The Flat Tax : debates in the mid-1990s

Standard Note: SN/BT/28
Last updated: 3 June 2005
Author: Antony Seely
Business & Transport Section

In essence the proposal for a "flat tax" is a simple one: that the income tax system should charge one marginal rate of tax on all income. Under the current tax system in this country, and many others, the rate of tax charged rises in a series of steps, in line with one's income. In 1996 the campaign of the American millionaire Steve Forbes to obtain the Republican presidential nomination focused on the case for a flat tax in the United States, and this encouraged debates in both America and the UK about the merits of flat taxes. This note looks at Mr Forbes' original proposal and some of the arguments that it raised at the time.

More recently debate on the merits of flat taxes has been rekindled by the introduction of flat taxes in a number of central and eastern European countries over the last few years, and the forthcoming report in summer 2005 of a panel established by President George Bush to consider reform of the US tax code. These developments are discussed in a second note.[1]

Contents

A. The Flat Tax in America

Proposals for radically simplifying the US tax code are not new, but the surprising electoral successes won in January 1996 by Mr Steve Forbes, during the very first stages of the American presidential elections, lead to a major debate about flat taxes. Indeed Mr Forbes' success was largely attributed to his proposal for a federal income tax charged at the single flat rate of 17%. Mr Forbes also proposed that this tax on personal incomes would be mirrored by a flat rate business tax, charged at source at the same 17% rate on all returns to capital, while investment income - interest, dividends and capital gains - would be tax-exempt. There were two important corollaries to this plan. First, the minimum threshold that all individuals and married couples would be entitled to receive would be substantial, to ensure those on lower incomes paid no income tax. Second, the range of exemptions and deductions taxpayers were entitled to would be substantially reduced, to simplify the procedure for completing a tax return. Those

[1] "The Flat Tax : recent debates", Library standard note SN/BT/3651, 3 June 2005

supporting this proposal often suggested that this would mean that American families would file an annual return no larger than a postcard.

Responding to concerns that such a radical tax cut would result in an explosion in Government debt, Mr Forbes argued that that this plan would spur economic growth and boost tax revenues, compensating for the cost of charging a single tax rate. First, a proportional, rather than progressive, tax system would give people more incentive to work harder, as they would get to keep a much larger proportion of the fruits of their labour. Second, the low rate of tax on business profits and the abolition of any tax on income derived from investment in business - dividends, interest, capital gains - would stimulate savings, shareholdings, and investment generally. Finally, the simplification of tax assessment would liberate both individuals and businesses from costly administration. In addition, the abolition of many key tax exemptions would widen the base of national income on which the flat tax was charged. This too would boost tax revenues. These arguments proved contentious: in particular, many critics were sceptical of the anticipated relationship between tax cuts and economic activity, while others felt that scrapping tax exemptions – notably for charitable donations and interest paid on a home mortgage – would be very unpopular.

The origin of the flat tax appears to have been a book written by two academics at Stanford University - Robert Hall and Alvin Rabushka, entitled - suitably enough - *The Flat Tax,* and re-published the year before Mr Forbes' campaign.[2] The premise of the book is that income should be taxed as close to its source as possible, and taxed only once. If the same tax rate is charged - irrespective of whether the return is made by an individual or a business - the scope for tax avoidance is minimised. When a business is taxed on its income, no deductions would be allowed for interest, dividends, rent or fringe benefits. Wages and salaries would be deductible, as tax is levied on these payments in the hands of individuals and families.

The book, and Mr Forbes' success in popularising its principal idea, encouraged other academics, journalists and politicians to make their own suggestions for radically reforming the US tax system: for example, a flatter income tax (fewer rates and fewer deductions), a federal sales tax (equivalent to VAT in this country), or tax deductions tied to one's level of saving (penalising the proportion of one's income one spent).[3] Naturally, the translation of economic theory into campaign rhetoric tended to blunt the subtleties of Hall and Rabushka's thesis.

In January 1996 the Kemp Commission, which had been set up by the then Senate majority leader Robert Dole and the then House Speaker Newt Gingrich, produced a report on federal tax reform that was strongly supportive of the flat tax ideal.[4] The Commission equivocated on the abolition of two of the largest and most popular tax exemptions - mortgage interest and charitable contributions. For some, this would rob the flat tax of its principal appeal - tax

[2] "The magic allure of flat taxes", *Financial Times*, 17 July 1995

[3] "The tax tussle … a consumer's guide to the leading proposals", *Washington Post*, 10 September 1995

[4] "Radical overhaul of US tax sought", *Financial Times*, 18 January 1996

neutrality - while making its successful implementation that much less likely (that is, without causing a catastrophic shortfall in tax revenues):

> If the aim is truly to make houses affordable, then a flat tax is a fairer route. It would raise the return on investments, increase the pool of capital and thus drive down interest rates ... Under the current system, the higher your income, the bigger your house, the deeper your debt - the more you benefit from the mortgage deduction ... Members of the Kemp Commission, sophisticated in tax matters, are aware that the mortgage deduction has no economic justification. Their report even has a section that properly lauds the principle of neutrality - the notion that a tax code's purpose is to raise revenue and leave people free to make their own decisions, not to direct them toward one kind of investment over another. The mortgage deduction, however, has encouraged Americans to over-invest in real estate and to under-invest in more dynamic business ventures that would create jobs and stimulate the economy ... The effect of the deduction is to raise the price of houses by about the same amount as the tax saving. Current homeowners, especially in high tax brackets, may indeed see the value of their real estate fall [if mortgage deduction was abolished], but the value of their other assets, like stocks and bonds, as well as their after-tax income, should rise.[5]

Other critics noted that Mr. Forbes and other flat tax proponents spent little time discussing the spending side of a tax cut equation. Unsurprisingly, a tax cut that comes at no cost was found to be hugely popular by opinion polls:

> The Hall and Rabushka 'bible' [as *The Flat Tax* has come to be called by its supporters] ... contradicts Forbes in some important areas ... The bible says that under its plan, which calls for a 19 percent tax after deducting $25,500 for a family of four, 'the flat tax is a little higher than the current income tax in the range from $30,000 to $90,000.' Oops. That would raise taxes on most of the middle class - hardly the way to get elected. So Forbes massaged the numbers. He boosted deductions to $36,800 for a family of four and used a 17 percent rate. Look Ma, no middle-class tax increase. Hall and Rabushka say their plan is revenue-neutral ... When I asked Forbes last week how his lower tax rate and bigger exemptions square with the bible, his answer was, 'Who says it has to be revenue-neutral?' He says his plan is a tax cut - how big, he doesn't say. How will we fill the gap? With economic growth and government spending cuts? Forbes isn't saying.[6]

Some suggested this was intentional: in the *Independent on Sunday* Hamish McRae argued the flat tax campaign had something of a hidden agenda to reduce the size of government; to buttress his case, Mr McRae cited a conversation he had had with Mr Forbes some time before:

> We were talking in New York about the Reagan tax-cutting plan. I had expressed my worry that it was irresponsible to cut taxes before the administration had any evidence it could also cut spending. "You don't understand," he replied. "They can't cut spending first because the whole political process does not allow them to do so. But if

---

[5] "The flat tax proposal - a boon for house owners", *Washington Post*, 16 January 1996

[6] "Forbes speaks from a flat tax Bible", *Washington Post*, 23 January 1996

you cut taxation, then you cut away revenue and that ultimately forces cuts in spending." In other words, the real motive behind those tax cuts was smaller government, not efficiency or fairness. If that is what the flat tax is about, it is a legitimate democratic choice if it is made clear. But that is not, in the main, what its supporters are saying. When the debate comes here, as it will, we need to be honest about it.[7]

Other critics argued that the principle on which the flat tax is based - that charging tax on savings income represents taxing income twice - was mistaken:

> It is often said that money saved, unlike money spent, is taxed twice: once when it is earned initially and again on the profit from saving it. That statement is mistaken. Two separate, economic decisions are involved: the decision to forgo leisure by working and the decision to forgo consumption by saving. All taxation discourages the activity being taxed. For any given level of desired tax revenue, though, reducing the burden on the decision to save means increasing the burden on the decision to work.[8]

At the time the Clinton Administration was rather critical of the proposal for a Flat Tax. Robert Rubin, then US Treasury Secretary, pointed out a number of serious drawbacks to this type of reform. First, under Mr Forbes' plan, no distinction was made between savings income and inherited wealth: both would be tax exempt. Many might want just inherited wealth to be taxed, though regulations to ensure this might well result in legislation more complex than the current system. Second, the empirical evidence on savings behaviour in the 1980s did not provide much support, if any, for the notion that Americans would save more if savings were taxed less. Finally, the complexity of the tax code did not actually affect the majority of Americans: over three in five of all taxpayers paid federal income tax at the lowest rate of 15%.[9] This last point was not lost on the more sceptical observers of Mr Forbes' campaign:[10]

7 "What's the catch with a flat-rate tax?", *Independent on Sunday*, 11 February 1996

8 "The flat tax society", *New Yorker*, 1 May 1995

9 "The high wire man", *Economist*, 3 February 1996

In one sense the success of Mr Forbes' big idea derived from the fact that it was three big ideas rolled into one: tax simplification, tax progressivity, and the general tax burden. Reducing the number of exemptions in the US tax code might well enable a reduction in the average rate of tax. Of course, that need not go hand in hand with abolishing higher marginal rates of tax on higher incomes. Indeed, it is the variety and scope of deductions that American taxpayers may make, rather the structure of marginal tax rates, which contributes to such a complex tax return. Similarly some commentators felt that the flat tax's principal virtue was that it held up the entire tax system for scrutiny, allowing taxpayers to re-examine the question of what taxes are **for**; thus Michael Prowse in the *Financial Times*:

> Should the government levy proportionately higher taxes on the wealthy than on middle and low income workers in order to achieve a 'fairer' overall distribution of income? ... In a market economy, income is generated by individuals. It reflects individual effort and talent. There is no obvious reason why the less talented and less industrious should have an automatic lien on the extra earnings of the more productive. And when they do - when extensive redistribution is regarded as a 'right' - an economy's growth prospects are usually impaired. And those whose envy and resentment of the wealthy motivates the policy of steeply rising tax rates are among the first to suffer. [11]

The flat tax debate might allow the concept of a fair tax system, and what fairness can be taken to be, to be addressed. For its part the *Economist* found this a convincing argument, although the paper's assumption that this could facilitate increased taxes for the middle classes was, perhaps, characteristically quixotic:

> In America, however, sensible discussion is at last beginning. This is because the quickening debate over tax reform is for once forcing people to ask the right question: what is 'fair'? Surely, a lot of people say, it is unfair for the poor to have to live radically differently from the rich. But set aside the usual arguments in favour of 'letting' people get richer; the case for redistributing income through the income tax has an even more devastating flaw. In practice, Robin Hood almost always robs from the rich and gives to the middle classes.
>
> This points to what is perhaps the flat tax's greatest advantage. It can be used to focus efforts to redistribute income precisely where they belong: on the poor. A flat tax that allowed an exemption for a big slice of wage income and levied a single tax rate on everything else would force all of society to pay for whatever level of public charity it deems appropriate. Envy of the rich could no longer masquerade as love of the poor. Moreover, after the exemption had allowed everyone to shelter a basic income, everyone who earned more than that would have to pay for government activities, regardless of their congressman's clout or their accountant's cleverness. To have such a tax system, the middle class must make a middling contribution - more than they do now - to government.[12]

---

[10] "Doonesbury", *Guardian*, 31 January 1996

[11] "Flat tax frenzy", *Financial Times*, 22 January 1996

[12] "America's tax revolution", *Economist*, 13 January 1996

Indeed there are many examples of the difficulty in abolishing tax reliefs once they have become established: one case around this time was the withdrawal of tax relief for discretionary share option schemes. The then Conservative Government first published proposals to do this on 17 July 1995. Opposition was such that plans to withdraw relief with immediate effect were amended three times in quick succession: first, by allowing those options already granted to continue to attract income tax relief (on 27 July); second, to extend relief to any new options granted up to a value of £20,000 (under the Company Share Option Plan (CSOP) scheme announced in the 1995 Budget speech on 28 November); and third, to augment the ceiling for CSOPs to £30,000 (on 23 January 1996). As the Institute for Fiscal Studies commented in October 1995 "the episode made it very clear quite how difficult it is to remove a tax privilege once it has been established, even though the need to give share option schemes a boost to their popularity had evidently passed."[13]

Nevertheless, for some, the American experience suggested tax reform was a viable option for other countries, the UK included; as Michael Prowse in the *Financial Times* "if the dream of an efficient, fair and comprehensible tax is ever to be realised, it will be in the US. And once America has shown the way, other nations will scramble to catch up, just as they did in the last wave of tax reform in the 1980s."[14]

B. The Flat Tax in the UK

In this country the debate about flat taxes was much less frenetic than in the United States. One reason was that income tax in the UK was a good deal 'flatter' than its American counterpart:

> Ironically, Britain is closer to Forbes's tax nirvana than America. 'Britain already has a flat tax with an exemption for the low-paid,' says John Kay, an economist with the consultancy London Economics. Even though there are three times as many higher-rate taxpayers as in 1979, only 5 per cent of taxpayers pay the top rate of 40 per cent. The lower rate of 20 per cent introduced by Kenneth Clarke in 1994 has complicated the tax structure, but the bulk of most people's income is taxed at the basic rate of 24 per cent. In addition, there are far fewer exemptions in Britain whose abolition could fund a significantly lower flat tax rate ...
>
> Making saving more attractive is one of Forbes's aims. Yet in Britain we do not have anything like the penalties to saving that they have in the USA. According to Andrew Dilnot, director of the Institute for Fiscal Studies: 'We are moving towards a tax rate of zero on savings.' Savings plans such as Tessas are tax-free and some forms of saving in Britain - pensions and housing - even get a subsidy ...
>
> [Moreover] it is because the British tax system is relatively simple and does not penalise saving that a flat tax has little attraction here. The other main argument against it is that it would most benefit the richest by delivering a big tax cut for those

---

13 IFS, *Options for 1996: the Green Budget*, October 1995 p.41
14 "The magic allure of flat taxes", *Financial Times*, 17 July 1995

> on high incomes. 'The only motivation for a flat tax in the UK is wanting to cut tax rates for those on high incomes,' says Mr Leape. That, of course, is precisely the aim of the British right. 'What remains contentious in Britain is whether there should be a higher rate,' says Barry Bracewell-Milne, tax expert for the Institute of Economic Affairs, a free-market think-tank. In America, he says, there is a tradition of hostility to progressive taxation. The notion that the tax system should be used to redistribute money from the well-off to the poor has little hold in the US. In Britain it still does. [15]

A second reason was that these debates about tax complexity coincided with the establishment of the Tax Law Rewrite project. In December 1995 the Inland Revenue published a report on tax simplification, which made the recommendation that most of the primary legislation on taxes collected by the Revenue should be rewritten in simpler, more user-friendly language.[16] In his November 1995 Budget speech the then Chancellor, Kenneth Clarke, announced a rewrite of tax legislation could begin sometime in 1996, once a number of practical issues had been addressed, including the most appropriate Parliamentary procedures for enacting rewritten legislation.[17] Since then the Project has delivered three rewrite Acts.[18] While it is true that the process is taking considerably more time than initially envisaged, and that there are criticisms that the law is being rewritten, rather than simplified, tax professionals have widely welcomed this reform.[19]

Finally, as in the United States, estimates of the costs in scrapping all higher rates of tax were quite breathtaking:[20]

> **Mr. David Shaw:** To ask the Chancellor of the Exchequer (1) if he will provide a range of estimates on how a flat rate income tax could operate in the United Kingdom; (2) what would be the estimated yield in a full year from a flat rate income tax if *(a)* the first (i) £7,000 and (ii) £10,000 of each taxpayers income was exempted from tax, *(b)* no tax allowances or deductions were allowed against income other then in *(a)* and *(c)* the income tax rates on the income above the levels in *(a)* were (1) 10 per cent., (2) 15 per cent. and (3) 20 per cent.
>
> **Mr. Jack:** Estimated full-year costs at 1996-97 income levels are given in the table. These estimates include the abolition of mortgage interest relief and tax relief on employees' contributions to occupational and personal pension schemes. Adjustments have also been made to allow for the abolition of reliefs for TESSAS, PEPS, profit-related pay, national savings certificates, employee share schemes and for charitable giving. The estimates do not take into account the substantial behavioural effects which might results from the introduction of such changes nor do they allow for any

---

15 "Want a 17% tax rate?", *Independent*, 2 February 1996

16 Inland Revenue, *The Path to Tax Simplification*, December 1995

17 HC Deb 28 November 1995 c 1066 & Inland Revenue press notice, *Simpler legislation for Inland Revenue taxes*, 28 November 1995

18 Full details of its work is given on the Rewrite Project's site: http://www.hmrc.gov.uk/rewrite/index.htm

19 Further background is given in, *Tax Law Rewrite: the Capital Allowances Bill*, Library Research paper 01/04 11 January 2001, and, "Tax Law Rewrite: the Income Tax (Trading and Other Income) Bill 2004-05", Library standard note SN/BT/3309, 3 March 2005.

20 HC Deb 7 February 1996 c 186W

subsequent changes to the tax system, such as changes to tax relief on employers' contributions to pension schemes or relief for investment income in pension funds. It is assumed that employers' and employees' national insurance contributions would remain as at present.

Estimates full-year costs at 1996-97 income levels (£ billion)

Income exempt from tax (£)	Flat rate of income tax 10 per cent.	15 per cent.	20 per cent.
£7,000	45	32	18
£10,000	51	40	29

In a second written answer it was estimated that a single rate of 23% would be revenue neutral, assuming a personal allowance of just £5,000, along with the abolition of all other income tax allowances, and the tax reliefs listed above.[21] Notably the estimate made no account of the substantial behaviour effects that might result from these changes.

What might these behavioural effects be? If one focuses first on the effects a flat rate tax may have at the individual - or micro - level, one way to tackle the question is to ask to what degree someone does something because of the tax relief connected with it. The abolition of all personal income tax reliefs would see the end of relief on employee pension contributions, relief on tax privileged savings vehicles, relief for charitable giving and for certain types of remuneration (such as employee share schemes) – along with other reliefs which have been abolished (for example, mortgage interest relief and profit related pay, which were both withdrawn during 2000).

Clearly, for some activities that attract income tax relief, the withdrawal of relief would not stop the activity in question. Abolishing tax relief on pension contributions would encourage some to use other forms of saving to provide a steady and secure income when they retired; say through the purchase of Government stock, or the use of high interest long term bank and building society accounts. Pensions themselves seem too important a part of everyone's financial planning for the loss of income tax relief to result in an end to the use of pension funds. The abolition of mortgage interest relief in April 2000 did not see a collapse in the housing market, although it may have meant that some buyers decided on smaller houses or rented a property instead of buying it.

There is a difference in degree with other reliefs – such as tax-privileged saving schemes, where the individual's decision to choose this particular form of saving seems primarily associated with the tax relief. The tax relief on charitable donations goes primarily to the charity concerned, not the taxpayer, and so it is not a personal financial incentive that underpins the donor's decision. Withdrawing relief might result in some donors wishing to make good their charity's loss, but it would seem inevitable that overall charities' income would fall significantly.

---

21 HC Deb 26 February 1996 cc 371-372W

In other areas the behavioural effects are more ambiguous. Tax relief on employee shares schemes, and – while it operated – profit related pay (PRP) work in a different fashion. Clearly employees would not simply stop work if either relief were withdrawn, though the value of each scheme for employee motivation and loyalty could well result in a fall in company productivity, affecting profits and wages in turn. Estimating this benefit is difficult, some would say impossible, and it makes the prediction of these 'second order' effects much harder.

The case is similar with the personal tax allowance, given to all taxpayers, which boosts take home pay and, in effect, increases the money value of someone's working time. It is hard to generalise about whether someone will work longer hours in this situation to maximise their pay, or work shorter hours, maintaining a constant income but enjoying more leisure. This question was debated at some length during the 1980s, when the Conservative Government cut both the number of tax rates and the level at which tax was charged: this is discussed in the following section of this note.

Similarly it is hard to generalise about individual decisions about whether to save income or spend it when the tax regime for saving is changed. Both sets of decisions will affect Government tax revenues - so the assumptions one makes about these types of behavioural responses are critical in making predictions at the national - or macro - level. In moving from the individual to the household, from one-off choices to a series of economic decisions, one is faced either with the complexities of econometrics, or the preferences of what one might call 'gut feeling'. Indeed this would apply to more general comments about the numbers of winners and losers from the introduction of a flat tax.

Nevertheless, the possibilities of introducing a flat tax in the UK were discussed during the Standing Committee debates on the Finance Bill in February 1996, when both David Shaw and Nigel Forman examined some of the advantages to such a tax.[22] Mr Forman suggested there were five factors all in favour of an income tax system with fewer rates, if not one single rate, and fewer allowances:

- greater simplicity in the tax code, especially desirable in the context of self assessment,
- improved efficiency in tax collection, by cutting Revenue costs and widening the tax base,
- an enhanced competitive position in attracting individuals to live and work in the UK,
- an enlarged constituency of support for public expenditure restraint given most people would be paying tax at a 'reasonable' average rate, and,
- reducing the potential for the tax system being used for 'social engineering'.

Mr Forman also made his case in an opinion piece published in the *Financial Times*:

> Mr Steve Forbes, the millionaire US publisher, may have pulled out of the race for the Republican presidential nomination. But his idea for a radical reform of the tax code

[22] SC Deb (E) 13 February 1996 cc 233-235, cc 241-247

and the introduction of a single rate of income tax is unlikely to go away. His programme would mean sweeping away all reliefs and tax breaks except for a generous personal allowance, and then levying US federal income tax at a single rate of 17 per cent. The idea was originally put forward by Robert Hall and Alvin Rabushka, two Stanford University academics, in a book entitled The Flat Tax. Since then it has been endorsed with varying degrees of enthusiasm by Bob Dole, the clear front-runner for the Republican nomination, Newt Gingrich, speaker of the House of Representatives, and even some leading Democrats. In the US, it appears to be an idea whose time has come.

There is an equally strong case for a flat-rate tax in the UK, even if the chancellor who introduced it insisted on being cautious with its initial effects on public borrowing. It would be possible to change to a flat-tax regime without reducing tax revenue by setting the rate at an initial 23 per cent and permitting an indexed-transferable allowance of £5,000 per person. All other expenditures, exemptions and reliefs allowable against income tax would be abolished. Most income taxpayers would gain something from such a move, even those who currently pay tax only at the 20 per cent rate. This is because the increase in their rate would be offset by the larger allowance. If tax relief on employers' contributions to pension schemes and on investment income in pension funds were also abolished, a further £8bn would become available with which to cut tax below 23 per cent without sacrificing revenue neutrality.

The first advantage of a flat-tax system would be much greater simplicity. At present, there are three income tax rates and at least 30 reliefs and exemptions. The planned introduction of income tax self-assessment in 1997 means a move to simplify the present system would be timely and helpful to individual taxpayers faced with having to make their own tax calculations. The second advantage would be greater efficiency and cost- effectiveness. A simplified income tax structure would result in lower Inland Revenue overheads and reduced private-sector compliance costs. There is, moreover, a high probability that more tax revenue could be raised from a flat-tax regime than from the present system, riddled as it is with tax shelters and economic distortions. This is because there would be less incentive than at present for relatively wealthy individuals to go legitimately to great lengths to avoid tax.

The third advantage would be the enhancement of the UK's competitive position in the global economy. With growing competition between different tax and regulatory jurisdictions, it is in the UK's interests to have a simple and attractive income tax system. The simpler the system, the more likely we are to attract and retain mobile and enterprising individuals who might otherwise decide to create wealth and jobs elsewhere. The fourth advantage would be a significant reduction in the opportunities for economic and social engineering by ministers, often at the behest of importunate interest groups. Such opportunities have been taken by chancellors of both main parties seeking, via mechanisms of tax relief, to encourage or reward various sectors of economic activity and forms of social behaviour.

It is widely recognised that such manipulation of the tax system has narrowed the tax base, created economically harmful distortions and led millions of people to make a range of decisions on the basis of how best to minimise the amount of tax they pay, rather than other more positive considerations. Moreover, as long as the personal allowance is pitched at a high enough level, lower income taxpayers would continue to enjoy a significantly lower average rate of tax than higher income taxpayers. A flat-tax regime organised along these lines would, in short, offer British taxpayers a fairer system of income tax in which greater attention was paid to the effective rate of tax rather than to marginal rates.

Proposals for a flat-tax rate would, nonetheless, be highly controversial in the UK. The scope of such a reform would, therefore, need to be bold and radical for politicians and the general public to be convinced that the game was worth the candle. To give it the necessary legitimacy, the idea ought to be put in the next Conservative general election manifesto. It could then be introduced in the first Budget of the new parliament.

The author is Conservative MP for Carshalton and Wallington and a member of the Commons Treasury committee.[23]

In the Standing Committee debate, the then Financial Secretary to the Treasury, Michael Jack, said his colleagues were "putting forward ideas that should be considered by anyone thinking about the future of taxation", but made a number of serious objections to a flat tax: the substantial cost involved; the abolition of several 'very popular' savings vehicles - such as PEPs; and, the fact that the UK tax code remained much 'flatter' than its American counterpart. Notably the Financial Secretary said, "I do not entirely share my hon. Friend's opinion that he would not want a tax system that could influence people's behaviour."[24] A neutral tax system which leaves the economy and the decisions of its participants unaffected by its existence may be some time in coming.

C. Tax rates and work incentives

The current income tax structure has its roots in a series of reforms in the late 1980s, which gave rise to a general debate about the incentive effects from cutting tax rates. It was Nigel Lawson's 1988 Budget which saw the basic rate of tax cut - by 2 pence in the pound - to 25 per cent, and the sliding scale of higher rates going up to 60 per cent replaced with the single higher rate of 40 per cent. The cut in the basic rate had been among the pledges given in the Conservative Party's 1987 election manifesto, and was not unexpected. The abolition of rates above 40 per cent was far more controversial. In his Budget speech, Mr Lawson set this change in an international context, where a number of other democracies had cut income tax rates: "The reason for the worldwide trend towards lower top rates is clear. Excessive rates of income tax destroy enterprise, encourage avoidance, and drive talent to more hospitable shores overseas. As a result, so far from raising additional revenue, over time they actually raise less."[25]

---

23 "Personal View: A radical reform that should not fall flat - there is now a strong case for the introduction of a single rate of income tax", *Financial Times*, March 19 1996

24 SC Deb (E) 13 February 1996 c 261

25 HC Deb 15 March 1988 c 1012

The then Chancellor's statement made some implicit assertions about individual incentives for work, leisure and tax avoidance, something Mr Lawson took up in his memoirs published four years later. Here, Mr Lawson suggests that by cutting the average tax rate paid by higher earners, tax avoidance becomes less profitable, and the creation of wealth becomes more lucrative. When taken together, these two trends boost not only the incomes of the higher paid but, through their enterprise, increase employment and wealth throughout the economy:

> So long as this approach is persevered with there is a virtuous circle to be had. Reducing or eliminating tax breaks provides increased revenue which can be used to bring down tax rates. Lower tax rates themselves reduce the value of tax breaks. So it is then a little easier to reduce the privileges that remain. This in turn releases more money to reduce tax rates.[26]

At the time, this was associated with the so-called "Laffer curve" proposition; namely, that a reduction in tax rates may - by providing better incentives to work, save, invest and take risks - increase tax receipts in the long run. Arthur Laffer was one of a number of American economists whose work came to prominence in the late 1970s, as conservative politicians in both America and the UK argued that "supply side" constraints on the economy had been ignored, in favour of "demand side" incentives, at considerable economic cost.

Clearly, if the entire profits of all economic activity were taxed, the economy would grind to a halt. From this position, any reduction in tax rates would see an immediate increase in tax revenues. Professor Laffer went on to make a more controversial proposal: that there existed a relatively simple relationship between tax rates and revenues, producing an optimal tax rate - somewhere between 100% and zero - which would maximise total tax revenues. If the current tax rate was higher than the optimal rate, then a programme of tax cuts would pay for itself. Unfortunately the theory said nothing about the complex ways in which reductions in tax rates may stimulate the economy, nor provide any means to tell what an economy's position on the curve is, and at what stage a programme of tax cuts should stop. Despite this, the Laffer curve had a startling rhetorical force - much as the flat tax - which undoubtedly contributed to its enthusiastic adoption by many in the early 1980s.

Nigel Lawson cites two incentive effects, both familiar from the Laffer curve theory, when discussing income tax in his memoirs. By cutting the average tax rate paid by higher earners, the creation of wealth becomes more lucrative, and, tax avoidance becomes less profitable. When taken together, these two trends boost not only the incomes of the higher paid but, through their enterprise, increase employment and wealth throughout the economy.[27] One could argue that only significant numbers of part-time workers, or individuals in specific professions, will be in a context where they can make marginal changes in the number of hours they work in response to changes in the tax system. This leaves open the question of whether these incentives would play a significant part in economic growth - say, compared to technological progress.

---

[26] Nigel Lawson, *The View from No.11*, 1992 p 815, pp 341-342

[27] *ibid.*

Around the time that these arguments came to prominence in the UK, a substantial study of labour supply patterns was published - perhaps the most significant finding of which was that only 19% of workers were found to have any choice in working more hours in their main job.[28] The study received some Treasury funding in the early 1980s, and when discussing it in his memoirs, Lord Lawson makes a slightly different argument for lower income tax rates:

> Since the bulk of the fieldwork had been done during the recession of 1981, when little overtime was indeed available, this 'finding' was hardly surprising, and seemed to me to prove nothing. In any event the case for low taxation is first and foremost a moral one. It is the case for enlarging individual freedom of choice and keeping to a necessary minimum the area where decisions are taken for people by the State. It is within that context that it makes obvious economic sense to have a system which does least damage to incentives and is least likely to drive the enterprising and the talented overseas.[29]

The academic who organised this work, Professor C.V. Brown, reviewed some of the other survey material on work incentives in an article, published by the Institute of Fiscal Studies in 1988, on whether Nigel Lawson's reforms would improve incentives or boost tax revenues.[30] The author concluded "there is little evidence that there will be any significant changes in short-run labour supply as a result of the increases in allowances or the cut in the basic rate of tax ... Evidence about the labour supply effects of higher rates of tax is weaker but most evidence suggests that the cuts in the higher rates of tax will not increase work incentives."

Less work has been done on whether the reductions made in tax rates did, in practice, boost tax revenues. In one econometric study published in 1988,[31] the authors found that their mathematical model could predict the overall changes in tax receipts during this period, without need to simulate any incentive effects in their equations. However, their model did not replicate the actual distribution of tax payments. The authors explained that "we underestimate the share of tax paid by the richest taxpayers. This is consistent with the existence of moderate incentive effects." However, "it is also consistent with other explanations which have little or no connection with incentive effects."[32] As a consequence, the authors felt that tax cuts in this period *could* have encouraged the richest taxpayers to earn more, though they could not prove this categorically. At best, any behavioural change had been "moderate."

Finally, in 1990 Professor Brown published a survey of responses to the 1988 tax cuts, based on interviews with 316 partners, principals and sole proprietors in accountancy firms.[33] No strong

---

28 C.V.Brown et al, *Taxation and Family Labour Supply in Great Britain*, 1986

29 Nigel Lawson, *The View from No.11*, 1992 pp 692-693

30 C.Brown, "Will the 1988 income tax cuts either increase work incentives or raise more revenue?", *Fiscal Studies*, November 1988

31 A.Dilnot & M.Kell, "Top-Rate Tax Cuts and Incentives ..." *Fiscal Studies*, November 1988

32 *op.cit.* pp 70-71

33 C.V.Brown & C.T.Sandford, *Taxes & Incentives: the effects of the 1988 cuts in the higher rates of income tax*, Institute for Public Policy Research 1990

evidence was found that the 1988 reductions in income tax rates had resulted in members of this group to increase their work load, nor that lower tax rates diminished the incidence of highly talented individuals emigrating - the so-called "brain drain" factor. However, the authors did find evidence that "cuts in the higher rates of tax will reduce avoidance and lead to a potentially important improvement in the quality of investment, and that the reductions could reduce evasion." Lower income tax rates had made costly tax avoidance schemes less profitable, and had made illegal tax evasion less attractive. However, this trend had also been encouraged by changes in other taxes; notably capital gains tax and employers' national insurance. That notd, the authors went on to say, "reductions in avoidance and evasion are important both because they reduce distortions in the economy and because such reductions will increase revenue."[34]

To conclude, though it is quite clear that a flatter income tax structure affects the incentives facing all taxpayers in their decisions regarding work, leisure and evading tax, on the basis of the UK's experience in the late 1980s, it is much harder to be certain these incentives operate in the same way, right across the income spectrum, or that the "virtuous circle" effects cited by some flat tax proponents are something to be relied upon.

[34] *op.cit.* p.19