

# VALUES ADDED

| Rethinking tax for the 21st century

**Edited by Daisy-Rose Srblin**

*With Fran Bennett, Alan Finlayson, Andrew Gambier, Suzanne Hall, Michael Izza, Martin O'Neill and Laura Wilkes*

**FABIAN  
SOCIETY**

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Head of editorial: Ed Wallis  
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First published February 2015

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## Acknowledgements

The editor would like to thank Fran Bennett, Alan Finlayson, Andrew Gambier, Suzanne Hall, Michael Izza, Martin O'Neill and Laura Wilkes for their contributions to this collection.

Thanks also go to all Fabian Society staff for their support and motivation, offered in different ways, including Ciara Dunne, Andrew Harrop, Phil Mutero, Marcus Roberts, Felicity Slater, Richard Speight, Cameron Tait, Rob Tinker, and Giles Wright. Particular thanks to Anya Pearson and Ed Wallis for their guidance and advice.

Lastly, I would like to extend special thanks to the Barry Amiel & Norman Melburn Trust for generously funding a year-long research fellowship at the Fabian Society, allowing me to work on the 'Future of Tax' project, of which this collection is just the beginning.

# 1 INTRODUCTION

Daisy-Rose Srblin

As we approach the general election in May, tax is on the agenda for both the Conservatives and Labour. Yet, inevitably, the narrow nature of our campaign conversation crowds out the bigger questions about why tax matters and whether our system is fit for purpose. Instead of simplistic discussions of whether tax should go ‘up’ or ‘down’, we urgently need a fundamental reassessment of *how* we tax, and to what end. With the Institute for Fiscal Studies - hardly a leftist organisation - seeing tax increases as almost unavoidable in the next parliament, the unwillingness of politicians to engage with the tax debate is concerning and stores up problems for the future.

Tax is still perceived as a political taboo, but it remains a cornerstone in the relationship between the citizen and the state in a representative democracy. Our perception of fairness about what we ‘pay in’ shapes our attitudes to society, with wide-ranging repercussions on, for example, our willingness to engage with the democratic process or to trust our elected representatives.

Despite the longstanding political belief that talking about tax is a toxic vote loser, current polling suggests overwhelming support for richer people paying their fair share, whether through the introduction of a ‘mansion tax’ or tackling tax avoidance. The unprecedented success of Thomas Piketty’s analysis in *Capital in the Twenty-First Century* is a symbol of increasing public appetite for more progressive wealth taxation and state intervention globally: in short, there are renewed foundations for a real debate on radical tax reform.

Some 15 years ago, the Fabian Society’s Commission on Tax and Citizenship, chaired by Lord Plant, argued that taxpayers need to feel better ‘connected’ to their taxes and to the public services which they finance. Revisiting this core concept, this collection explores the values and principles of taxation with the aim of encouraging renewed debate in a crucial political year. It forms part of the Fabian Society’s new ‘Future of Tax’ project launched with a selection of articles in the Winter 2014 edition of the Fabian Review.

In this collection, Alan Finlayson suggests that political arguments in favour of tax rises cannot be made in isolation, but must be located in arguments about something else (such as the need for increased NHS spending) with tax increases becoming the unavoidable conclusion to the political argument. Taking the study of public attitudes data one step further, Finlayson explores how discussions around tax reform can be made to resonate with public ‘common sense’ logic, by politicians with good popular intuition.

Fran Bennett revisits the Fabian’s Tax Commission (of which she was a member) and its 2000 report *Paying for Progress*. That report led to discussions around ‘hypothecation’ and was a precursor to Gordon Brown’s increase of national insurance contributions to pay for new NHS funding. The essay identifies how a political climate which made tax seem fundamentally ille-

gitimate in the 1990s and early 2000s is still widespread today. As Bennett argues, public misunderstanding around taxation and mistrust of mainstream political parties have fuelled an ever-growing disconnection between voters, the tax they pay, and the society this revenue contributes to.

So if tax matters in principle, how should this inform how it works in practice? While Bennett argues that tackling the deficit provides the rationale for tax reform, Martin O'Neill suggests that the prime argument for both reforming and increasing tax revenue should be reinvigorated public services and the fight against inequality. While celebrating transitional steps such as the 'mansion tax', he argues for a more fundamental shifting of tax burdens from income to wealth, and suggests that 'predistribution', now a very fashionable aim amongst the Labour front bench, achieves little without the counterpart of redistribution.

But reform doesn't happen in a vacuum; what the public thinks about tax and how our politicians talk about it are crucial parts of the landscape. Exploring the nuances of polling data, Ipsos MORI's Suzanne Hall shows that public attitudes towards tax and the economy are contradictory. While people are generally optimistic about the prospects of the national economy, they seem overwhelmingly pessimistic about their own personal financial prospects in the near future. And, frustratingly for advocates of tax reform, Hall identifies that such pessimism does not naturally translate into support for a more progressive tax system, particularly because of a fundamental misunderstanding of just how unequal society is. These attitudes are also generationally nuanced, with a strong, prevailing sense of 'individualism' seemingly weakening younger generations' sense of interdependence and responsibility to one another.

The collection concludes with two broad case studies examining different aspects of the complex tax system and exploring the overarching questions reformers need to address. Laura Wilkes identifies a fraught dimension of tax reform, asking what implications localism and devolution have for our tax system. While the virtues of localism are regularly trumpeted, within England no political party is committed to the sort of fiscal autonomy that would be needed for truly powerful and revived local democracy. Wilkes's discussion of council tax and business rates demonstrates that, as she puts it, 'tax reform is tough'. However, local taxation, bridging the gap between the citizen and the state, could help invigorate not only local council finances, but local democracy itself.

Finally, Michael Izza and Andrew Gambier from the Institute of Chartered Accountants in England and Wales (ICAEW) explore the complexity behind 'tax avoidance', a subject generating considerable public anger. They argue that governments themselves are responsible for creating 'tax avoidance' mechanisms, which are, in fact, intended to incentivise socially responsible corporate behaviour. Izza and Gambier explore the operational difficulties of tax for business, particularly in the context of multinational business, as well as the principles of a sound system of business taxation. Izza and Gambier argue that what might look like tax avoidance is often the legal and legitimate use of mechanisms governments have chosen to introduce, which opens up the question of who is ultimately responsible for fair and robust business taxation.

The essays in this collection present different views on the future of tax, but the common thread is simple: we need to start debating tax and tax reform again. Furthermore, proposals for reform need to have popular appeal and

resonance without seeming piecemeal or hinging on a single issue. To keep the public in the conversation, politicians need to ask the big questions about tax and public spending, without becoming overly technical and inaccessible in the process.

With a general election campaign already underway, it will fall to the next government to grapple seriously with the question of tax reform. The Fabian Society will explore specific options for reform early in the new parliament and publish public attitudes research on the contradictions and nuances of opinion on today's tax system and future proposals for reform.

But, in the meantime, we must all work to detoxify debate on tax reform, both in terms of political messaging and technical reform. This includes changing how tax is conceptualised, and asking how tax responsibilities upon different income groups can be made more progressive – for example, moving tax burdens away from some areas (say income) towards others (say wealth). Existing discussions about tax are predicated on confusion, misinformation, and complexity: in this collection and the future publications in our programme, we hope to re-establish the case for tax reform and start a debate in which the public can realistically take part.

# 2 WHAT WE ARGUE ABOUT WHEN WE ARGUE ABOUT TAX

Alan Finlayson

It's not easy to argue in favour of tax. The word has so many negative connotations: something difficult or complicated, an aggravation, the evil Sherriff of Nottingham. Getting beyond this is difficult since the workings of the taxation system are arcane and the economic debates about it esoteric; Gini coefficients and Laffer curves are not part of the everyday vocabulary of most of us. Sent out to defend taxation one might justly feel thrust into a no-man's land from which the chances of returning unscathed are vanishingly small.

In such circumstances, there seems only one viable course of action: don't argue in favour of taxation. I am not suggesting that we surrender and become opponents of taxation, 'intensely relaxed' about wealth inequality. But there is no point expending valuable energy on fighting a losing battle when there is a war to be won on other fronts. Claims in favour of tax rises need be part of arguments about something else, as opposed to being made in isolation. They need to cease being propositions in need of defence and become conclusions clear to any reasonable person. Fortunately, this can be done because it is exactly how political arguments work.

## The ambiguities of argument

A peculiar feature of political arguments is that they very rarely concern what they appear to be about. From a distance, an argument may look as if it is about how best to teach primary school children to read. On inspection it turns out to be a claim about the extent to which hippies, liberals and trendy lefties have weakened the morale of the British people. An argument about a new bypass is, from one angle, a specific and highly technocratic debate about logistics; from another, it concerns the legitimacy of rival claims from local and national government.

This frequent 'displacement' of political argument is frustrating for experts. We spend years, perhaps decades, becoming fully versed in an issue and all its dimensions, steeped in the facts and sophisticated in our analysis, only to see complexity stripped of all nuance and our work subsumed within somebody else's ideological obsession.

One's instinct as a professional is to take this as evidence of the superficiality of our politics. It seems even an indictment of democracy itself: rule by the inexpert, swayed by sensationalist media and courted by politicians able to think only of the electoral cycle. Perhaps the rough and tumble of exchange in the 'marketplace of ideas' is inevitably bound to debase the quality of argument. Maybe it would all be better if policy were made only on the basis of randomized control trials and Cochrane reviews?

In academic seminars policy matters can be dissected and debated in detail and with rigour. That is because such discussions take place against the back-

ground of a shared understanding of what counts as good evidence, of what proper argument is and of what a correct outcome would look like. But the same cannot be said for politics. Technocratic debate can tell you the best means to a particular end. It cannot tell you what the best end is.

We have democratic politics because we accept that people have different conceptions of the goals of individual and collective life and that deciding upon action requires an agreement to be forged between them. Creating a political consensus is hard because people don't have a shared understanding of what it is they are trying to achieve. We have to learn to make arguments suited to people as they really are - not generic embodiments of behaviouralist theories or averages in public opinion polls, but people of flesh and blood, rooted in particular communities and shaped by unique experiences.

For this reason, the most important resources of political argument are found not in textbooks but rather within 'common sense', people's 'everyday' opinions and assumptions. This is what the classical rhetoricians called 'doxa'.

This rhetoric has often been rejected on the grounds that it tells people only what they already know and want to hear. However, the rhetoricians never thought that 'common sense' comprised a single approach spread evenly between all people. It is, as Antonio Gramsci put it, "ambiguous, contradictory and multiform". People simultaneously hold lots of different, often contradictory opinions which do not always fit together into a seamless whole. A good rhetorician finds ways to put some parts together in order to defend ideas or to help people think something new.

For example, people in the UK, 'for the most part' and 'on the whole' probably agree with the following sorts of claims:

1. 'It is unfair or unjust for some people to get lots of money while contributing nothing to the rest of society';
2. 'Skill and dedication are admirable qualities and should be rewarded';
3. 'It is good to help people down on their luck and suffering'.

These are, broadly speaking, moral feelings found within our parables, stories and popular culture and pervasive in newspaper columns, radio phone-ins and casual conversations. They are also very general claims and do not really tell us much about any particular issue when asserted in isolation. To what do they apply, and when? If we believe Premiership footballers earning six figures a week are receiving a reward for their skill, why might we think bankers on similar salaries are getting something for nothing? Are people on benefits victims of unfortunate circumstance or are they actually improperly receiving money while others do all the work? How do we define 'lots of money' referred to above? What counts as 'suffering'?

The precise way in which we apply such 'common sense' to a particular case is almost always ambiguous and open to contestation. Political rhetoric is therefore concerned with shaping arguments that connect some general, recognisable common sense views to particular issues in a way that enables people to draw conclusions about what to do.

## 'Which pub shall we go to?' and other political arguments

Imagine that your workplace is organising an evening get-together and

that you and your colleagues have to decide between a couple of different pubs. Suppose that everyone knows that Pub A is a good pub with a range of drinks and decent food. When people vote on which pub is nicest Pub A will beat Pub B hands down. But unlike Pub B, Pub A (as everyone knows) is some distance in the opposite direction from where you and most of your colleagues live. If people are thinking about which venue is the most convenient then Pub B will be the easy winner. Pub B cannot win so long as the argument is about the best pub. But Pub A can't win an argument about accessibility.

In this example, there isn't any argument over which is the nicest pub and which the most accessible. Nobody disputes this. Instead the question concerns which of the two perfectly sensible evaluative criteria is most important. Choosing the best pub is certainly common sense, but so is choosing the most convenient for everyone to get to. The question is, against which part of 'common sense' should the decision be assessed?

A crucial feature of this argument is that propositions are being developed into conclusions. Advocates of Pub B will always lose so long as they propose that everyone should go there. But if they instead propose that the venue should be one that is conveniently located, as Pub B is, then going to Pub B becomes not just their claim but a conclusion which everyone must logically make.

The lesson in the current context is this: there is a world of difference between saying 'we want to raise taxes', justifying this by saying that it will help fund the health service, or saying 'funding for the health service needs to be increased', allowing people to conclude that, therefore, some tax increases will be needed.

## Definition

In such an argument everything turns on how one defines an issue. The classical tradition of rhetoric understood this in terms of two broad categories of argument. The first includes definitions relating to 'genus and species', the larger category of which our subject is an example, the class of things to which it belongs. The second is based on 'division', breaking up the subject at hand into different components, and perhaps emphasising some over others.

For example, when David Cameron says that tax is a moral issue he is defining it very precisely as a species of 'moral issue'. This allows him to make an argument about the moral behaviour of the state, which, because it doesn't produce anything itself, is always using other people's money. Now, it is common sense that when using other people's money on their behalf you should do so carefully and sparingly, not thinking of yourself. A high-tax state, we might then conclude, is selfish. A low-tax state is generous. This is why Cameron is able to connect this definition to a metaphorical 'naming' of Labour as "ideologically addicted to spending and borrowing and taxing" (my emphasis). It is out of control, fixated on its own needs and incapable of exercising moral judgement.

'Division' is what happens when, instead of making the general proposition that the welfare state is immoral, someone picks on a particular benefit (or a seemingly shocking example of benefit 'entitlement') and emphasises it in order to connect with a 'common sense' idea, such as that 'some people getting something for nothing is unfair'. The 'unfairness' of the welfare state is thus a 'common sense' conclusion.

In the face of these arguments one could try to refute them: to assert that taxation is a moral good or that examples of seemingly excessive benefits are outliers which give a misleading impression of the whole. But these are defensive arguments; they leave you fighting on uncomfortable terrain your opponent chose and entangled in all sorts of supplementary argument. It would be much better to fight on a different front, to shift the criteria of evaluation and make taxation a 'common sense' conclusion drawn from other propositions.

That means that tax policy must always be presented as more than a single issue in isolation: it must be an outcome of a broader programme. The left often struggles to clarify why higher taxation is desirable and it sometimes gives the impression that it thinks tax is, in and of itself, a 'good thing'.

Instead, we have to ask, what is tax for and to what question is it the answer? Is it primarily a means to reduce the deficit? If so then it must be located as part of an argument about how to achieve the same fiscal policy goals as George Osborne more quickly. Alternatively, is it about affecting behaviours, making investors think in the long term or reducing carbon emissions? Is it about reducing inequality? Is it about generating money for investment? The argument of the ultimate purpose of taxation, the proposition to which it is a conclusion, can only be won with clarity.

## Conclusion

Because political arguments draw on 'common sense' they are always, at some level, debates about which of the conflicting general principles, values and assumptions held across a community matter most in a given situation. And that means that true public political debate isn't simply a technocratic discussion but rather a way of reflecting on deep questions about who and what we think we are as a people. That means that politicians must have good popular intuition: indeed, one important reason for current discontent with politicians can be found in the gulf between popular 'common sense' and the 'common sense' of those who work in Westminster.

Discussions about tax are part of a larger argument about who we are, who we want to be and who is best placed to get us there; about the character of our culture and of our society; about fundamental relationships between people themselves and between individuals and the state. And it is within this field that we can find fundamental propositions to be made, from which 'common sense' can conclude that tax is the unequivocal answer.

# 3 STILL PAYING FOR PROGRESS?

Fran Bennett

W should be talking about taxes', wrote Paul Johnson of the Institute for Fiscal Studies recently.<sup>1</sup> It is now nearly 15 years since the Commission on Taxation and Citizenship, of which I was a member, produced its report *Paying for Progress*.<sup>2</sup> What relevance, if any, do the principles it set out, and the values and thinking underlying it, have today?

The Commission was an independent body, chaired by political philosopher Raymond Plant. It was set up by the Fabian Society because of a pervasive view in the late 1990s that tax had become a taboo subject in British politics. Whilst tax had never been popular, it had increasingly become seen as illegitimate. But it was also clear that taxation was essential to a modern society. A population with rising living standards expected high quality public services; the degree of inequality in the UK demanded an effective mechanism to address it; environmental damage needed to be tackled. A situation which saw tax as illegitimate was therefore a dangerous one given society's pressures and priorities.

Indeed, public opinion surveys continued to demonstrate a willingness, in principle, to pay more in tax, especially for core services such as education and health. Yet politicians seemed convinced in the late 1990s that increasing taxes would inevitably cost them votes, and thus avoided the subject. The Commission on Taxation and Citizenship was therefore set up to initiate a more mature and informed political and public debate about taxation.

## The Commission and the present debate

How does this political background compare with the current situation? Do our main political parties still seem allergic to discussing the case for taxation as they increasingly delineate their policy positions in the run-up to the general election?

David Cameron recently made a clear moral case for the Conservative party's 'long-term plan' for over £7bn worth of tax cuts, based on the premise that 'every single pound of public money started as private earning'.<sup>3</sup> However, as Will Hutton pointed out acerbically, this assertion ignores the essential contribution of infrastructure and public services to the ability to create any sort of livelihood. Indeed, most people would lose out if they had to pay privately for public goods.<sup>4</sup> In 2000 the Commission set out a clear case for supporting a strong conception of citizenship, within a socially just and inclusive society, that would have no chance of being fulfilled in the context of a minimalist state, or this kind of imperative to cut taxation. Ultimately, promises of tax cuts are arguably the Conservatives' answer to the crisis in living standards. But the *Financial Times* has argued that rather than 'unfunded tax cuts', the answer to stagnant pay levels for the low paid is actually investments in skills, technology and infrastructure to create a more productive economy.

The Liberal Democrats' recent priority has also been tax cuts, via real increases in the personal tax allowance, although they have suggested in addition a 'mansion tax' to increase revenue from the most valuable properties. They have, however, found both these ideas also being put forward by other major parties. Labour has suggested reintroducing a 10 per cent tax rate, while its proposal to introduce a mansion tax has increasingly come with various caveats; and the resurrection of the 50 per cent income tax rate is currently only proposed on a temporary basis, to help deal with the deficit (Furthermore, seemingly contrary to its principles, its recent proposal to freeze child benefit in the short term also means families with children would have a proportionately lower tax-free income than childless people). In fact, debate on the Labour fringes increasingly focuses on 'pre-distribution', rather than on changes to taxation and benefits, which it is argued have run their course. In addition, there seems currently to be no political appetite to suggest ways to make taxation of wealth via inheritance more progressive. It could be argued therefore that the tax taboo is at least as strong now as it was in the late 1990s.

However, two factors have radically changed the political landscape. The first is the economic and fiscal context. Following the recent financial crisis and recession, the coalition government's initial recipe for deficit reduction was about one-fifth tax increases to four-fifths spending cuts, though in practice, this has been more like 15 to 85 per cent respectively. As a result of the economic status quo, any proposal to increase taxation is now likely to be judged against the need to tackle the deficit, rather than primarily to improve services as was the case in 2000. This was the context of the coalition government's move to increase VAT to 20 per cent, a less visible 'stealth' tax, of a kind which public attitudes research by the Commission demonstrated was particularly unpopular, as well as being regressive. The irony is that the Commission's research also found people even more concerned about the declining quality of public services than about levels of taxation. Indeed, in the 1990s some 60 per cent of the population favoured increased taxes in return for increased public spending in annual British Social Attitudes surveys. A rallying call today for increases in tax to help repay government debt does not have quite the same ring to it. In any case, the proportion of the public supporting this option has declined, to 35 per cent in the 2012 British Social Attitudes report - although this was an increase on 2010, when support had fallen to 31 per cent.<sup>5</sup>

Secondly, the Commission was concerned about public ignorance of the tax system and its relationship with public services, as well as about governments' lack of openness in this area. This led it to propose a raft of measures to make the tax system more transparent and governments more accountable. It could be argued that some of these measures have been implemented, albeit not in exactly the ways envisaged by the Commission. The Office for Budget Responsibility has been set up, and fulfils some of the independent functions of the Office for Public Accountability proposed by the Commission, though the latter would have had more focus on public services. The Office of National Statistics has taken up the fight for an honest presentation of official statistics, as advocated by the Commission. On the other hand, the recent statement sent to taxpayers by the Chancellor about what your taxes pay for, which could be seen as resembling the annual 'citizen's leaflet' proposed by the Commission, falls woefully short. Not only does it have no explanation of the tax system itself, such as how it is composed, and what individuals in

different situations pay, which the Commission called for; it also aggregates different kinds of spending under the heading 'welfare'. Indeed, some commentators have alleged political motives, suggesting that its main purpose has been to mobilise support for tax cuts by playing on popular prejudices.

More generally, the 'disconnection' described by the Commission in 2000 between citizens, the tax they paid and the services this revenue pays for has arguably worsened. Back in 2000, one reason for public concern about taxation was seen to be scepticism about how governments used the money raised, the common perception being that tax paid disappeared down a 'black hole'. This was a fundamental reason behind the Commission's proposal for hypothecating increases in some taxes (and in the case of the NHS the whole of the income tax take devoted to it) so that people could more easily see what their money was spent on.<sup>6</sup> But whilst Gordon Brown did introduce limited hypothecation for health, this was additional spending from an increase in national insurance contributions, rather than an implementation of the Commission's idea.

Today, a majority of the electorate apparently believes it will be possible to eliminate the deficit after the election by reducing 'waste', a belief arguably shored up by Labour's recent focus on 'Tory welfare waste'.<sup>7</sup> Yet, as in the past, despite being a favourite mantra of politicians, cutting waste is highly unlikely in practice to yield enough to avoid either spending cuts or tax increases.

More worryingly, however, there seems to have been an increase in mistrust of government in general, rather than just in relation to the use of tax revenues. Back in 2000, discussions in Commission meetings recognised a critical attitude towards those in power as denoting a healthy lack of deference. But the current emphasis on not voting at all, together with the rise of populist parties appearing to endorse the view that 'they're all the same' (apart from the populist parties themselves, of course), suggest a more deep-seated lack of trust in political collective action for the public good. Rereading the Commission's report now suggests a faith in the ability to detach issues as sensitive as tax from the political arena (evident in its proposal for a Royal Commission on Taxation to consider impartially ideas for new taxes) that seems unlikely today.

## Looking forward

However, in other ways the glass could be seen as half full, rather than half empty, when it comes to taxation. David Cameron recently claimed that it was 'morally right' that the rich pay their 'fair share' in tax, and that those able to contribute to 'our public services and safety nets' should do so.<sup>8</sup> Furthermore, the past decade has seen public outrage at multi-national corporations failing to pay their dues to the countries and societies in which they operate. Customer boycotts have served to make tax increasingly a reputational issue for many companies. Indeed, the subject is of such significance that the OECD has recently elaborated rules for the international oversight of tax on corporations in the global marketplace. This was an issue which the Commission on Taxation and Citizenship considered briefly; but fifteen years later, the subject of tax avoidance has become pivotal. Research by Richard Murphy and civil society campaigns by UK Uncut amongst others have contributed to this upsurge in public awareness and concern. Similarly, when it comes to personal taxation, there are reasons to be cheerful. There has been

increasing emphasis in recent years on the fairness of the tax system (or lack thereof) and the need for the 'super-rich' to make an appropriate and proportionate contribution. The billionaire Warren Buffett has been famously critical of the fact that he is liable to pay tax at a lower rate than his secretary.

However, despite these positive developments, contemporary debates around taxation have tended to be confined to calls for corporations and the very richest individuals to contribute more. This may be due in part to the tendency for people to under-estimate their own wealth and how close to the top of the income distribution they are. Yet, since the Commission reported in 2000, the separation of 'taxpayers' from recipients of public services (in particular social security benefits), has increasingly featured as a media theme - exacerbated by the language used by politicians from all the major parties.

If this rhetoric is allowed to continue, the future of the strong citizenship and renewed 'civic contract' between citizens and governments advocated by the Commission in 2000 will inevitably be at risk. As John Hills argues in his recent book,<sup>9</sup> the idea that society can be unambiguously divided into 'them' versus 'us', between those contributing via taxation and those benefiting from cash transfers and services, is mistaken. Nearly a decade and a half after the report of the Commission on Taxation and Citizenship, the need to make the case for 'paying for progress', by re-forging and strengthening the connections between taxation and a socially just, inclusive and solidaristic society, is even more urgent than it was then.

Endnotes:

- 1 *The Times*, 7 November 2014.
- 2 The Commission on Taxation and Citizenship (2000) *Paying for Progress: A new politics of tax for public spending*, London: 2000. This article only discusses a few of the principles and proposals from the report.
- 3 *The Times*, 30 November 2014.
- 4 *The Observer*, 2 November 2014.
- 5 *New Statesman* blog by George Eaton, 17.9.12. Support was somewhat lower between 1998 and 2000. See British Social Attitudes (2012) report - <http://www.bsa-29.natcen.ac.uk/>
- 6 In the case of the hypothecated income tax for the NHS, a majority of the Commissioners were in favour, but not all; I was one of the dissenters whose names were noted.
- 7 Reported in *Financial Times*, 12 November 2014.
- 8 *The Times*, 30 November 2014.
- 9 Hills, J. (2014) *Good Times Bad Times: The welfare myth of them and us*, Bristol: The Policy Press

# 4 TURNING THE TIDE ON TAX

Martin O'Neill

Nobody should be surprised that the main political parties are currently doing all they can to avoid talking seriously about tax. With the least predictable election in living memory on the horizon, no party wants to give their rivals the opportunity to wheel out the kind of 'tax bombshell' accusations that worked so well for John Major in 1992. But, whatever the short-run tactical demands of the coming election campaign, the next government is going to have to rescue Britain's decrepit, ramshackle tax system.

You wouldn't know it from listening to frontline politicians, but it is obvious that Britain's tax regime requires a radical, root-and-branch overhaul. Sir James Mirrlees, the Nobel Prize-winning economist who chaired a systematic review of the UK tax system in 2011, diagnosed the system of taxation in this country as inefficient, unfair and disorganised.<sup>1</sup> More starkly, and more urgently, with the annual deficit still approaching the £100bn mark, the tax system simply does not raise sufficient revenue to cover even current attenuated levels of government expenditure under austerity. Paul Johnson of the Institute for Fiscal Studies has pointed out that, if a post-2015 government were to stick to the regressive aim of keeping the 80:20 split between spending cuts and tax rises in closing the deficit, there is an annual tax shortfall of some £6bn in the system.<sup>2</sup> If a Labour or Labour-led government were to aim to do something more humane, with less severe cuts and a brake on austerity, then cutting the deficit would demand even greater increases in taxes. And this is to assume current OBR projections whereas, as George Osborne has discovered to his continuing discredit, the fiscal reality again and again turns out to be bleaker than the OBR likes to suppose.

This sounds like doom and gloom. It need not be. Firstly, getting serious about raising taxes can save us all money. Secondly, creating a more stable and effective tax system can go hand-in-hand with reducing taxes on income for all but the most affluent.

## Raising taxes can save us money

The recent Stevens Report on NHS funding argues that, with increasing demand for healthcare services and only limited scope for efficiency gains, there will on current trends be an annual shortfall in NHS funding of more than £20bn per year by the end of the next parliament.<sup>3</sup> Significant rises in taxpayer funding of the NHS will be necessary if it is not to fall back into the kind of disarray last seen under the Tory governments of the 1980s and early 1990s, before Labour raised NHS funding to more reasonable levels.

If the Stevens Report presents the facts accurately, as we have every reason to believe that it does, then consider what the alternative might be to raising NHS funding through the tax system by £20-£30bn per year. We can be

certain that our healthcare needs will not somehow disappear, nor that those costs can be avoided. Instead, the alternative would be that our healthcare needs would have to be met through inefficient and inequitable piecemeal private provision, instead of meeting those collective costs together.

Rising health-related costs are in many respects a sign of societal success rather than societal failure. It is a matter for celebration that people live longer and it is right and natural that healthcare expenditures will increase as our lifespans extend, and as medical technology advances in sophistication, thereby allowing us to improve and extend our lives in ways that previous generations could scarcely have dreamed about. Moreover, as William Baumol famously argued, the scope for productivity gains in sectors that make intensive use of highly-skilled labour are extremely limited, compared to capital-intensive sectors like manufacturing, where increased productivity can be driven by technological advances.<sup>4</sup>

For all these reasons, healthcare costs will rise over time in successful societies. It is therefore not surprising (nor, for the reasons given, is it even genuinely regrettable) that healthcare costs are rising in all the advanced industrial countries, including the UK. We are well placed to meet these growing costs efficiently and fairly given our access to the civilizational achievement that is the free-at-the-point-of-use NHS, a health system the basic efficiency of which is recognised internationally, but not always as widely celebrated as it should be in this country.<sup>5</sup>

Failing to meet these costs through the tax system means falling back on private alternatives that are both less efficient and deeply corrosive of social justice.

The point about the efficiency of taxpayer-funded healthcare needs emphasis. US spending on healthcare (at around 18 per cent of GDP), is roughly twice as much per person as UK spending levels (at around 9 per cent), and yet produces outcomes that are worse for most people, apart from the most wealthy. Indeed, the US has higher infant mortality than the UK, Taiwan, Belarus or Cuba (according to no less an authority than the CIA World Fact Book), and average life expectancies that are not only worse than most EU countries, but also worse than Costa Rica, Taiwan and Lebanon (according to World Health Organization data). The private provision alternative to raising taxes to fund a world-class NHS in 2020 or 2025 will not amount to saving the money that is not taxed; on the contrary, that money and plenty more with it will instead be spent on similar goods, but delivered in a more bureaucratic and less equitable fashion, as we see with US healthcare.

In many cases, reducing the share of our collective income that gets paid in taxes is no saving whatsoever, except perhaps for being a saving for the very richest among us. The relevant comparison is not with some imaginary world in which those expenditures somehow disappear, but with the all-too-unappealing world in which collective social provision is increasingly replaced by inferior private provision.<sup>6</sup> Moreover, given the incredible power of tax-payer funded welfare-state institutions such as the NHS to deliver social insurance across our whole life-cycles, we should remember the extraordinary benefits they bring in allowing all of us, rich and poor alike, to even-out good times and bad times within our own lives. Nobody among the rich knows whether they may end-up being a net beneficiary of the welfare state, given unpredictable future circumstances.<sup>7</sup> Where goods are best provided through the tax system, and where those goods are vital elements of human flourishing and well-being, we should not be reluctant to make the case for raising the taxes

to pay for them; kneejerk squeamishness about tax is a poor reason to rush blindly to inferior private-sector provision.

If we recognise that, in general, we are going to have to raise taxes if we want to adequately fund public services, then the specific question becomes which taxes should we raise?

## Fight inequality while reducing taxes on income

One function of the tax system is to fund collective goods that are best provided outside the market, for reasons of efficiency and/or fairness. Another function of the tax system is to reduce unwelcome levels of inequality. When functioning at its best, a tax system can perform both functions at the same time.

Consider the extraordinary level of inequality in the UK. Figures from the Office for National Statistics show that the gross incomes (before tax and benefits) of the top fifth of households are fifteen times greater than for the poorest fifth, with incomes for those at the top of the distribution increasing more rapidly than for everyone else. By way of illustration, it is striking to realise that if the national minimum wage had kept pace with FTSE 100 CEO salaries since 1999, it would now stand at £18.89 per hour instead of £6.50.

But the levels of inequality with regard to wealth are much starker than the levels of inequality with regard to income. ONS data shows that the wealthiest 10 per cent of UK households own a staggering 44 per cent of total aggregate wealth, with the bottom half of households owning only 10 per cent of total wealth between them. Disturbingly, the richest 1 per cent of households in the UK have as much wealth as the poorest 55 per cent put together. There is a clear lesson to be drawn from these extraordinary levels of inequality: if you want the tax system to raise revenue while addressing the most shocking and egregious dimensions of inequality, there is good reason to support a relative shift from the taxation of income to the taxation of wealth.

One of the most significant of Thomas Piketty's findings points in the direction of shifting towards the taxation of stocks rather than flows, of capital rather than income. Piketty tells us that the economies of the advanced nations have returned to the default state, from which they departed only during the middle years of the twentieth century, where the rate of return to capital is greater than the growth rate of the economy (Piketty's famous ' $r > g$ ').<sup>8</sup> Consequently, whereas the UK capital stock represented only about twice national income in the middle of the twentieth century, it now stands at five or six times national income, and continues to rise sharply. If an emphasis on income taxation made sense in the immediate post-war period, when the capital stock was historically low, a switch toward a greater emphasis on capital taxation makes sense now, when the capital stock is historically high (and growing strongly).

Labour's 'mansion tax' proposals are a move in the right direction, in that the policy is about funding vital collective public services through the taxation of the upper tail of the distribution of housing assets. Much of the recent gains in asset prices have been a windfall that has come as a direct consequence of the Bank of England's vast programme of quantitative easing (QE), as its own research demonstrates.<sup>9</sup> As the Bank has bought hundreds of billions of pounds of government bonds, driving up their price in the process, the sellers of those bonds have then shifted their investments to other asset classes, thereby increasing demand for the kinds of capital assets favoured by

the rich, such as the most expensive parts of the housing stock, and thereby also driving up levels of wealth inequality. The Bank's research claims that 40 per cent of the gains in wealth generated by QE went to the richest 5 per cent of people. Those who have seen their houses inflate rapidly in price simply as the result of unconventional monetary policy can have few plausible complaints if some of those windfall gains are reallocated to the provision of collective goods. Labour should therefore feel confident that it has started to develop an approach to tax which, although it has generated the inevitable media backlash that accompanies any new tax proposals, does so mainly because it provokes the anger of a dismal cadre of moaning celebrities who have an over-developed sense of entitlement and an underdeveloped sense of their own sheer good fortune.

Four points, however, need to be made about the mansion tax. Firstly, it is at best a transitional move in the direction of a more comprehensive and unified approach towards the taxation of capital assets, covering both the taxation of capital holdings and, even more importantly, the taxation of capital transfers (i.e. gifts and inheritances).<sup>10</sup> Secondly, with regard to the taxation of residential property alone, the mansion tax should be a step towards the end goal of an integrated system that overhauls regressive council tax and replaces stamp duty land tax, which taxes people arbitrarily on the frequency with which they move home, to refocus tax upon property wealth itself. Thirdly, such taxes need to be highly progressive at the top end, with higher bands for the ultra-rich, for the sake of both revenue raising and the reduction of runaway inequality. Finally, we need to become much more serious about taxing the capital gains of overseas investors who are happy to free-ride on the stability and vibrancy of our society and who use their investments in London properties as a safe-haven for parking their wealth: they need to be made to pay for the benefits that our society provides for them.

The attractive side of raising more revenue from capital taxation is that, in the long-run, the pressure can to some degree be taken off income taxes. Changing the mix of taxes can allow a progressive government to pursue the dual aims of increasing overall tax revenue while decreasing the taxation of productive economic activity. There is no reason why a tax system that raises much more revenue from the capital holdings of the most wealthy should not at the same time significantly reduce taxes on the incomes of the majority of its citizens. That would be a recipe for a tax system that could win the political support of most members of society.

However, care needs to be taken in approaching the potential reduction of income tax rates. The coalition government has, at the insistence of the Liberal Democrats, found an almost uniquely bad approach to doing so by continually raising the tax-free personal allowance. As numerous distributional analyses show, raising these thresholds is an extremely blunt tool for helping those on low incomes, as it confers an equal benefit on all basic rate tax payers who earn more than the threshold amount, thereby also giving a double benefit to dual-income households, which tend to be more affluent to begin with. Furthermore, it brings no benefit at all to the very worst-off, whose earnings fall below the threshold.<sup>11</sup>

The coalition's approach also creates an invidious distinction between taxpayers and non-taxpayers. As Fabian Society authors have rightly argued for some time, participation in the tax system is part of what it is to be a citizen, engaging in relationships of reciprocal support and interdependence with others.<sup>12</sup> The rhetoric of "taking people out of taxation" may have an initial

simplistic appeal, but it carries an unwelcome sting in its tail. Instead of creating an exclusionary system in which we no longer seem to be tied together in a collective enterprise with our fellow citizens, the tax system should be made more progressive through a combination of tiered progressive rates. “In it together” should be a political reality, not an empty slogan.

## Conclusion: tax, inequality and redistribution

There is a tale that may seem tempting to progressive and social democratic politicians during hard economic times, which would tell us that the tax system no longer plays a central role in delivering a more just society, and that social justice can instead be delivered by ‘predistribution’ strategies alone. One attraction of this tale is that it allows politicians of the left to avoid the tactical costs of transgressing the taboo and talking seriously about tax. But it is a tall tale, and one by which we should not become bewitched.

Addressing pre-tax inequalities through redistribution is vitally important, but pursuing this alone while ignoring the role of taxation will not create a path towards a fairer society. Some forms of redistribution, from reforming corporate governance to undertaking government procurement in a smarter way, can be done without much public spending. But such strategies, important as they are, go only so far. Other forms of redistribution, such as increasing state investment in education and training to ensure that people fare better within the market economy, do require serious public funding.<sup>13</sup>

And no matter how much one achieves with redistribution, it cannot replace the central role of the state in providing tax-funded public services. Redistribution and tax-and-spend policies are not rivals, but rather they complement each other; a just society requires both/-and, not either/-or. That is why so many progressive economists, from Meade to Piketty, emphasize the dual necessity of both redistribution and redistribution.<sup>14</sup>

We stand at a worrying and precarious time in the development of the British state and economy. It is difficult to overestimate how much turns on the 2015 election, and on the performance of the government that is elected at this pivotal time. A government led by Ed Miliband will have a vital set of goals to realise, in protecting our most treasured public services, while making sure that work pays for the many and not just for a disconnected elite. Our economy has undergone a dispiriting decades-long shift away from the interests of productive working people and towards the interests of wealthy rentiers. A successful Labour government will have to arrest and then reverse this shift. None of these aims can be achieved without thinking seriously about the future of the UK tax system, and acting with political courage to transform it.<sup>15</sup>

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# 5 HEARTS AND MINDS

Suzanne Hall

## Economic attitudes

The growing financial insecurity felt by so many is not only one of the major trends of the past decade; it also has considerable implications for how any politician's plans for taxation are received. Only one third of the public rate their current financial situation as strong and there is little confidence that things will get better, with just one in four predicting that their financial position will be stronger in six months' time.<sup>1</sup>

Conversely, this is in stark contrast to more general attitudes towards the state of the economy. Throughout 2014, Ipsos MORI has recorded some of the highest economic optimism scores ever, defined as the percentage of those who feel the economy will get better, minus the percentage of those who think it will get worse, with an all-time peak of +35 in May. While these scores did dip towards the end of the year, on balance attitudes towards the economy are still positive.<sup>2</sup> This may seem a contradiction given the widespread sense of financial insecurity. However, as wages fail to keep pace with economic growth, it is unsurprising that people can be positive about the economic state of the country, while still worrying about what is in their own back pocket.

This financial insecurity has an interesting generational aspect. The belief that the next generation will necessarily have a better quality of life than the one that went before may have once been a truism, but today it no longer holds.<sup>3</sup> Only a third of British adults think that their generation will have a better quality of life than their parents. By breaking these issues down by generation we see a still bleaker picture; only one in five of those aged under 30 think their generation will have had a better life than that of their parents. Given the challenges faced by today's young, with the under 30s making up 40 per cent of the global unemployed population, this pessimism about their future isn't surprising.<sup>4</sup>

## Disappointing support for progressive taxation

Against this backdrop, it might be reasonable to assume that the conditions are apt for strong support for a progressive system of taxation across society. However, while two thirds agree that having large differences of income and wealth is bad for society overall, this doesn't translate into support for redistribution. Indeed, an analysis of data from the British Social Attitudes survey shows the opposite, with support for redistribution steadily declining over the past twenty years. While there has been a slight upturn in the latest survey, the overall trend is down, from over half supporting redistribution through increased welfare in 1987 to around a third by 2013.<sup>5</sup>

Once again, there is a generational angle to this: the young are simply less supportive, partly due to the completely different contexts in which they have grown up. These generational differences are most noticeable with regard to attitudes to the welfare state: while 71 per cent of the pre-war generation say it is one of Britain's proudest achievements, only a quarter of Generation Y feel the same way.<sup>6</sup> Qualitative research indicates that the young see the welfare state as complicated and less relevant to them, compounded by the fact that, unlike the pre-war generation, they have no recollection of life before it.

Closely related to this, US public philosopher Michael Sandel argues that people in modern societies are 'more entangled [with] but less attached [to]' one another. He suggests that contemporary emphasis on individual choices and identities over and above common cultures is juxtaposed by the myriad ways in which people continue to depend on one another. As a result there is now a tension between individualist outlooks and shared fates – something which helps explain declining levels of support for the welfare state amongst the younger generation.<sup>7</sup>

These attitudes translate to weak support for progressive measures when applied to the taxation system, even when the very richest in society are targeted. In recent work for the Equality Trust, Ipsos MORI asked the public about their preferred and actual total tax takes for those on a range of incomes: perhaps surprisingly, there was little appetite for those at the top to be taxed more than they are now. For instance, the public believes that households in the highest wealth decile pay 36 per cent of their total income in tax – but their preferred tax take for the wealthiest is only 39 per cent, indicating support for the status quo, and limited appetite for a more progressive tax system.<sup>8</sup>

Conversely, the 'mansion tax' commands a higher level of public approval, with 63 per cent supporting it, but only when applied at the high threshold for properties worth £2m or above. And while 85 per cent support taking people out of income tax by raising the earnings threshold to £12,500, two thirds of the public also support increasing the earnings limit at which taxpayers are moved onto the higher rate of 40 per cent to £50,000.<sup>9</sup> In sum, these attitudinal statistics are evidence of a contradiction within public opinion, simultaneously supporting a more proportional tax system in some ways, but also favouring reduced income tax burden in others. For instance, despite support for the 'mansion tax', the proposal to increase the top rate to 50p in the pound proves the least popular of all tax reform plans, with 30 per cent opposing this policy. Once again, younger generations are least likely to support the proposal, with opposition among those aged 18 – 34 at 37 per cent). Furthermore, when the policy is presented to the public as being a Labour one, support for it drops further still, by two percentage points, down to 59 per cent.<sup>10</sup>

## Motivations behind public attitudes

In part, these views are driven by a number of misperceptions, including how wealth is currently distributed. While the public agree that some level of inequality is acceptable, they vastly underestimate how unequal society is. In fact, the majority of us believe that the top 20 per cent own 40 per cent of the nation's wealth and that the bottom 20 per cent own 10 per cent: in

reality, the top 20 per cent own 60 per cent and the bottom 20 per cent less than 1 per cent.<sup>11</sup>

Additionally, a lack of understanding with regard to how government spends taxpayers' money may also explain the low levels of support for progressive measures. A quarter of the public think that foreign aid is, alongside pensions, one of the top recipients of government expenditure: in reality, spending on pensions accounts for ten times the amount spent on foreign aid, in real terms. There is also mistrust as to whether our taxes are going where they are needed: for instance it is widely believed that a quarter of all welfare benefits are claimed fraudulently, in stark contrast to the DWP's best estimate of only 0.7 per cent, including error.<sup>12</sup>

Over and above this though, these views reflect our society's growing individualised sense of fairness, the idea that people deserve to keep the money they have earned. Nowhere is this more apparent than in the public's hostility to inheritance tax, deemed unfair by 69 per cent of us.<sup>13</sup> This sentiment is prevalent also through Ipsos MORI's qualitative work which has repeatedly shown that the younger generation understands the role of the state as providing opportunities and skills rather than managing risks, again reflecting a more individualised outlook.

### Labour's tax plans: persuading the public

At face value, it may seem that Labour's tax plans are at odds with the direction of travel of public opinion. In its quest to create a fairer, more equitable society through progressive taxation, does it run the risk of losing the support of the electorate, particularly younger voters?

Not necessarily. Just because younger generations are less attached to institutions like the welfare state and hold a more individualised outlook it doesn't necessarily follow that they are less inclined to vote Labour. In fact, quite the opposite: the young are more likely to say that they will vote for Labour than for any other party.<sup>14</sup>

The key is in how the tax plans are 'framed'. Emphasising that they are not only fairer, but will also help to build an economy that delivers prosperity for all, is much more in line with what the public wants to hear. This is because the growing sense of insecurity people feel with regard to their own generation and future ones is, in part, a reflection of concerns that the UK is falling behind the rest of the world economically. However, in recent qualitative work, participants painted a picture of an ideal society where employers were rewarded with tax breaks for paying the living wage, and where government works in tandem to upskill individuals and help them move into better paid jobs. This in turn would increase the indirect tax yield as people would be able to spend more.<sup>15</sup> As such, arguments proposing tax reform must be located within a clear sense of public priorities.

In addition, there may be merit in tying Labour's tax plans to the policy areas where it traditionally performs well. This is most notably the case for the NHS, where Labour is rated as the best party by 39 per cent of the population, nearly double the figure for the Conservatives. This will be important given that tax plans articulated in isolation are hardly election winners. Indeed, only 8 per cent cite them as being an issue that will be very important to them when deciding which party to vote for, as opposed to the big ticket items like managing the economy (31 per cent), asylum and immigration (30 per cent), healthcare and the NHS (29 per cent) and education (23 per cent).<sup>16</sup>

Public support can also be harnessed by demonstrating that the tax burden will be shouldered by all. This should address the prevalent sense that some companies fail to pay their share, highlighted by the sharp fall in the proportion of those believing that British business behaves ethically, down ten percentage points to only 48 per cent in 2012. Indeed, when asked about the issues that need addressing in relation to company behaviour, the second most popular answer behind excessive executive pay was corporate tax avoidance.<sup>17</sup> 90 per cent of the public agree that it is unfair they have to pay their taxes when multinational companies can avoid doing so, while a similar proportion believe that corporate tax avoidance is too easy. This sense of unfairness is compounded by the sense that government fails to have a handle on this problem, with only 43 per cent believing it has a genuine desire to combat tax avoidance.<sup>18</sup> Therefore, if Labour can successfully occupy this space, its tax plans could gain traction and recognition with voters.

## Conclusions

None of this will be easy for Labour. 45 per cent of the public thinks the Conservatives have the best policies on managing the economy, compared with 20 per cent thinking the same of Labour. This is up from just six months ago, when 35 per cent backed the Conservatives on this issue, against 22 per cent for Labour.<sup>19</sup> Further, while the difference is less pronounced than on the subject of the economy, more of the public think that the Conservatives have the best policies on taxation than Labour, 31 per cent to 27 per cent respectively.<sup>20</sup>

Beyond battling against the Conservatives to secure public favour, trust in politics as a whole may constitute an obstacle to favourable public opinion. Only 16 per cent of people trust politicians to tell the truth, meaning even the most articulately crafted message could fail in its delivery. Indeed, with around a third trusting business leaders, a comparatively higher percentage, Labour might struggle in strengthening its credibility, given the extent of coverage about big business's often negative response to Labour's tax plans.<sup>21</sup>

Political motivations also come under question and pose a potential obstacle. In response to the reasons behind Labour's plans for the 50p tax rate, the claim that Labour made the move as a means of targeting the rich for party political reasons is given by nearly half of all respondents.<sup>22</sup>

Furthermore, the distinct generational differences highlighted throughout this essay need to be acknowledged, given profound changes they indicate in how the population engages with politics and institutions. Identifying, understanding and responding credibly to the nuances of public attitudes, opinion and priorities will not only be key in the run up to 7 May. It will also decide whether the public is receptive to Labour's tax proposals if the party does win office this year.

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# 6

## THINK LOCAL

Laura Wilkes

Any debate about localism and greater local determination must take account of, and aim to reform, how local government is funded. Our existing system is broken, and while successive governments have preached the importance of devolving powers to local government, none have had the courage to do anything but tinker around the edges of a highly flawed financial system.

The principal dichotomy is that while central government gives the impression that local authorities have control over tax locally and are accountable for subsequent local spending decisions, levels of grant funding are actually set centrally, often with restrictive ring-fences on what can be spent where. Similarly, business rates, although collected locally, are set centrally and councils are only able to retain a small proportion of them, decided centrally through a complicated growth formula.<sup>1</sup>

The only part of the local funding pot that councils have any real power over is the level of council tax that they can charge. However, any council tax raised above a centrally imposed 2 per cent threshold is currently subject to a local referendum, in other words, capping by the back door. Furthermore, let's not forget that council tax itself is based on valuations from 1991, while huge changes in the housing market mean that in many areas house valuations are significantly out of date. For instance, the top council tax band H covers all properties worth £320,000 and over.

In the absence of real freedoms over levels of local taxation and with so many statutory duties and direct, ring-fenced grants, local authorities have become reliant on central government revenue support by default. As the non-ringfenced revenue support grants are being stripped back, and with no real ability to raise funds locally, resourcing vital local services has become highly problematic, weakening the vital tie between citizens, their local tax pounds and decisions around spending on local services. These are crucial precursors to strong local democracy.

### Localism, devolution and tax

It is vital that local taxation and decisions on how (and how much) to raise should be made locally. For the left, it underpins the foundations of the local welfare state and the ability of councils to provide services and benefits to individuals, as well as reducing poverty and inequality. Indeed, tax is at the heart of the relationship between the citizen and the state, strengthening accountability and the capacity of the state to act.

It is also widely understood that taxation can mobilise citizens, engaging them in public policy, public expenditure decisions and the provision of public good.<sup>2</sup> However, our current climate of falling participation, not least decreasing numbers voting in local elections, is juxtaposed with a need for

people to contribute more in crucial service provision such as care for the elderly, community cohesion and the public realm. As such, mobilising and engaging citizens in public policy and reducing poverty becomes a central goal, and taxation itself a crucial tool.

The problem is that giving real power to local government, councillors, and citizens themselves to tackle poverty and inequality would involve devolving tax raising powers to allow councils to determine the level and nature of spend, becoming duly accountable for doing so. And while all parties are talking about greater freedoms and powers to local government, none are promising any real financial devolution. Without this, such talk is almost meaningless.

We must ask ourselves how we ended up here. For a start, we have come to accept so much central control as the new normal, though it has not always been this way. Indeed, before 1991, many local authorities raised more money through rates than they received in central grants. Long before the spending cuts imposed in 2010, we knew the financial system was at breaking point.

There is seemingly universal agreement that we want a stronger and more resilient citizenry able to tackle inequalities: so why are there no substantial offers on the table to bring citizens closer to decisions around taxation through devolution to local government? For many on the left, it is starting to feel like we have been here before, and each time the same choices have been made, reaffirming central control over local government finance.

Historically, two separate Labour governments have set up independent reviews to look into options for local government financial reform (Layfield 1976, Lyons 2007).<sup>3</sup> Layfield recognised the central-local tension, suggesting that whoever is responsible for spending money should also be responsible for raising it so that the amount of expenditure is subject to democratic control. In other words, if local authorities are to have any control over their services and functions, it is for them to determine what money they spend on services. Crucially, they must be responsible for raising this money through local taxes and be accountable for doing so.

Decades later, recognising the importance of taxation in shaping the sort of country we want to live in and the balance between citizen, state, power and voice, Sir Michael Lyons was tasked by the Blair government with reviewing local government taxation. Unsurprisingly he came to remarkably similar conclusions, suggesting that in the long term government should consider radical reform to local finance, such as local income tax. In the medium term, however, he recommended that council bands needed to be revalued and expanded to improve fairness, that a fixed proportion of income tax should be given to local government, and that councils should have greater powers to levy a tourist tax in some areas. For Lyons, council tax wasn't broken, but seen by the public as hugely unfair given that living in a high band property does not always reflect ability to pay the tax. As we know for the left, progressive tax is seen as the best way to reduce the gap in income between the rich and poor.

That two separate independent reviews, almost 30 years apart, reached very similar conclusions is indicative of an important point: our system of funding local government needs to change. So why have these reviews been largely ignored?

The 'too difficult box' gives us much of the answer – tax reform is tough. As history tells us, any changes to local tax are not politically popular, particularly changes that would deliver a large number of losers. If council tax bands

are revalued there would undoubtedly be individuals who would have to pay more; the issue for the left is how progressive this would be. Whilst there are many individuals who can and should pay more council tax, revaluation would also ensure a number of families find themselves in properties that are worth much more than in 1991, whose income, however, has not risen in line with inflated house prices. Unlike income tax, council tax is a fixed rate that does not reflect earnings and ability to pay. If revaluation were to happen, the burden of council tax would be shifted south, which would then require some sort of graded and regional system to redress the balance.

Wider and more radical reforms, such as a local income tax, would not be any easier to implement. If local authorities had the ability to charge a suite of local taxes based on property, income and consumption, in favour of government grants, the outcome might be a mixed blessing. While this might deliver the left's desire for greater freedoms in local government, it would threaten what the left hates to love about central involvement in local finance: redistribution. Perhaps correctly, the left fears the consequences that radical reform of this type would have on the ability to deliver an equitable and fair settlement for all, which is currently achieved through redistribution of finance across the whole system. A more local system makes this much more difficult to achieve.

## Conclusion

The problem remains how government can deliver a local funding system that removes the need for central control, but still delivers fairness. Some will say this is simply not possible. Significantly, areas with relatively less deprivation, and on the whole less need, will have a greater ability to raise (and pay) taxes, yet less need for the vital services that they provide, while the reverse will be true for poorer areas. Ultimately, it seems the only choice for the left in this scenario is central intervention, not localism.

The real question for the left is what options remain. Quite clearly there is a need to take a pragmatic approach, which would reform the system to ensure greater local control, whilst also delivering equity. Further freedoms around business rates and the ability to levy tourist and consumer taxes would be a step in this direction, as would a revaluation of council tax bands which takes account of regional differences, and those who may be property rich, but cash poor.

But the system has been broken for so long: council tax bands are absolutely out of date; and all the incremental changes are so complex. In sum, this means that any moves to correct these would just paper over cracks, potentially leading to bigger issues further down the line. So is now the time to start from scratch?

Radical reforms would include considering options around a local income taxation model, and strengthening the link between the citizen, tax and local democracy. If a local income tax were to be explored, this would have to be rebalanced with a national income tax to plug gaps and rebalance finance in less prosperous places.

However, any reforms of this sort must address the challenge of bringing political and public support for change. As other commentators have suggested, we need the public to 'fall in love with tax' and the act of contribution, but we also need our politicians to show real leadership. A strong case must be made about tax, active citizenship and greater devolution of financial

powers to local government.

This will mean accepting and even championing greater local determination and control. The prize, of course, is the potential to reinvigorate local democracy, generate a more active citizenry and really start to tackle some of the deep-rooted inequalities that our communities face.

Endnotes:

- 1 See DCLG, 'Local Government Resource review: Proposals for Business Rate Retention', 2011 ([https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/8469/1947200.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/8469/1947200.pdf)) and DCLG, 'A Plain English guide to Business Rates Retention', 2012 ([https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/5946/2182624.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/5946/2182624.pdf))
- 2 OECD (2008), *Governance, Taxation and Accountability: Issues and Practices*
- 3 Lyons Inquiry into Local Government, 2007 - <http://www.lyonsinquiry.org.uk/index8a20.html>

# 7 THE RULES OF THE GAME

Michael Izza and Andrew Gambier

The widespread public concern that many businesses, particularly large multinational corporations, are not paying enough tax on their profits has been widely documented. The issue of 'tax avoidance' is a serious one at a time when public finances are under strain.

This concern is based on the assumption that it is fair to levy a corporate tax based on 'how well a company has done', with the profits figures in accounts, generally speaking, expected to provide a suitable basis for assessing this. Furthermore, companies are expected to pay more tax if they are 'doing well'.

However, governments also wish to use the corporate tax system to satisfy a variety of policy objectives. In doing so, they can cause taxable profits to diverge from the profits figure in the accounts. This creates a dilemma: achieving government policy through the corporate tax system risks undermining the credibility of the tax system and company accounts because of differences between how each measures profits. Broadly speaking, government policy allows companies to pay less tax if they are doing good deeds. This can lead to complex and sometimes contradictory views of what is 'fair'.

## A fair tax system...

The concept of fairness encapsulates many different dimensions, some of which conflict with each other. An important moral foundation is that everyone should contribute something to the tax system, resonating with the broad idea that the role of taxation is to support government and wider society. It's also generally considered fair to make special provision for those at a disadvantage, such as the young, the elderly and those with disabilities. So ensuring fairness in tax should mean that any tax system also incorporates ability to pay. For income-based taxes, this can be achieved by taking a percentage of income and giving a tax-free personal allowance.

Another key aspect of fairness relates to the taxpayer. Hypothetically, it would be possible to wait until the end of the year and then assess retrospectively how much tax every citizen and business should pay based on their needs, income, expenditure and property. But, as well as making tax a lot more difficult to collect, this would prevent taxpayers from knowing how much tax they would be expected to pay before committing themselves to incur it. So another vital dimension of a fair tax system is that taxpayers should be confident that once they have decided to commit themselves to a taxable transaction, the tax rules won't change.

Finally, it is seen as fair for government to use the tax system to incentivise or penalise certain types of behaviour if, in doing so, desirable social objectives are achieved. For example, society supports so-called 'sin taxes' on products such as alcohol and tobacco or differential rates of duty on cars depending on their CO2 emissions to disincentivise harmful behaviour. Gov-

ernments also use the tax system to attract investment and to encourage businesses to invest in ways likely to increase employment and economic growth.

In sum, these principles of fair contribution, transparency and behaviour-shaping form the basis of our modern taxation system.

### ... can still produce unfair results

However, even in a nation whose tax system takes account of ability to pay and whose collection of tax rules are fixed in advance, outcomes that may be seen as unfair can still be produced. Deploying a range of different taxes and levies can help to offset some of these issues, as well as ensuring that governments are less exposed to the tax revenue fluctuations as a result of economic shocks. But governments need to be mindful of the overall effect of the tax systems they manage in case they produce outcomes that are perhaps unfair.

In addition, 'tax avoidance', especially using legal reliefs in unforeseen ways to obtain a tax advantage, is widely viewed as unfair. This is both because it leaves other taxpayers having to pay more to make up for tax revenue that had been expected but which wasn't paid, and because of the general principle of all in society paying their 'fair share'.

However, the distinction between using a tax incentive to avoid tax and using that same incentive in the way it was intended isn't always clear. Society sees it as a benefit for people to be allowed to donate to charity from their pre-tax income. But some see it as unfair that a rich person can fund a charitable foundation and, as a result, pay much less tax. Not all perceived corporate tax avoidance is what it might appear. Sometimes the legitimate use of tax reliefs, causing the reported profit and taxable income to differ, creates a result that looks like tax avoidance.

The calculation of the profits that companies report in accounts required by company law is governed by financial reporting standards. Society wants financial reporting standards that encourage investment, jobs and growth, supporting business decision-making over whether to extend credit to companies. While other users of company accounts, such as tax authorities, might find this information useful, standards are not written to satisfy their objectives.

There is much debate over how to determine profit for financial reporting purposes. For example, many argue for prudence (the accounting principle which makes sure that assets and income are not overstated and liabilities and expenses are not understated) on the basis that it is important that income isn't recognised too early and that costs aren't recognised too late, otherwise profit will be overstated and accounting information will be less useful for current and potential investors. Others disagree and think that information should be completely neutral, which would move towards recognising gains and losses on the same basis.

The objectives of corporate taxation are different from financial reporting. The tax system exists to serve government and, through government, society as a whole whereas financial reporting exists to provide relevant information to current and future investors. Various forces will be at work in determining the tax a company will pay on profits which are adjusted for tax purposes. Policy objectives and considerations of fairness will be highly relevant.

## Where do corporate profits get taxed?

When a business manufactures and sells its products entirely within a single country, it is clear who has the authority to tax that business's profits: the country where the business is based. For businesses with one-off sales in foreign countries, this basic principle is often still applied, and the business pays tax on its profits solely in the country in which it is based.

This approach has the advantage of simplicity for small businesses, which do not have to file foreign tax returns every time a customer from another country wants to buy from them. While a country may 'lose' tax in this way, this approach means it 'gains' tax from sales its own small businesses make in other countries, while small businesses benefit from the administrative simplicity.

Larger businesses tend not to fit this simple model. Many multinational groups establish separate companies in each country in which they operate. Some centralise business functions such as manufacturing, finance or intellectual property into separate companies, which charge other group companies for the benefit of using them. Because multinational groups have profits in more than one country, it is fair that they should be taxed in more than one country.

However, this incentivises countries to compete against each other on tax to encourage companies to undertake economic activity in their country rather than another, by providing the most favourable tax rates for businesses. Again appeals to fairness are complicated. Historically, it has often only been seen as unfair when other governments use tax incentives to attract business to their countries. However, in the wake of 'LuxLeaks' – which exposed how multinationals sought to save tax through deals in Luxembourg – public attitudes may be changing.

In order to prevent the corporation tax system becoming a 'race to the bottom' and to ensure that the tax system is fair, countries need a set of international tax rules to help establish a fair way to tax multinational businesses. For instance, many countries have signed bilateral tax agreements that conform to the model tax convention of the Organisation for Economic Co-operation and Development (OECD). This gives tax authorities powers to overwrite the amounts in subsidiary company accounts where they are deemed not to have taken place on an arm's-length basis.

However, these rules can fail to keep up to date with changes to modern business. The development of information technology has led to some companies conducting business activity in a virtual world, involving participation by people in many different countries. Financial reporting, which is concerned primarily with a single, consolidated profit figure, does not help determine where economic activity takes place. The OECD's current project on Base Erosion and Profit Shifting (BEPS) seeks to ensure that all business profits are taxed somewhere, avoiding situations where one group company claims a tax deduction for an intercompany transaction which does not give rise to taxable income in another.

## Hard choices for business and governments

These issues give rise to hard choices for business and governments, some of which are outlined below.

## 1. Should businesses respond to incentives or just pay their taxes?

Because of possible public criticism, businesses face uncertainty as to whether to respond to incentives in the tax system that allow them to pay less tax. These incentives exist because an objective of the tax system is to encourage business to act in ways that boost investment and sustainable economic growth. If business does not behave in ways policymakers believe is best for investment and growth, there is a risk that economies will fail to reach their full potential. And if trust in business is undermined in an economy, a business may choose to invest in other markets instead, depriving the economy of growth and jobs altogether.

This problem is particularly acute internationally. A business that operates internationally faces a complex series of overlapping and competing incentives offered by different countries which, taken together, erode the tax base on which tax is charged and undermine trust. In particular, an international company may face criticism in one country for the tax incentives received in another and claims that this gives it an unfair advantage over local businesses. Consequently, businesses face uncertainty as to what is the 'right' course of action.

## 2. Should governments provide tax incentives to businesses?

Tax reliefs for businesses are used to help manage the economy but may fuel the belief that some businesses are able to get away with paying less than their fair share. This risks undermining confidence in the tax system. Lack of credibility in the tax system can be damaging to 'tax morale', the belief that the tax system is fair and should be complied with. Low tax morale reduces the overall tax that is collected and makes tax collection and the enforcement of tax law more expensive.

The dilemma is worse at an international level. In order to manage an economy to be internationally competitive, governments risk being seen as discriminating against individuals and local businesses.

## 3. Is disclosure the answer?

These choices are hard, and it may be tempting to seek to use transparency to avoid having to make them. Companies already provide disclosures in accounts and elsewhere to aim to bridge the gap between taxable profit and other measures of profit. ICAEW supports transparency in corporate reporting. But extra disclosures put the burden on users to interpret them, and financial reports are already lengthy.

For a multinational business, its published financial information will comprise the consolidation of many companies and its tax charge will be calculated from the results of each of those companies. No matter how much transparency there is, public concern will continue to be tested by the apparent gap between reported profits and actual corporation tax liabilities.

## 4. What next?

It is easy for businesses and governments to try to avoid the reality of the hard choices they face by blaming each other for public perceptions of unfair-

ness or by blaming those who administer or support tax systems. But it is in everyone's interest for there to be an open well-informed debate about why there are tensions between government responsibilities for the management of economies and for perceptions of fairness in taxing corporate profits. Businesses and governments need to take a view on these hard choices and to be prepared to explain and stand behind their decisions.

# VALUES ADDED |

## RETHINKING TAX FOR THE 21ST CENTURY

Edited by Daisy-Rose Srblin

In a crucial election year, tax is on the agenda for both the Conservatives and Labour. But inevitably the campaign conversation crowds out the bigger questions about why tax matters and whether our system is fit for purpose.

Tax is still perceived as a political taboo, yet it remains a cornerstone in the relationship between the citizen and the state. Our perception of fairness about what we 'pay in' shapes our attitudes to society, with wide-ranging repercussions on, for example, our willingness to engage with the democratic process or to trust our elected representatives.

Some 15 years ago, the Fabian Society's Commission on Tax and Citizenship, chaired by Lord Plant, argued that taxpayers need to feel better 'connected' to their taxes and to the public services which they finance. Revisiting this core concept, this collection explores the values and principles of taxation with the aim of encouraging renewed debate.

With contributions from:

**Fran Bennett**  
**Alan Finlayson**  
**Andrew Gambier**  
**Suzanne Hall**  
**Michael Izza**  
**Martin O'Neill**  
**Laura Wilkes**