How big a state do we want?

A future strategy to end child poverty will need to be honest about the size and role of the state, and how the necessary investments can be funded. Drawing on CPAG's latest book, *Let's Talk About Tax*, Tom Lee **puts the size of the UK state in international context and considers a range of options for increasing tax revenues in a progressive fashion.**

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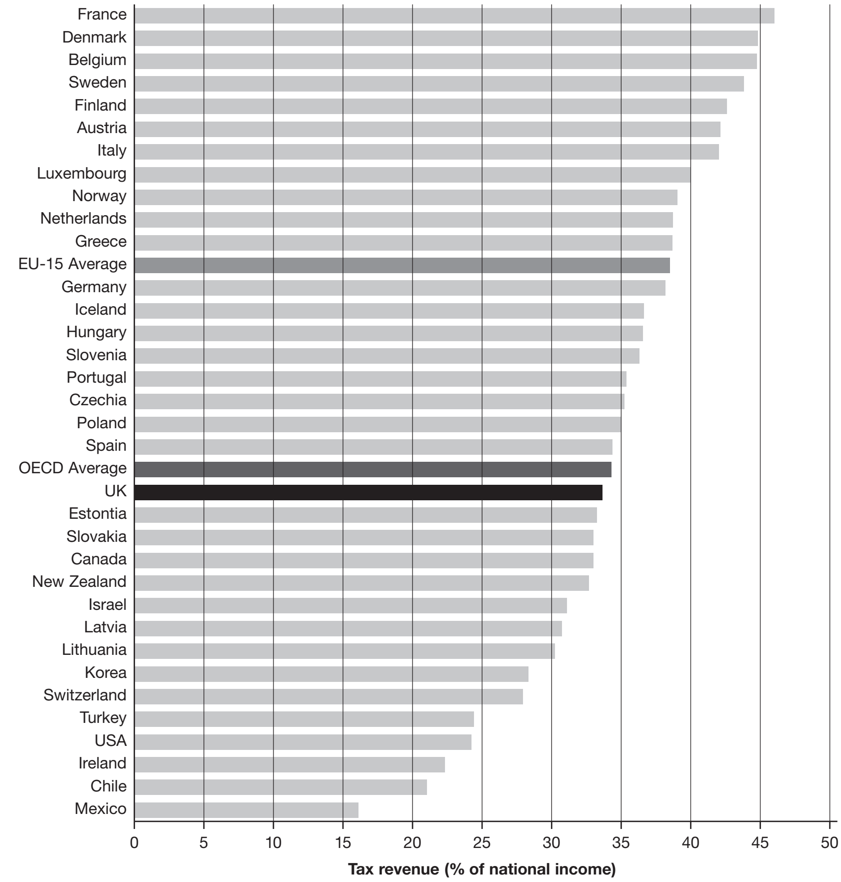
THE recent UK election saw the Conservatives and Labour present radically different manifestos on the role of the state. Labour was planning to substantially raise taxation in order to fund a rise in expenditure, while the Conservatives were proposing more of the status quo. So what scope is there to increase the size of the state in the UK? And, what options are there to increase existing taxes or introduce new ones?

The best way to measure the size of the state is to look at tax revenue as a percentage of national income. Figure 1 shows that, in 2018, the UK raised 33.5 per cent of national income in taxation. This is below the OECD average of 34.3 per cent and substantially less than the European Union average of 38.5 per cent. If the UK raised an additional £100 billion in tax, it would still have a lower level of taxation than the Netherlands, and an additional £250 billion would make it still less than Denmark. This shows that there is definitely scope to increase the size of the state in the UK.

However, this is does not answer the question of what options the UK has to raise taxes. The rest of the article examines the principles of taxation, how the UK currently raises taxes and the options for increasing current taxes or introducing new ones.

Figure 1: **Tax revenue as a percentage of national income across OECD countries, 2018**



Source: OECD Tax Revenue https://data.oecd.org/tax/tax-revenue.htm, data extracted on 23 December 2019. The EU-15 average is the author's own calculation.

Principles of taxation

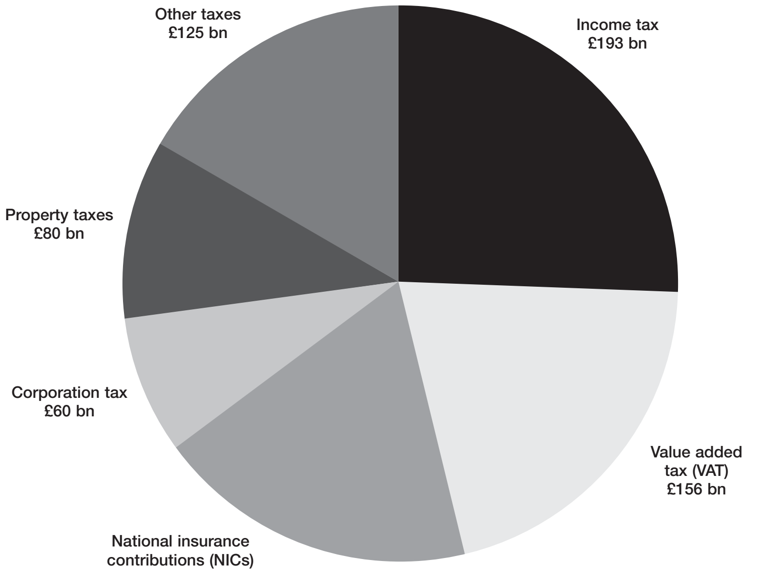
First, it is important to think about wider philosophical considerations about who/what should be taxed. Most people agree that the tax system should be progressive, but the degree of desired progressivity is likely to depend on what is deemed 'fair'. It is important to think about factors such as earned/unearned income, luck and ownership when designing a tax system.[1]

Second, incentives are key to the design of any tax system. Anticipating how economic agents might respond to a change in a particular tax is vital. This is likely to be impossible to predict exactly, but careful empirical analysis of reforms in similar settings can improve our understanding of the knock-on effect of different taxes.

Third, it is important to think carefully about how taxes affect markets. Many markets do not lead to desirable outcomes due to externalities (a consequence of an industrial or commercial activity which affects other parties without this being reflected in market prices – for example, pollution). In this case, taxes can correct for ‘market failure’, leading to more efficient outcomes. On the other hand, some taxes can add distortions across markets, which can lead to over- or under-consumption of certain goods. For instance, having a reduced VAT rate for domestic fuel means that households may overheat their homes, while consuming fewer goods subject to the standard 20 per cent rate, compared with a world in which all goods are taxed at the same rate.

Fourth, we need to consider the overall tax-benefits system. It is widely accepted that the tax system as a whole should be progressive, but this does not mean that every individual tax needs to be progressive. It may be desirable to introduce a regressive tax, for example, a standard VAT rate for domestic fuel, and then make another part of the system more progressive to ensure that poorer households do not lose out.

Figure 2: **Sources of tax revenue, 2019/20**



Source: HM Treasury, Budget 2018, 2018

Taxation in the UK and options for reform

Figure 2 shows how taxes are currently raised in the UK: £193 billion is raised through income tax; £156 billion from VAT; £142 billion from national insurance contributions; and £60 billion comes from corporation tax. Property taxes, including council tax, stamp duty and business rates, raise £80 billion, while £125 billion comes from other smaller taxes.[2]

It is hard to compare precisely across countries, but tax composition in the UK is fairly similar to that in other developed countries.[3] The amounts raised from income tax, VAT, other indirect taxes and corporation tax are similar to the OECD average. The one area in which the UK raises substantially less is social security contributions (in the case of the UK, national insurance contributions) – raising only 6.3 per cent of national income. The average amount raised among OECD countries is 9.7 per cent of national income, while the average across EU-15 countries is 11.5 per cent. The UK raises more in property taxes than most other countries.

When considering the options for reforming existing taxes or introducing new ones, it is important not to think about taxes in isolation. Different tax rates can systematically change people’s behaviour. For instance, income tax and corporation tax may seem to many people like taxes in two distinct areas of the economy, but the relationship between the two influences behaviour. The current tax system in the UK has a much lower rate of corporation tax than income tax. As a result, someone generating £100,000 of value as an employee would pay £40,000 in tax, while someone providing similar services through a one-person company and taking advantage of entrepreneurs’ relief may pay only £22,000.[4] This has led to a massive increase in the number of company-owner managers over time.[5]

There are a variety of options for reforming income taxation to raise more revenue. These include increasing the rates (basic, higher and additional), changing the threshold of the personal tax allowance (or removing it entirely) and restricting relief on pension contributions.

The higher and additional rates have received a lot of attention in recent years. Proponents of a more progressive tax system have focused on increasing the rates as a way of obtaining more revenue from richer households, while critics have claimed that this would be an inefficient way to raise money. It is difficult to know exactly how much would be raised, but the best estimates suggest that increasing the higher rate from 40 per cent to 41 per cent would raise £1.2 billion, while increasing the additional rate from 45 per cent to 46 per cent would only raise an estimated £0.2 billion.[6] There are two key reasons why not much additional revenue would be raised. First, not many people are in these tax bands. Second, it is highly likely that people will change their behaviour, resulting in less revenue raised. This could happen either through people working less or shifting income into other sources. Becoming self-employed, a company owner-manager or increasing pension contributions, for example, would all lead to substantially less tax being paid. Restricting relief on pension contributions to the basic rate would raise an estimated £10.8 billion, substantially more than increasing the higher rate of income tax.

Another area that has been subject to policy reform is the personal tax allowance. Over the past decade the personal tax allowance has nearly doubled (in nominal terms), leading to richer households paying thousands of pounds less in tax. Reducing the personal tax allowance by £1,000 would increase revenue by £8.5 billion, and scrapping it entirely would increase revenue by £107 billion, a substantial amount of money.[7] However, it is important to think about the effect on incentives of scrapping the personal tax allowance. In the current benefits system, work incentives are not great for people at the bottom of the income distribution – for every £1 earned, 63p of universal credit is withdrawn (above a small work allowance). Scrapping the personal tax allowance would mean that as well as 63p of benefits being withdrawn, 20p of every £1 would be paid in income tax. This would add a further disincentive to work to an already high effective marginal tax rate.

The UK raises substantially less from social security contributions than other developed economies. Employer social security contributions, in particular, are much lower than in other European countries. However, the UK does not have to have copy the tax composition of other countries. Denmark, for instance, also raises very little through social security contributions, instead raising the majority of its revenue through income taxation.[8]

There are various options for raising more revenue through social security contributions. Increasing the employer rate by one percentage point across all categories would raise £2.8 billion. Other options include raising the upper earnings limit to £100,000 a year (£6.6 billion), raising the main employee and self-employed rate by one percentage point (£4.3 billion), or applying a one per cent rate to private pension income (£0.6 billion).

It is perhaps worth having a bigger discussion about the role of contributory benefits. In many other countries, social security contributions function more like a public insurance scheme. This means that paying higher contributions entitles people to much more generous benefits in times of need, such as unemployment benefit. In the UK, this link has been eroded over time.

The UK raises about an average amount of tax revenue from VAT, although it has a relatively large number of reduced rates and exemptions for particular goods and services. The justification behind many of these is that poorer households spend a higher proportion of their income on necessities and are therefore disproportionately hit by the tax. However, the reduced rates and exemptions also mean that some goods are relatively more expensive/cheaper than others and a substantial amount of tax revenue is lost. Removing all zero and reduced rates of VAT would raise £53 billion, which could be given back to poorer households through higher benefits. Increasing the main rate from 20 to 21 per cent would raise £6.2 billion.

Corporation tax has been cut considerably over the past 40 years. In 2019, the main rate of corporation tax was 19 per cent, substantially lower than the 52 per cent seen in the 1970s. A key reason for this is the competition between countries to attract international companies to register in their jurisdiction. Raising corporation tax from 19 per cent to 20 per cent would raise about £2.7 billion.

Proponents of a higher rate of corporation tax often claim that corporation tax is highly progressive as it only has an impact on rich shareholders. However, it is important to think about how companies will respond to a higher tax rate and therefore who, ultimately, will bear the incidence of the tax. Broadly speaking, there are three groups: shareholders, workers and consumers. A company could respond to a rise in corporation tax by paying its shareholders less in dividends, paying its workers less, or increasing the prices of the goods it sells. The empirical evidence on the issue is mixed, but the consensus view is that workers face about half the incidence of any tax increase (through reduced wages or lay-offs).

The UK raises more revenue from property taxes than other advanced economies. However, property taxes in the UK are not well designed. Council tax is not based on the current values of

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properties, but rather (except in Wales) valuations from more than 25 years ago. In addition, the tax is regressive as the more expensive the property, the lower share of the value paid in tax. Stamp duty, a tax levied on transactions above a certain threshold in the housing market, means people are less willing to move house as they have to pay an additional cost to do so. It may make sense to raise additional revenue through property taxes, but it would be better to do this through a progressive tax levied on the current value of all properties, not just on those being bought.

Another option for property taxation is a more full-blown wealth tax. Wealth taxation is becomingly increasingly *en vogue* as inequality has become more of a topical issue. Since the mid-1970s, total private wealth in the UK has risen from around 250 per cent of national income to nearly 700 per cent of national income.[9] Yet, over the same period, revenue from taxes on wealth has remained fairly constant at around two per cent of national income.

Some taxes are more progressive than others, but it is important to note that it will be difficult to increase the size of the state by only making the rich pay more

Proponents of a wealth tax argue that a small tax on wealth could raise a large amount of revenue and target the rich without distorting economic activity too much. It could also be 'fairer' in the sense that it would be taxing total income (unearned plus earned), whereas income tax is only on earned income. Critics claim that 'capital flight' and tax evasion mean that the costs are too high. A lack of previous examples means that it is hard to estimate accurately how much tax will be raised. Many European countries have scrapped wealth taxes in the past 20 years (and a variety of loopholes has meant that they were not particularly effective ways of raising taxes).

Another option is to raise more revenue from profits made from the sale of assets, as opposed to a full-blown tax on all assets. The main tax of this type in the UK is capital gains tax, which raised an estimated £9.3 billion in 2018/19.[10] The rate of capital gains tax depends on the type of asset being sold and the income of the household, but for all households and assets the rate is less than the income tax rate. This creates the incentive to shift income so that less is paid in income tax and more is paid in capital gains tax. Estimates indicate that, as well as stopping people carrying out the economically useless activity of shifting income, taxing capital gains at the same rate as income tax would raise about £10 billion.[11]

One tax which has fallen out of fashion in recent years, despite there being a strong economic justification for it, is a carbon tax. Free markets do not lead to desirable outcomes as firms do not pay the true cost of their damage to the environment. In recent years, emission trading schemes have been introduced in an attempt to make firms pay the true cost of their production. However, design flaws (for example, giving out too many permits, exempting too many industries) have meant that they have had limited effectiveness. A well designed carbon tax or emission trading scheme could result in firms paying for the cost of their pollution, reduce emissions and raise a substantial amount of revenue.

There is no blueprint for how taxes should be raised or what the optimal amount of taxation is. These questions ultimately depend on preferences about what the government should provide, the desired level of redistribution and wider philosophical views on fairness. However, there is definitely scope to raise taxes in the UK. The UK raises a smaller share of GDP in tax than many advanced economies, largely due to raising substantially less from social security contributions. There are a variety of options to increase taxes in these areas, as well as more radical options such as a wealth or carbon tax. Some taxes are more progressive than others, but it is important to note that it will be difficult to increase the size of the state by only making the rich pay more. Every country that raises substantially more in taxation than the UK does so through higher taxes across the income distribution.[12] ■

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Let's Talk About Tax: how the tax system works and how to change it, edited by Jonathan Bradshaw, is available to buy from cpag.org.uk/shop.

[1] See L Murphy and T Nagel, *The Myth of Ownership: taxes and justice*, Oxford University Press, 2002, for greater discussion of these philosophical issues.

[2] For more detailed explanations of different taxes, see J Bradshaw (ed), *Let's Talk About Tax: how the tax system works and how to change it*, CPAG, 2019

[3] M Conte, H Miller and T Pope, *How Do Other Countries Raise More in Tax Than the UK?*, Institute for Fiscal Studies, 2019

[4] A Corlett, *The Shifting Shape of UK Tax*, Resolution Foundation, 2019, Figure 25

[5] J Cribb, H Miller and T Pope, *Who Are Business Owners and What Are They Doing?*, Institute for Fiscal Studies, 2019

[6] All tax revenue estimates, unless otherwise stated, come from S Adam and T Waters, 'Options for raising taxes', in C Emmerson, C Farquharson and P Johnson (eds), *The IFS Green Budget: October 2018*, Institute for Fiscal Studies, 2018, Table 5.3

[7] S Arnold and A Stirling, *Nothing Personal: replacing the personal tax allowance with a weekly national allowance*, New Economics Foundation, 2019

[8] Denmark, OECD

[9] A Corlett and L Gardiner, *Home Affairs: options for reforming property taxation*, Resolution Foundation, 2018, p15, Figure 1

[10] https://obr.uk/forecasts-in-depth/tax-by-tax-spend-by-spend/capital-gains-tax/

[11] S Nanda and H Parkes, *Just Tax: reforming the taxation of income from wealth and work*, Institute for Public Policy Research, 2019

[12] M Conte, H Miller and T Pope, *How Do Other Countries Raise More in Tax Than the UK?*, Institute for Fiscal Studies, 2019