

4 TURNING THE TIDE ON TAX

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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.¹ 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.² 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.³ 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.⁴

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.⁵

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.⁶ 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.⁷ 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 ' $r > g$ ').⁸ 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.⁹ 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).¹⁰ 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.¹¹

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.¹² 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.¹³

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.¹⁴

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.¹⁵

Endnotes:

- 1 James Mirrlees, et al (2011a), *Tax By Design: The Mirrlees Review*, (Oxford University Press for the Institute for Fiscal Studies); James Mirrlees, et al, (2011b), “The Mirrlees Review: Conclusions and Recommendations for Reform,” *Fiscal Studies*, 32 (3), 331-59.
- 2 Institute for Fiscal Studies (2013), *The 2015-16 Spending Round*. See especially Paul Johnson’s “Introductory Remarks” online at http://www.ifs.org.uk/tools_and_resources/budget/418
- 3 Simon Stevens, et al, (2014), *NHS Five Year Forward View*, online at <http://www.england.nhs.uk/ourwork/futurenhs/>

- 4 Baumol, William J., et al, (2013), *The Cost Disease: Why Computers Get Cheaper and Health Care Doesn't* (Yale University Press)
- 5 A recent report from the Washington-based Commonwealth Fund marks the NHS as the most efficient health system in the world. See Davis, Karen, et al, (2014), *Mirror, Mirror on the Wall: How the Performance of the U.S. Health Care System Compares Internationally, a Report from the Commonwealth Fund*, online at: <http://www.commonwealthfund.org/publications/fund-reports/2014/jun/mirror-mirror> ; and see also Reynolds, Lucy, (2014), "The inconveniently excellent Beveridge NHS model," *Cost of Living*, online at: <http://www.cost-of-living.net/the-inconveniently-excellent-beveridge-nhs-model-made-redundant-for-being-too-good/>
- 6 For more on this point, see Ch. 4 of Joseph Heath, (2010), *Economics Without Illusions: Debunking Myths of Modern Capitalism*, (Random House)
- 7 See Nicholas Barr, (2001), *The Welfare State as Piggy Bank: Information, Risk, Uncertainty, and the Role of the State*, (Oxford University Press); Nicholas Barr, (2012), *The Economics of the Welfare State*, 5th edition, (Oxford University Press); and John Hills, (2015), *Good Times, Bad Times: The Welfare Myth of Them and Us*, (Policy Press)
- 8 Thomas Piketty, (2014), *Capital in the Twenty-First Century*, translated by Arthur Goldhammer, (Harvard University Press)
- 9 Bank of England (2012), *The Distributional Effects of Asset Purchases*, available online at: <http://www.bankofengland.co.uk/publications/Documents/news/2012/nr073.pdf>
- 10 See Martin O'Neill, (2007), "Death and Taxes: Social Justice and the Politics of Inheritance Tax," *Renewal: A Journal of Social Democracy*, 15 (4), 62-71, online here: <http://www.renewal.org.uk/articles/death-and-taxes>. See also Martin O'Neill and Thad Williamson, (2012a), "Philosophical Foundations for 'Good Capitalism'?", *Renewal: A Journal of Social Democracy*, 20 (1), 20-32, online here: <http://www.renewal.org.uk/articles/philosophical-foundations-for-good-capitalism>, and Prabhakar, Rajiv, Rowlingson, Karen, and White, Stuart, (2008), *How to Defend Inheritance Tax*, (Fabian Society), online at: <http://www.fabians.org.uk/wp-content/uploads/2012/04/HowtoDefendInheritanceTax.pdf>
- 11 See Horton, Tim and Reed, Howard, "Think Again, Nick!" Why Spending £17 Billion to Raise Tax Thresholds Would Not Help the Poorest, report for Left Foot Forward, online at: <http://www.leftfootforward.org/images/2010/03/Think-Again-Nick-FINAL.pdf>; and Hurrell, Alex, (2014), *Analysing the Impact of Increasing the Person Tax Allowance to £10,500 in 2015*, report for the Resolution Foundation, online at: <http://www.resolutionfoundation.org/publications/analysing-impact-increasing-personal-tax-allowance-10500-2015/>
- 12 See Jacobs, Michael, et al, (2000), *Paying for Progress: A New Politics of Tax for Public Spending, report of the Commission on Tax and Citizenship*, (Fabian Society), and Horton, Tim and Gregory, James, (2010), *The Solidarity Society*, (Fabian Society) online here: <http://www.fabians.org.uk/publications/the-solidarity-society/>
- 13 See O'Neill, Martin and Williamson, Thad, (2012b), "The Promise of Predistribution," Policy Network, online at: http://www.policy-network.net/pno_detail.aspx?ID=4262&title=The-promise-of-pre-distribution; and Ben Jackson and Martin O'Neill, (2013), "Interview: the Politics of Predistribution" (an interview with Jacob Hacker), *Renewal: a Journal of Social Democracy*, 21 (2/3), 54-64, online here: <http://www.renewal.org.uk/articles/interview-the-politics-of-predistribution>
- 14 See James Meade, (1964), *Efficiency, Equality and the Ownership of Property*, (George Allen & Unwin); Piketty, op. cit.; see also Martin O'Neill, (2012), "Free (and Fair) Markets without Capitalism: Political Values, Principles of Justice and Property-Owning Democracy," in Martin O'Neill and Thad Williamson, eds., *Property-Owning Democracy: Rawls and Beyond*, (Wiley-Blackwell); and O'Neill, Martin and Pearce, Nick, (2014), "Inequality and What to Do About It: An Interview with Thomas Piketty," *Renewal: A Journal of Social Democracy*, 22 (3-4), 101-115, online at: <http://www.renewal.org.uk/articles/interview-inequality-and-what-to-do-about-it>