than 20% of the yield from income tax comes from the top 1% of earners. Would the treasury go bankrupt and would public services have to be cut drastically? Perhaps we should cherish those private sector people who earn high incomes. We certainly shouldn't denigrate them.

All this leads to a predisposition in favour of "progressive" taxes and against "regressive" ones. Actually there is nothing inherently wrong with a regressive tax - let alone a flat tax.. For example somebody with a taxable income of £100,000 p.a. paying a 20% tax rate would contribute £20,000 p.a. to the exchequer whereas somebody on a taxable income of £20,000 p.a. paying a 30% tax rate would contribute "only" (!) £6,000 p.a. - yet the richer person would still contribute nearly two and a half times as much as the poorer one! There does not seem to be anything inherently "unfair" in this - unless perhaps it is unfair to the richer person. It all depends upon what the taxes are used for and the relative sizes of the benefits that each party receives.

There is no real moral case for any form of so-called "progressive" taxation at a national level. Those who argue in its favour are usually, but not always, driven to do so by the unattractive motives of avarice, envy or selfishness. Yet they tend to try to pin the last epithet on those who created the wealth in the first place! After all, what right have I to a share of my neighbour's wealth? If I have done something that has materially contributed to my neighbour being wealthy, then I might indeed have a claim. Likewise, if my neighbour has done something that has tended to make me materially poorer than I would otherwise have been, then I may again have some sort of claim. If both of these conditions are fulfilled, then any claim will be that much stronger. However, if, as is usually the case, neither of these conditions apply, then the claim is wholly without moral foundation. My neighbour's well-being and my own ill-being are unconnected.

Progressive taxes tend to exacerbate the tendency towards wastefulness, inefficiency and over- spending endemic in all parts of government and the public sector . If I only pay 50% of the cost of a service that actually costs 50% more than it "should" do, then I get a very good deal. I only contribute 75% of the value that I actually receive. Of course somebody else has to make up the difference. In such a situation, if I were selfish and hypocritical, I would vote for more public spending and higher taxes! The danger comes when he who calls the tune pays too little of the piper's wages.

7. CONCLUDING REMARKS

In general properly implemented flat taxes yield more revenue, produce more dynamic economies and are often "fairer" than conventional progressive taxes. They also usually lead to lower rates of tax and more efficient public spending. High tax pushes people into the "non-observed" economy. It just isn't worth slaving one's guts out to suffer 41% extra on hard earned pay and then another 17.5% or more when you spend what's left. The higher go the tax rates, the higher goes the burden on those unable to escape. IMF statistics indicate that one third of the Italian workforce operates "off the books". In Greece it's far higher. However they are not a universal panacea.

As we have shown, a flat rate income tax coupled with a negative poll tax treats the poor, (and the rich), far better than does a conventional progressive tax system. Obviously somebody pays for this - and that is those on middle incomes. Since these people also have the most votes, it is hardly surprising that flat rate taxes have been vilified for so long as being "unfair".

We believe that combining appropriate flat rate taxes with what is essentially a flat rate benefit system in which everyone would receive a sort of "citizen's income", payable to all citizens from birth until death at a rate dependent only on their age would yield substantial advantages. Poverty traps would be a thing of the past; separate child benefit, old age pensions, unemployment benefit, income supplement, personal allowance, married person's allowance and so on could all be eliminated and subsumed within the "citizen's income"; the number of officials, and the corresponding costs, necessary to administer and police the tax and benefits systems would be much reduced; all work, however marginal or lowly paid, would be profitable to undertake - enabling those able in mind or body to contribute to society instead of being thrown on the scrap heap. Unemployment would virtually disappear, (providing of course that job destroying minimum wage legislation were repealed at the same time).

However the biggest benefit of such a system is that it is politically neutral: extreme egalitarians could have very high rates of income tax coupled with high rates of Citizen's Income, whilst extreme incentivists could have low rates of income tax and low rates of Citizen's Income.