FAIR AND SQUARE:

A Reasonable Approach to Splitting Bills and Taxing Wealth is Key to Sound Finance and Fair Taxes

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Given the existing pressures on government finances, and – after years of austerity – the public's distinct lack of appetite for further cuts to spending, recent promises to slash taxes will not survive contact with reality. Tax rises are inevitable over the coming decade, whoever is in power, and the key question is who will pay. Instead of reaching for familiar levers that fall on regular workers, there is another option.

Our research shows that substantial revenue can be raised from taxing the wealthy. If done properly, taxes on wealth are an effective tool against inequality and can be implemented without harming the economy. With good design, they can also be made very difficult to avoid, and so play a crucial role in ensuring that the richest pay their fair share.

The usual suspects

When looking for new revenue, politicians of all parties tend to reach for a tried-and-tested playbook: increase the main rates of one of the 'Big Three' taxes – Income Tax, National Insurance Contributions (NICs) or VAT.

Rishi Sunak's decision to increase the rate of NICs by 1.25% was just about the worst way to raise additional revenue. NICs taxes workers without taxing the wealthy, taxes the young more than the old, and drives an even bigger wedge between employees and the self-employed. Fiddling with rates does nothing to correct these flaws. And Sunak's rate rise also did nothing to address the 'quirk' that means the NICs rate actually falls by 10% for those with the highest earnings.

We have argued that there was a much better way to raise money from NICs, which would have corrected rather than exacerbated its current flaws. Instead of increasing the main rate, NICs should be applied to all sources of income rather than (as at present) only to the earnings of those below pension age. Pensions themselves would be exempt, on the basis that NICs have (usually) already been paid 'on the way in'. But under our proposal, investors and working pensioners would have to pay NICs in full, just like the rest of the working population.

Doing this would raise £12billion – the same amount that the Conservative Government chose instead to raise from regular workers. To raise another £20billion, the government could also remove the regressive 'cap' on contributions by the highest earners, which currently tops out at 3.25% above £50,000 even though workers on lower salaries pay 13.25%. Together, this would be £32billion that a progressively-minded government could raise as a direct alternative to existing policy on NICs.

The status quo isn't working

While many of the oddities listed above are particular to NICs, there is one aspect that applies more broadly across the tax system: work is taxed much more heavily than wealth. This has two effects on inequality.

First, it means that in practice the tax system is substantially less progressive than headline rates suggest even when NICs are factored in. Our research using confidential tax records has shown that in 2016, the average person with total remuneration of £10 million had an effective tax rate of just 21%: less than the rate that would be paid by someone on median earnings of £30,000.

Second, it creates unfairness even among people who have very high incomes. A quarter of those with total remuneration of £1 million paid the headline rate of around 47%, but one in ten paid a lower effective tax rate than someone earning just £15,000.

Much of this is driven by the lower rates of tax on wealth. This is particularly problematic because wealth has been growing much faster than income. Ownership of wealth, rather than access to high paying jobs, is therefore the key to financial success. Inheritances have become increasingly important, relative to earnings, in determining lifetime resources. This would be damaging for social mobility even if inheritances were taxed well, but the government's own advisors, the Office of Tax Simplification, have shown how the effective tax rate on estates actually declines with increasing wealth above £2 million, to just 10% for estates above £10 million.

Priorities for reform

So what should a new government do? After fixing NICs, there are three obvious reforms needed to taxes on wealth.

First, Capital Gains Tax (CGT) rates should be aligned with taxes on income, including NICs. Low rates for those who happen to be successful are not an effective way to incentivise investment. The ultra-low 10% rate for owner-managers – now renamed BAD Relief, which tells you everything you need to know – has been costly, poorly targeted, and encouraged excellent employees to set up as mediocre managers in order to benefit from the tax break. An equalised rate with an indexation-allowance that gives credit for capital actually put at risk would be much more effective. And any reform to CGT must end the nonsense that CGT bills are wiped out if someone can afford to hang on to the assets until their death. Making these reforms would raise a further £16billion.

Second, the major gaps in Inheritance Tax (IHT) must be plugged. This means scrapping or capping the reliefs that allow agricultural and business property to be passed on tax free. It also means scrapping the more 'middle class' benefit that allows untouched pension pots to be passed on, thereby encouraging people to save not for old age but as a tax-free route to make bequests. Removing these reliefs would increase the tax take from IHT by more than 60%, raising almost £4billion in additional revenue. Any reform should also extend the tax on large gifts beyond the current seven-year window, to remove early giving as a planning opportunity for the wealthiest.

Third, property tax in the UK needs reform. Council Tax is based on values that are more than thirty years out of date, and the rate structure is heavily regressive, so that someone in the lowest Council Tax band pays an average of 1.7% of the property value in tax each year, while someone in the highest band pays just 0.2% on average. Restructuring the tax to be 0.5% of property value would raise the same amount of money overall, but much more fairly.

This reform has more households directly affected than either CGT or IHT, which is presumably why no government has touched the issue for three decades. But with housing making up a third of UK wealth, and treated exceptionally in CGT and IHT, this is an issue that cannot be ignored. The Fairer Share campaign have made proposals for how a transition to this system could work.

Tackling top-end inequality

Extending NICs and reforming existing taxes on wealth are 'easy wins' that are straightforward to implement. But they are unlikely to dent the extreme inequality at the very top, because the very wealthiest can afford to hang on to assets, and borrow against them rather than selling them, thus not paying CGT.

For this reason, the Wealth Tax Commission recommended that an annual Wealth Tax would be justified on extreme wealth, if a government was aiming to reduce wealth inequality. A Wealth Tax of just over 1% on individual wealth above £10million would raise £10billion from the wealthiest 0.04% of the population. The small number of taxpayers makes the administrative costs of tractable (around £3million a year for government), allows the tax to be designed in a 'high quality' way that avoids unfairness in how different asset classes are treated, and eliminates concerns about taxing 'ordinary' savers.

A policy win-win-win

This issue [of Tribune] highlights a range of challenges for a future Labour administration, together with a suite of policy actions to tackle them. Whilst crucial, such actions don't come cheap. Fortunately, taxing wealth better can provide a solution to this dilemma. The reforms that we have proposed would bring in serious cash – around £60billion in total. They would also reduce wealth inequality, whilst improving economic efficiency at the same time; unusually in tax policymaking, there is actually no trade-off here. Finally, if implemented properly, our reformed taxes on wealth would be very difficult for the rich to avoid, helping to restore public trust in the wider tax system as well. What's not to like?

Further reading

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