Adam Smith Institute

B R I E F I N G

A Flat Tax for the UK – a Practical Reality

by Richard Teather[*]

Introduction

The concept of a "flat tax", a simple tax system that charges a single rate of tax on all income, is growing in popularity. It contrasts clearly with the current systems operated in most countries, with different tax rates depending on the level[1] and type[2] of income or on the personal circumstances[3] of the individual taxpayer.

Initially confined to academic discussion and a few small islands, the flat tax has recently been introduced in several of the ex-communist countries of central Europe, including new members of the European Union. Additionally, Poland has announced its intention to adopt a flat tax system. So far none of the 'old' EU nations has taken this step, although Ireland is introducing a flat tax for companies.

Introduction of flat tax:[4]

Country	Year	Rate
Jersey	1940	20%
Hong Kong	1947	16%
Guernsey	1960	20%
Estonia	1994	26%
Lithuania	1994	33%
Latvia	1995	25%
Russia	2001	13%
Serbia	2003	14%
Ukraine	2003	13%
Slovakia	2003	19%

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[1] In the UK we have a 10% starting rate of tax, a 22% basic rate and a 40% higher rate.

[2] The tax rates of 10%, 22% and 40% given above for the UK are replaced by 10%, 20% and 40% for investment income, except for dividends where they are 0%, 0% and 32.5%. Tax on capital gains is even more complicated, with 39 potential effective tax rates depending on the type of asset sold and how long it has been owned for.

[3] Such as the UK's additional allowances for the elderly, and for certain married couples.

[4] Data collected from Grecu, *Flat Tax – the British Case*, Adam Smith Institute, London, 2004.

The flat tax is therefore no longer a theoretical concept or one confined to specific 'tax havens'. It is on the UK's doorstep, and our competitors are enjoying a more benign tax climate than we are. Concern about tax, particularly amongst those starting their career, is rising; in a recent survey of 18-22 year olds the high levels of tax was their biggest worry, cited by 81% (above war, the environment and tuition fees). There is clearly therefore a real current concern, both with business and individuals, international and domestic, with the UK's tax system.

In the 1980s the UK led the way in tax reform; now the question is whether we can keep up or be left behind.

What is a flat tax?

The concept of a flat tax can be made to cover a wide range of different tax systems,[5] but the fundamental principle is that income should be taxed at a single rate of tax for all taxpayers.

In practice there are additional aspects that are common to most flat tax proposals, and flow from this basic principle:

> ***A low rate of tax***
> Theoretically we could calculate an average rate of tax under the current multi-rate system, and charge everyone this rate under the flat tax. However this would result in taxpayers (particularly the lower earners) paying more tax. In practice therefore most flat tax systems propose a single rate roughly the same as, or lower than, the existing standard rate. This means that no-one will pay more tax on the transition to a flat tax.
>
> ***Remove most tax allowances and deductions***
> One of the advantages of the flat rate is its simplicity, in that taxpayers and collectors only have to use one rate of tax in their calculations. This simplicity is commonly extended by removing most of the specific tax deductions within the existing system that try to give allowances for specific circumstances or incentives for particular activities. In part this removal of allowances is practical because once a single low flat rate is introduced they become less important.
>
> ***Greatly increased personal allowance***
> The personal allowance is the basic amount that each taxpayer is allowed to earn free of tax. Most flat tax proposals involve a significant increase in this amount, primarily to ensure that all low earners are better off under the flat tax system (in many cases by being taken out of the tax net altogether), even after abolishing many of the specific allowances.

This analysis will therefore assume that a flat tax for the UK will incorporate all of these aspects, specifically:

- a single flat rate of 22% (equal to the current basic rate tax);
- a personal allowance of £12,000, or at least in the range between the minimum wage (roughly £8,750[6]) and the average income (say £22,000[7]).

[5] Some of the US proposals (such as the Unlimited Savings Allowance system) are more complex, as they combine a flat tax with a proposal to switch from taxing income to effectively taxing consumption.
[6] Based on the 2005/6 proposed figure of £5.05 per hour, with a 7.5 hour working day and 230 working days per year.

Why a flat tax?

The advantages of a flat tax have been examined by many commentators,[8] but in summary the main reasons for adopting a flat tax are:

> ***Reduced compliance costs***
> A flat tax is much simpler, especially if combined with eliminating existing tax deductions. This reduces costs for the government revenue departments, and for taxpayers. In addition, most tax is currently collected by employers through the compulsory PAYE system; their administrative costs (and hence the costs of employment) will also be reduced.
>
> ***Reduced avoidance & evasion***
> A simpler tax system reduces the scope for legal tax avoidance, by removing many of the deductions, thresholds and anomalies on which most avoidance is based, and makes enforcement of taxes easier, reducing the possibility of illegal tax evasion. In addition replacing a system of higher rate taxes with a single, low, flat rate reduces the motivation for avoidance.[9]
>
> ***Reduced distortion***
> High tax rates combined with tax exemptions and deductions for particular activities cause economic distortions, with investment being made for tax purposes rather than to generate pre-tax profits.[10] This reduces economic performance and hence jobs. The effects can be alarming; one study calculated that raising one extra pound of tax would reduce the economy by two pounds in a system with high tax rates and many exemptions, but by only 20p in a flat-tax system.[11]
>
> ***Reduced disincentives***
> Income tax is a great disincentive to investment (which has to be profitable enough to cover the tax as well as to give a return for the investor), to business start-ups or expansion (with few exceptions the tax system is usually more willing to tax profits than to give relief for losses), and for employment.
>
> ***Reduces tax wedge***
> The cost of employing a worker (gross salary plus national insurance) can easily be twice what the worker actually receives. This difference is known as the 'tax wedge', and makes many jobs, particularly at the bottom of the employment ladder, uneconomic because the gross cost for the employer of providing a reasonable after-tax wage becomes more than the work is worth. This problem particularly damages the unemployed and low skilled, as it reduces job opportunities. The tax wedge, and the number of potential jobs that it destroys, would be reduced by the flat tax.

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[7] Average incomes are remarkably variable, depending on which average is taken. According to the National Statistics 2004 Annual Survey of Hours and Earnings, average earnings could range from £18,191 (median average, all workers) through £22,060 (median average, all full-time workers) to £26,989 (mean average, full-time workers) or even £30,131 (mean average, full-time male workers). However, whichever figure is taken the current personal allowance of £4,745 (2004/5) is grossly inadequate.

[8] For a recent general discussion of the economic damage caused by low taxes, see Congdon, "Limits on the Tax Burden", in *Towards a Liberal Utopia* (ed. Booth), iea, London, 2005.

[9] One of the reasons for Russia's adoption of the flat tax was its high level of avoidance under the earlier multi-rate system.

[10] Some of this is intentional activity by politicians in order to promote their favoured activities, some of it is accidental or unintended, however all is damaging as it distorts economic signals.

[11] Feldstein, *Tax Avoidance and the Deadweight Loss of the Income Tax*, National Bureau of Economic Research Working Papers 5055.

The cost of a flat tax

Obviously a flat tax will reduce the overall tax take, at least initially, unless it is set at the current average rate (in which case many taxpayers would pay more under the reforms than they do currently). Certainly raising the personal allowance significantly will also result in a substantial loss of tax revenue. But how much?

Most people assume that the cost would be prohibitive, sometimes because they have not examined the issue but often because the figures quoted by the Treasury or Inland Revenue for the cost of tax reforms only work within very narrow bands. For example the 'cost' to the Treasury of increasing the personal allowance by £100 is given as £630 million p.a.,[12] but each £100 increase takes some people out of the tax net altogether, and takes others out of the higher rate band, so the next £100 increase will cost less.

We have calculated the cost of the flat tax, from Inland Revenue figures, and the cost of a £10,000 increase in the personal allowance is significantly less than 100 times the cost of a £100 increase. The cost of abolishing higher rate tax is also much lower than many would expect. Our figures are maximums; with more detailed breakdowns in the data the true costs would definitely be less than this.

Depending on the level of personal allowance chosen, the total tax loss for various options is as follows:

Cost of flat tax
(Tax loss from having a single flat tax rate of 22%, with an increased personal allowance as shown)

New PA (£)	**Reduced tax revenues[13] p.a.**		
	Increasing PA	Abolishing HR tax[14]	**Total**
	£ million	£ million	**£ billion**
7,500	11,735	18,107	**29**
10,000	26,285	16,592	**42**
15,000	49,970	13,561	**63**
20,000	65,795	12,182	**78**

Derived from Inland Revenue data, 2004/5

Although the figures look large, to put them into perspective the tax loss from a flat tax with a personal allowance of £15,000 is roughly 6% of GDP. The Taxpayers' Alliance identified £81 billion of annual savings, enough to fund the full package with a £20,000 personal allowance; even the James Review identified nearly £35 billion of administrative savings.

[12] HM Treasury, "Tax Ready Reckoner and Tax Reliefs", London, December 2003, quoted in *The IFS Green Budget January 2004*, Institute for Fiscal Studies, London, 2004.

[13] Figures calculated using 2004/5 tax rates and allowances, and based on Inland Revenue statistical data Table 2.5 "Income tax liabilities, by income range, 2004-05"

[14] The cost of abolishing higher rate tax is lower for higher levels of personal allowance, because increasing the personal allowance takes people out of the higher rate band. Abolishing the higher rate tax on its own would initially reduce tax revenues by roughly £20 billion.

Wider effects

This is only the crude initial loss of tax revenues. The actual revenue loss would be lower, due to decreased tax avoidance. Also these revenue reductions should not result in an equal increase in public sector borrowing, as the greater incentives to work should reduce benefit payments.

In addition numerous studies show that reducing taxes causes the economy to grow faster than it would otherwise, resulting in increased wealth for the population and (in time) increased tax revenues. As an estimate, this increased economic growth means that tax revenues will recover in just over 3 years.[15]

Coupled with the reduced avoidance, reduced compliance and enforcement costs, and reduced levels of benefit take-up due to increased employment, these reforms should put the national economy in a much more secure position within the lifetime of one Parliament.

Indeed the 'payback' may be even faster; as discussed above,[16] most of the negative impact of taxes comes from the combination of high rates and exemptions. By removing these two most damaging aspects, the flat tax would be expected to have a much greater positive impact on the economy than a general tax cut.

Indeed this is what has happened in previous similar reforms. Past reforms in the UK and USA reduced the number and levels of higher rate tax bands (a flatter tax, if not a fully flat one), and very quickly more tax was collected from the rich; during the Thatcher governments in the 1980s, when the top rate of tax was cut progressively from 83% to 40%:

> "high–earning individuals ended up paying a higher percentage of the total revenue: the top 10 percent earners went from paying a 35% share of total revenues collected in 1979, to contributing 42% of total revenues in 1990"[17]

The same thing happened in the USA, during each of 3 major tax cuts; 1921-26 (top rate reduced from 63% to 25%); 1964 (top rate 91% to 70%); and 1981-84 (the Reagan tax cuts). As a result of the latter:

> "if you look at the bottom 50%, you'll find that they paid 8.3% *less* in tax in 1984 than they did in 1981. In contrast, the share for the top 5% of taxpayers increased; in 1981 they paid 35.3% of the total income tax collected, in 1984, they paid 38.9%."[18]

The country would also benefit by attracting more wealthy foreigners, both as private individuals and (more importantly) as company executives. These, by moving their spending and business to the UK, create wealth and jobs (and pay taxes) that would otherwise not have come here.

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[15] Based on a reduction in taxes of 1% of GDP causing an increase in trend GDP growth of 0.3%. This is the mid-point of the studies reviewed in "The negative impact of taxation on economic growth", Leach, Reform (London), September 2003.
[16] See Feldstein, *Tax Avoidance and the Deadweight Loss of the Income Tax*, National Bureau of Economic Research Working Papers 5055.
[17] Grecu, *Flat Tax – The British Case*, Adam Smith Institute, London, 2004
[18] *It Pays to Cut Taxes*, Adam Smith Institute, London, 1986

Who benefits?

Are these benefits just for the rich? Certainly not. Some of the tax reductions are targeted at lower earners; for example, all benefit from the increase in the personal allowance, and this benefits the poor (roughly 10 million of whom could have their whole income tax bill cancelled) proportionally more than the rich.

The effects of these tax reductions on those with the lowest incomes are remarkable:

Effect of current income tax system, compared with flat tax of 22% with £12,000 personal allowance

Families:	Average income (£)	Current income tax (% income)	Flat tax (% income)	Saving (% income)
Poorest 10%	2,549	9.2	0	9.2
2nd	4,280	7.9	0	7.9
3rd	6,811	9.8	0	9.8
4th	11,464	12.1	0	12.1
5th	16,792	11.9	6.0	5.6
6th	21,696	12.8	9.8	3.0
7th	28,427	14.0	12.7	1.3
8th	35,571	14.9	14.6	0.3
9th	44,981	16.3	16.1	0.2
Richest 10%	79,187	20.1	18.7	1.4

Figures derived from National Statistics data[19]

As can be seen, the greatest savings (of around 12% of their income) are for those with incomes just below the average. The poorest third still benefit more than the richest third.

- Currently the poorest third of families pay over 9% of their income in income tax;
  under the flat tax they will pay nothing.

- Families on below-average incomes[20] pay 12% of their income in income tax;
  under the flat tax they will pay less than half of that.

In all, a flat tax with a personal allowance of £12,000 would remove around 10 million current taxpayers from the income tax net.

But surely the rich will benefit even more? It may be counterintuitive, but in fact (as discussed above) when higher-rate taxes are reduced the rich end up paying a *greater* share of the total tax bill, partly due to the incentive effects of abolishing the higher rate but also through reduced (legal) avoidance and (illegal) evasion.

[19] TABLE 14 (Appendix 1): Average incomes, taxes and benefits by decile groups of ALL households, 2001-02. Calculations for the flat tax proposal performed on average income for decile and assume single-earner households; dual earner households will show greater savings from the flat tax, due to the availability of two increased personal allowances.

[20] 4th & 5th deciles combined

Low, simple taxes help the poor, more than benefits

The best long-term help and security for the poor is for them to get well-paid jobs in a growing economy. Keeping millions on benefits only really helps those politicians who want to keep their voters dependent.

The flat tax will remove around 10 million taxpayers from the income tax net,[21] removing the tax disincentive to finding work. This will remove the current barriers to finding jobs, and reward effort, without the cost and distortions of the current 'tax credits' and means-tested benefit regimes. It will also serve a social benefit of increasing net income for the low paid, who proportionately benefit most from the flat tax proposal.

Even more importantly, the flat tax will take the brakes off the economy and allow the creation of many more jobs. As discussed above, the current tax system is full of disincentives to the creation of new businesses and the expansion of existing ones, to effort and risk-taking.

Furthermore, the UK can no longer isolate itself from the global economy; low taxes on business will improve the UK's international competitiveness and attract foreign investment, as has been done successfully by Ireland and many Central European countries. In a generation Ireland has gone from a poor, agricultural economy with high emigration to a rich, technologically advanced "Celtic Tiger". Thanks to its low taxes, Ireland now has the fourth highest effective GDP per head of the industrialised world: 11% higher than the UK.

This is not about "making the rich richer and the poor poorer"; low taxes stimulate investment, make businesses more productive, and so boost jobs, pulling people out of poverty. The low-paid in work also benefit, for as more jobs are created and the demand for workers goes up, wages will rise.

Removing tax deductions

Part of the flat tax proposal should be the abolition of various existing tax allowances, both to recoup some of the revenue loss and (most importantly) to reduce complexities and eliminate distortions.

The main (non-business) allowances, and the amount by which they reduce the tax take, are given below.[22] These do not include the tax reliefs given to charities (roughly £1 billion), personal pensions (roughly £13 billion, reform of which would need to be discussed in the wider context of pensions reform) and owner-occupied housing (£12 billion, and politically difficult to change[23]).

With the personal allowance raised to £12,000, all of these reliefs could be abolished and still leave everyone paying less (or at least no more) tax.

[21] Based on a personal allowance of £12,000; a higher allowance will remove more families from paying income tax.
[22] There will be some overlap between the cost of abolishing these reliefs and the cost of increasing the personal allowance and scrapping the higher rate; abolishing these reliefs along with implementing the flat tax may not therefore save the full current cost of the reliefs.
[23] See Sunday Times, 13th March 2005.

Current cost of main tax reliefs:[24]

	£ million	£ million
Main reliefs		
Personal savings (e.g. ISAs)		2,220
Employee share schemes		450
Age-related allowances		2,100
Tax-exempting certain state benefits		2,885
Capital gains tax taper relief & indexation		2,300
Minor reliefs		
Professional subscriptions	70	
Rent-a-room	90	
Termination payments	800	
Crown servants abroad	90	
Relocation packages	300	
Business tax credits for Research & Development	450	
Contaminated Land	80	
Substantial shareholding exemption for companies	260	
Blind person's allowance	10	
Profits averaging for farmers & creative artists	15	
Shipping reliefs	45	
Total minor reliefs		2,210
		12,165

Conclusions

A flat rate tax of 22%, with a tax-free personal allowance of £12,000, is possible. The initial loss of government revenue would be roughly £50 billion per year, under 5% of GDP. When you take into account the potential £12 billion of savings from abolishing minor tax reliefs, this comes to roughly the £35 billion of administrative waste identified by the James Review. Even the £20,000 personal allowance is affordable if the £81 billion of savings identified by the Taxpayers' Alliance could be realised.

These reforms are achievable. All taxpayers would be better off under the reform. Those on low incomes would benefit most; roughly 10 million taxpayers would be taken out of the tax net, ending the ridiculous situation of those on the minimum wage paying tax.

This is not a tax break for the rich; those on below-average earnings would see their after-tax income increase by over 12%, while the average benefit for the top third of earners is barely 0.5%.

The effect on the economy would be enormous; studies show that the aspects of the tax system that the flat tax would remove, namely high rates and exemptions, are precisely those that cause most economic damage. The resultant increase in economic activity, and reduction in distortions, would create jobs and so benefit current non-taxpayers as well.

Although not covered by this report, a flat tax should preferably tax companies at the same rate, and should certainly remove the current potential double taxation of dividends. This would remove the current scope for tax avoidance caused by the different tax treatments of companies and individuals, and ensure that all income was taxed once and once only.

[24] Based on Inland Revenue statistics, Table 1.5, "Tax expenditures and structural reliefs", 2004-05.