Tax and the coalition:
fairness and responsibility?

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Executive summary

The coalition is founded on ‘freedom, fairness and responsibility’.

Tax policy has to reconcile these sometimes conflicting aims. This paper looks at how Liberal Democrat policies on tax can, during this parliament, help realise the coalition’s aims of fairness and responsibility, whilst recognising the important liberal value of personal freedom.

The tax system has to be seen against the backdrop of a society which has over recent years become more unequal both in terms of income and wealth. The coalition has responded by seeking to make the fiscal consolidation as progressive as possible. The increases in the income tax threshold and in the top rate of capital gains tax are positive steps, but the changes in VAT and benefits move in the opposite direction. Overall, there is a perception that, as far as the most affluent are concerned, they are not ‘all in this together’.

This colours the discussion on whether or not to retain the 50p tax rate. The Liberal Democrats dropped their support for such a policy just before the fiscal crisis began on the grounds that it could, in the longer term, constrain growth. The 50p rate can however be justified as a crisis measure, and at a time when the crisis is still unresolved and when benefits are being cut and public sector pensions frozen or cut, it would be economically and politically a mistake to drop it now. The government should do so when the finances are stronger and it has other measures in place which tax the wealthy.

Such measures should include a mansion tax for properties valued at over £2 million, the restriction of tax relief on all pension contributions to the basic rate of income tax and an increase in capital gains tax to the marginal rate of income tax. It should also extend the period during which gifts are taxable from seven years before death to 15 years, to reflect increasing life expectancies.

The coalition must also crack down on tax evasion and avoidance by restricting the benefits of non-dom status to seven years' residence, closing the loophole under which higher value property transactions can avoid stamp duty by properties being placed in companies and introducing a General Anti-Avoidance Rule. Having clamped down on avoidance, it must then ensure that HMRC is incentivised to increase revenue collection by being allowed to reinvest a proportion of tax reclaimed beyond a target figure.

The government should also move now towards a land value basis for local business rates.

On environmental taxes, the government should move to a plane-based air passenger duty and change the banding of the duty to avoid penalising flights to the Caribbean.

Policies to promote growth are currently a top priority and so, as far as tax and growth is concerned, the government should extend the current national insurance holiday for new firms in the regions north and west of London and the South East to include existing small firms, and introduce a lower rate of VAT for repairs and refurbishments.

Other longer terms reforms to the tax system, including environmental and land taxes, will be the subject of a subsequent paper.

Introduction

"Freedom, fairness and responsibility" is the title of the coalition agreement. Its echoes of the 'liberty, equality and fraternity' of the French Revolution are perhaps coincidental, but it encapsulates the age old political challenge of marrying personal freedom with the broader responsibilities of all citizens towards the creation of a civilised society.

Nowhere is this tension felt more keenly than on tax policy. The freedom to earn as much as you can, and spend as much as you wish, has to be tempered with the need by the state to take some of these earnings and redirect them towards public goods and supporting the poor and vulnerable via welfare payments. The extent to which this process is fair, or helps create a fairer society, is the subject of perpetual debate. And one's view of fairness is very often closely correlated with where one sits on the income scale. Not surprisingly we often think it would be fairer if other people bore more of the tax strain than we do.

The coalition agreement doesn't say very much about tax, other than that the bulk of the burden for reducing the fiscal deficit would be met by reduced spending rather than higher taxes and that the government would stop the proposed rise in national insurance contributions. In reality, coalition action on tax has been dominated by the commitment to the phased raising of the income tax threshold over this parliament to £10,000 (partially funded by a modest increase in capital gains tax) - a Liberal Democrat policy – and the increased rate of VAT to 20%.

The government's deficit reduction policy has given it clear financial credibility, whilst containing significant areas of flexibility to deal with lower than anticipated growth. This paper does not seek to unpick the government's tax policy. Instead, it looks at how Liberal Democrat policies on tax can help realise the coalition's aims of fairness and responsibility during the lifetime of this parliament, whilst recognising the core liberal value of personal freedom.

It does not therefore purport to be a blueprint for an ideal tax system. Given the complexities and absurdities of the current tax system, such a blueprint could only be implemented over several parliaments. I intend, however, with Stephen Williams MP, my fellow co-chair of the Liberal Democrat parliamentary Treasury Policy Committee, to produce some ideas about what an overall Liberal Democrat tax system for the future might look like later this year.

How fair are we?

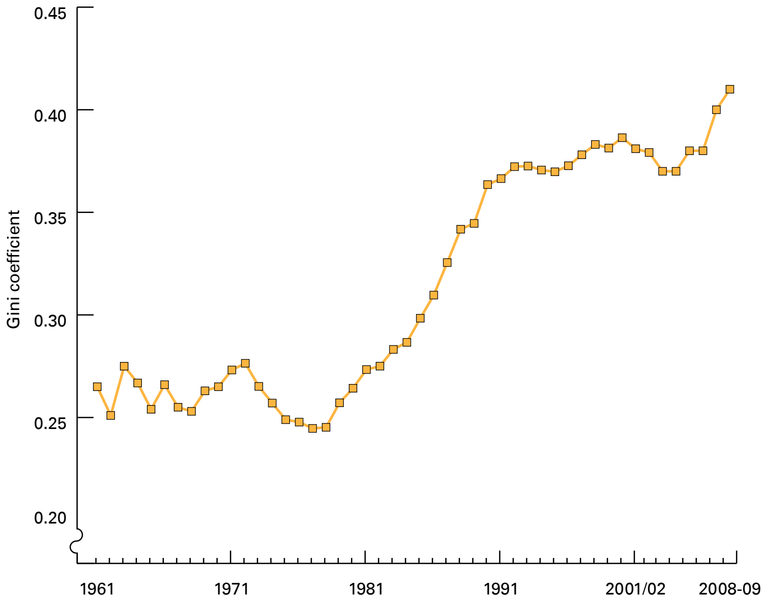
Attitudes towards the perceived fairness of the tax system depend not on any simple objective tests, but on how people feel society is ordered and the extent to which they think it is becoming more or less equal.

The coalition's tax and benefit changes were introduced against a backdrop of increasing income inequality. For 35 years after the Second World War, income inequalities fell, but the following 30 years saw the trend reversed to the extent that now personal income shares are comparable to those in the late 1940s. During the period of the Labour government, the income of those in the bottom quartile started to catch up with those in the middle, but the top incomes continued to race ahead. Figure 1 shows how income inequality has changed over the last 50 years.

A recent report by the Resolution Foundation's Commission on Living Standards found that over the period 2003-8, median real wages were stagnant despite GDP growth of 11%. Over the thirty years from 1977, the proportion of every £100 of value generated by the UK economy, which went to the bottom half of workers in wages, fell from £16 to £12 (or £10 when bonuses are included). Over the period 1996-2007, calculations by the High Pay Commission based on Her Majesty's Revenue and Customs (HMRC) data show that incomes of the top 0.1% of income earners rose by 68.7% whilst those of people in the middle of the income scale (50th percentile) only rose 9.5%.

The Commission on Living Standards calculates that, of this relative fall in the share of national income going to lower

Figure 1: Gini coefficient UK 1961-2008/09

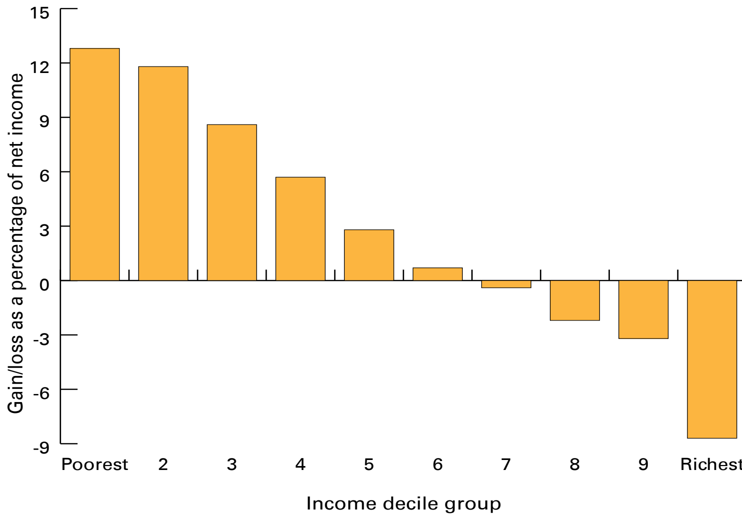


Note: The Gini coefficient is used to measure a population's overall income inequality on a scale between 0 and 1 with 0 indicating total equality (every household has an identical income) and 1 reflecting total inequality (one household has all the income, everyone else has none)

Source: IFS

paid workers, 14% of the fall was due to an increased share of profits in the economy, and 16% was due to increased social contributions by employers (employer National Insurance payments and pension contribution). But the vast majority – some 70% – was due to growing wage inequality. This growing inequality affected all sectors, but finance, business activities and retail show the greatest growth in inequality. As these are the sectors which have grown over the past 30 years, at the expense of manufacturing (where inequalities are somewhat less) it is hardly surprising that the trend has been so pronounced.

Figure 2: Gains and losses across the income distribution from tax and benefit reforms implemented since 1997



Sources: Family Resources Survey, 2006–07; Expenditure and Food Survey, 2007; various Budget and Pre-Budget reports; authors' calculations.

Labour attempted, with some success, to minimise this trend by its use of tax credits and other measures which were progressive in their effects, as shown in Figure 2. But it is a long term trend affecting both the UK and other advanced economies, from the US to Germany. A resurgence of manufacturing in the UK, were it to occur, might have some mitigating impact, but it is unlikely in itself to change matters significantly.

The distribution of wealth is even more unequal than income, although the trends have been less straightforward. The proportion of UK wealth owned by the top 1% fell dramatically during most of the 20th century, from around 70% in 1911 to less than 20% during the 1980s but since then has risen to reach 24% in 2002. In tandem with this, the top 10% owned a rising share – from 50% to 57% over the period 1976-2002.[1] Whilst overall wealth inequality has risen only modestly over

1 Office for National Statistics, 'Social Trends 40', April 2010, p.62

recent decades, the proportion of non-housing wealth held by the top 1% and top 10% has risen significantly. This suggests that the general rise in home ownership has, if anything, helped democratise wealth, although recent forecasts of a decline in home ownership might reverse this. However other forms of wealth – such as life insurance and pension funds, shares and other financial assets – have become much more concentrated. The proportion of non-housing wealth held by the top 10% rose from 57% to 71% of the total over the period 1976-2003.[2]

Overall, it is clear that the UK has become a less equal society in recent decades. In the years of economic growth, the relative decline in the position of lower paid workers was cloaked by generally rising standards of living and relatively easy availability of personal credit. Since 2008, the true situation has become more apparent. Coupled with the realisation that those in financial services who precipitated the collapse have emerged relatively unscathed – with bonuses last year, mainly in financial services, amounting to some £14 billion - it is hardly surprising that there is now a widespread perceived fairness deficit in British society.

How fair is the coalition?

The coalition has attempted to respond to this situation by undertaking the fiscal consolidation in as progressive a manner as possible. It has struggled to do so – despite the raising of the income tax threshold - because those towards the bottom of the income scale are more dependent on benefits and public services more generally than the more affluent. When these are cut, they inevitably lose most.

Of the principal tax changes made by the coalition, the increase in the income tax threshold, coupled with the increase in the top rate of capital gains tax to 28%, move clearly towards a fairer system. The increase in VAT by contrast is mildly regressive, although with the zero rating of food and children's clothing, the degree to which this is the case is often greatly overstated.

2 http://publicpolicyexchange.co.uk/docs/8J07-PPE_4_Gavin_Smart.pdf

The Institute for Fiscal Studies (IFS), seen by many as the authoritative commentator on this issue, finds that the overall distributional effect of reforms by income decile group is clearly regressive within the bottom nine decile groups of the income distribution when losses are expressed as a percentage of net income. The bottom decile group loses a larger proportion of their net income than the top decile group. This pattern is less clear cut when losses are considered as a percentage of expenditure. Moreover when losses for each expenditure decile group (which the Institute for Fiscal Studies has argued is in some respects a better basis of analysis) are expressed as a proportion of net income, the overall package of reforms is slightly progressive.[3]

So whilst the picture is not clear cut as to whether the effect of the tax and benefit changes are progressive or regressive overall, there is nonetheless a perception that we are not "all in this together" when it comes to the government's overall tax, benefit and public expenditure plans. It is felt that those at the top end of the income scale are not making a proportionate contribution to getting the nation's finances back into shape. This feeling is understandably fuelled not only by the evidence of growing inequality in incomes and wealth but also by the continuing and widespread tax avoidance by the wealthy.

These issues of persistent and growing inequality cannot be dealt with simply by the tax system, as the continuing growth in income inequality during the last government showed. For example, the High Pay Commission (chaired by Deborah Hargreaves) of which I am a member, is looking at how the excessive executive pay culture can be curbed. Its final report, with recommendations for changing corporate behaviour will be published in November 2011. But the tax system can and should be doing more.

This is not just a live issue in the UK. In recent weeks Warren Buffett has argued that the very affluent in the US should

3 Institute for Fiscal Studies, 'The distributional effect of tax and benefit reforms to be introduced between June 2010 and April 2014: a revised assessment', August 2010.

be contributing more in taxes because the rate of tax they pay is less than many of those who work for them. Buffett calculates that he pays 17.4% of his total earnings in tax compared to 33-41% for his colleagues. The reason is that there are lower rates of capital gains and dividends tax in the US than on income. The same applies here to the extent that the maximum rate of capital gains tax is 28%, so a private equity fund manager may only be paying the 28% capital gains tax rate compared to his salaried colleagues who will be paying at least 40%.

As in the US, so in France. There, some of the country's wealthiest individuals, including the L'Oreal heiress Liliane Bettencourt, recently called for additional taxation of the rich as a gesture of national solidarity as the country makes swinging expenditure cuts. Their wish was immediately met, to the extent that President Sarkozy has announced in late August plans for a temporary 3% tax to be levied on all incomes above 500,000 euros until the deficit falls below 3% of GDP.

This paper will show how the coalition, within the lifetime of this parliament, can make taxes fairer.

: A fairer tax system

The 50p rate

The tax issue which is currently dominating discussion in the UK is whether the 50p top rate of tax on income over £150,000 should be retained. This higher rate was introduced by the Labour government in 2010 as a response to the growing fiscal crisis. Many people think Gordon Brown had nevertheless been itching to do so for years on ideological grounds – but he was restrained by the combination of Tony Blair and the lack of a credible pretext. The tax was set to raise £2 billion per annum.

A 50p tax rate had been Liberal Democrat policy for many years. The party adopted it because they felt that, a decade or more ago, there was insufficient expenditure on core public services and that a 50p rate was one of the least worst ways of raising some of the revenue needed. The Liberal Democrats moved away from this policy in the run up to the 2010 election - ironically, just before Labour introduced it - for several reasons.

It argued that, once taxes on income exceed half of additional income, they began to have a disincentive effect on the individuals affected. And in normal times it also seems fair, at some basic level, that an individual should keep at least half of what they earn. With employees' national insurance levied at 2% on high incomes, high earners were already paying 52%. The repayment of the 9% of student tuition fees (now a much more serious consideration) by a small minority of them pushed the figure to 61%. This seemed too high.

The party also recognised that, in the international competition for talent, the UK cannot afford to be taxing more than its

principal competitors. And this was increasingly the case.

The Liberal Democrats accepted that, in the short term at least, the government would forego some additional revenue by not having a 50p rate. The party does not accept the argument that aggregate levels of tax rise as rates fall – the so-called Laffer effect. There is no credible evidence that this happens for anything other than extremely high rates of tax. However, very high marginal direct tax rates probably do have a longer term downward impact on growth.

Whilst these arguments are strong in normal times, somewhat different considerations apply at times of national crisis. Wartime is the obvious example of this. But the economic crisis through which we have recently passed – the gravest in the UK for at least 80 years – calls for and justifies exceptional measures. Hence the party's acceptance of the 50p rate as a crisis measure.

When the crisis recedes, so will the arguments for retaining the 50p rate.

However, it is surely premature to ditch it now. For a start, we are only at the beginning of the period of fiscal consolidation and the international horizon is full of economic storm clouds. We still need all the revenue we can collect and we're going to do so for the next few years. And so long as this is seen clearly as a short term, temporary measure, the Liberal Democrats do not believe that it will significantly influence companies' and individuals' willingness to locate in the UK. We should certainly wait and see the outcome of the Treasury's study of the extra revenue which the 50p rate raises.

But more important than this is the political argument. For the government to be cutting the most high profile tax on the affluent at a time when many benefits are being cut and pensions are being frozen or reduced, would send an appalling political signal about the priorities of the government. For Liberal Democrats, it would be particularly damaging.

So, provided it raises substantial additional revenue, the coalition should accept that the 50p rate is necessary until the

fiscal consolidation is well under way. The Liberal Democrats could signal that this is the case by outlining conditions for when it should be abolished. These should be when growth is clearly and sustainably under way and when the structural deficit is well on the way to being eliminated.

There is obviously strong Conservative pressure to move on the 50p rate more quickly than this. If Liberal Democrats in government have to compromise on the point at which the 50p rate is removed, they should only do so on the basis that the income foregone is replaced by other taxes on the affluent. Three ways of doing this are by introducing the mansion tax, raising capital gains tax and curbing higher rate pension tax relief. A recent ComRes poll indicated that the public support such a stance. It found that 57% opposed the scrapping of the 50p rate and 71% support Liberal Democrat calls for new taxes on wealth such as property.[4]

The mansion tax

One obvious way of beginning to make up for any abolition of the 50p rate would be to levy a new tax on high value properties. This is the proposal that the Liberal Democrats advocated in the run up to the last election and which earned the sobriquet of 'the mansion tax'. At the election Liberal Democrats advocated a tax of 1% on the value of a residential property above £2 million. This is not a perfect replacement for the 50p rate because many of those who pay the 50p rate don't own mansions. Many of those who own mansions are foreign owners whose principal sources of income are not in the UK or, in London, are pensioners who have benefited from substantial house price inflation over a long period. Although difficult to quantify, it is also unlikely that the mansion tax alone will generate as much revenue as the 50p rate. Taken together with my other proposals, it does constitute a credible alternative approach.

The case for a mansion tax however is extremely strong in its own right. It runs like this:

4 September 6th 2011.

Over 40% of the total assets held by individuals are in the form of property. The real values of residential property have been rising over a prolonged period and even after the crash, they are still at historically high levels. The mansion tax can therefore be seen as a de facto wealth tax, affecting only the most affluent. It also has the significant advantage over a more conventional wealth tax, that it is much simpler to calculate and levy.

Britain already, of course has an annual property tax – the council tax. It operates in bands linked to the value of the property in 1991 (there has been no revaluation for 20 years), with the top band (H) applying uniformly to all properties with a value of over £320,000. It would be possible in theory to generate far higher revenues from this tax by simply adding additional bands for higher value properties. But, given that this could only take place within the context of a wholesale revaluation of all properties in the UK it would be a long, cumbersome and contentious process. Concentrating simply on very high value properties is much easier. And, logically, the revenue from higher rate council tax bands would accrue to the local authorities where the property is situated, as at present. Given that these are the parts of the country least in need of additional revenue, the case for making the mansion tax a separate, national tax, with a uniform national rate and with proceeds going to the national exchequer, is compelling.

So too is the argument that such a tax is fair. The fairness case for a mansion tax can obviously be most starkly demonstrated by looking at the extremes. Take Park Place in Henley, recently bought for £140 million. Situated in South Oxfordshire, the council tax payable is approximately £2900 – the same amount payable on a property worth several hundred times less. And in Kensington and Chelsea, where property prices regularly run into the millions, top rate council tax is a mere £2158 – so that if Roman Abramovich does buy a house for £90 million in Kensington Palace Gardens, as rumoured, he'll be paying only 0.002% of its value in Council Tax per year. He could, and should, surely pay more than £41.50 per week

It has been suggested that as an alternative to the mansion tax, capital gains tax could be levied on the sale of properties where the owner profits by more than £1 million. Such a measure would probably raise less, as the charge would only be triggered when the property was sold rather than being an annual charge. It would also require a payment of up to 28% immediately, so reducing the incentive to sell (particularly amongst the elderly who might be looking to down size and move from, say, Twickenham to Torbay). It would also be necessary to decide whether to treat a house lived in for 20 years or 20 months in the same way. It is an idea worthy of more detailed work, but shouldn't be seen as an alternative to the mansion tax.

Needless to say, the mansion tax has its critics – not least from those who would have to pay it. One argument which can be dispelled, however, is that advanced by Eric Pickles who argued in a newspaper interview in August 2011 that it would be a "big mistake to start imposing taxation on the back of changes in property values" on "middle class families, [who] put a lot in and don't take a lot out".

Yet research undertaken earlier this year by Ledbury Research and published by Barclays Wealth helps demonstrate how misleading this assertion really is. It shows how the effect of a mansion tax would be concentrated in London and the South East and amongst foreign owners. In 2010, some 7450 properties were sold for over £1 million (the research doesn't give figures for those over £2 million) of which 6,680 were in London and the South East – some 90% of the total. By contrast, in the whole of Yorkshire, a mere 63 properties were sold worth over £1 million. The figures are based on Land Registry records and so do not include many very high value properties which change hands through the sale of the company of which they form the only asset – see below. The number of such properties is likely to be relatively modest, but their value in aggregate is very high. For properties worth over £2 million, the research shows that some 60% were bought by foreigners.

So, far from being a potential tax on the "squeezed middle", as Pickles implies, the mansion tax would be borne mainly by foreigners (who hardly "put a lot in" at present) and the very affluent, concentrated in a relatively small part of the country.

Capital Gains Tax

The coalition, in its first Budget, moved to reduce the gap between the rate of income tax paid by higher earners and that paid on capital gains. For higher rate taxpayers, capital gains tax is now levied at 28% (up from 18%). This still means however, that there is a strong incentive to find means of recategorising income as capital gains.

There is an easy way of dealing with this, namely to adopt the long standing Liberal Democrat policy of levying capital gains tax at the marginal rate of income tax paid by individual taxpayers. If a top capital gains tax of 50% seems too much to swallow (given that the 50p rate is likely to be temporary), the government could and should raise the top rate to 40%. Such a move would also bring greater tax neutrality between income and capital, which would be desirable in its own right.

Another aspect of the capital gains tax regime which is ripe for reform relates to the tax free gain which an individual can make in any tax year. This currently stands at £10,600, which seems illogical and anomalous when the amount that one can earn as income before incurring tax is only £7,475 albeit on a rising trend towards £10,000 in the lifetime of this parliament. The two amounts should be the same.

Pensions

The pensions system in the UK is unbelievably complex, opaque and inconsistent. The coalition is undertaking major reforms, both to ensure that everyone who can builds up a private pension to supplement the basic state pension (through NEST) and to guarantee everyone a basic state pension. Most of the issues around pensions do not, thankfully, relate to tax. But one certainly does.

For many years, payments into a private pension scheme have attracted tax relief at the marginal rate paid by the taxpayer. For many years there were annual limits to the level of contributions which received tax relief but this was relaxed by the Labour government to introduce a system with a much higher annual limit (rising annually from £215,000 pa in 2006) and a total lifetime cap of £1.8 million. Partly as a consequence, the highly paid made much larger contributions to their pension pots. Office of National Statistics figures show that individual contributions shot up by 50% between the 2004/05 tax year, when it totalled £6.6 billion, to £10.2 billion in the 2007/08 tax year. The taxpayer has been subsidising the wealthy to save more. The coalition reduced both of the limits in the 2011 Budget and, from 2012, there is an annual tax free amount of £50,000 and a lifetime allowance limit of £1.5 million. These changes are welcome but do not go far enough.

To give some idea of the revenue involved, in a written parliamentary answer to my colleague David Laws, David Gauke the Treasury Minister said that restricting pension tax relief to the basic rate of 20% would generate £7 billion per annum in additional tax revenue[5]

For many years, Liberal Democrats have argued that the state should not subsidise the affluent to save for their pension at a greater rate than those less well off. It surely should not be the role of the state to help the already well-off enjoy an affluent retirement, particularly when it struggles to provide a half decent basic pension to many of its citizens.

The rationale given for tax relief on contributions into a pension fund is both to encourage saving for retirement but also to avoid double taxation of income – once when the contribution is made, and again when the pension income is received. However there is no justification for giving tax relief at higher rates (40 or 50%) when very few pensioners will pay tax at the higher rate on their pension income. The substantial recent decline in annuity rates means that it

5 Written parliamentary answer to a question tabled on 4 April 2011

would now be necessary to have a pension pot of around £1.35 million (ie only just below the £1.5 million cap) before the resultant annuity income pushed a single male taking a pension at 65 into the 40% tax band.[6] Even the very small minority in this position would face an average tax rate on their income of well below 20%. The argument that higher rate tax relief is justified in order to avoid double taxation has ceased to be valid – if it ever were.

Fortunately, it is very easy to deal with the problem The government should simply legislate in the 2012 Finance Bill to limit tax relief on pension contributions to the standard rate.

Inheritance tax

Inheritance tax (IHT) has developed the reputation of being almost a 'voluntary' tax because it is so easy to avoid. Worthy, ethical organisations such as Which? give copious advice on IHT avoidance to those whose estates might be eligible for the tax. Yet, if the government are to do anything to stop a continuing and accelerating increase in wealth inequalities, one of the ways to do so is surely to tax wealth when it is crystallised, at the point of death.

IHT applies to most estates with a value of over £330,000 and is charged at a rate of 40%. The Chancellor announced in 2011 that this threshold would be frozen until 2015 and would rise with CPI inflation thereafter.

Stopping all the IHT loopholes would be a Sisyphean task, however there is one simple change which could be made which would make the tax more effective. At present, all gifts which are made more than seven years before the death of the donor are exempt. This no longer adequately reflects current life expectancies. One of the main purposes of this rule was to allow parents to help their children in the early stages of their career, either by helping them to buy a house or invest in their own business. With rapidly growing life

6 This assumes that the individual takes the 25% tax free lump sum and purchases an RPI linked annuity. Account is taken of the basic state pension but no other earnings.

expectancy, this rationale no longer applies. In many cases, parents are living into their nineties and beyond, so their children are often in late middle age when they inherit. In an ideal world there is a strong case for including all lifetime gifts within inheritance tax calculations. However, given life expectancies, it is impracticable to do so, because records would need to be kept for over 60 years in many cases. But the seven year exemption period certainly seems too short. It should be extended. Initially this should be to fifteen years, although there is a case for increasing it further as life expectancy grows. As it would be impossible to apply such a change retrospectively, it would generate little additional revenue for eight years. It is however a change well worth making.

Paying what is due

One aspect of the tax system which rightly infuriates many people is the sense, and reality, that the affluent can often avoid or evade tax. As Nick Clegg said in the aftermath of the riots "Too often it looks as if people who break the rules can prosper", before singling out tax evaders as being in this category.

Estimates of the total amount of tax which goes uncollected each year – the tax gap – run at some £42 billion according to the latest official figures. The gap has many causes, but much is the result of careful planning by those who have income or wealth which they wish to keep away from the taxman. And it is one of the downsides of having some of the most sophisticated accountancy firms in the world that the UK also has some of the most sophisticated purveyors of tax avoidance schemes.

Successive governments have tried to tackle the issue with mixed success. Most recently, Gordon Brown's frantic attempts to close every loophole have resulted in the most lengthy and complicated tax code in the world.

But there have recently been some successes, particularly in respect of assets squirrelled away in tax havens. Earlier this year HMRC announced that the so-called Liechtenstein

Disclosure Facility (LDF) will result in some £3 billion in proceeds to the Exchequer. The LDF, initiated in 2010, offers reduced penalties for those who have been evading tax by secretly holding funds in the principality. Some 1200 individuals have come forward to take advantage of the facility.

Even more significant was the agreement with the Swiss authorities, announced on 25 August 2011. Under this agreement, UK taxpayers who have evaded tax on assets held in secret Swiss bank accounts will pay an initial charge of between 19% and 34% and, from 2013, an annual charge of 48% on investment income and 27% on capital gains. The agreement could generate an additional £5 billion in revenue per annum.

The agreement has come under criticism by the Tax Justice Network and others for not going far enough and, in particular, failing to recoup tax which should have been paid over many years and which was being illegally evaded. It is also criticised because the Swiss authorities will collect the tax and pay it to the HMRC, but will not pass across details of individuals' financial details. These criticisms are understandable, but this agreement is almost certainly the best obtainable and has to be set against the Labour government's complete failure to make any inroads into the Swiss offshore account problem during its term of office.

It will also mean that, for the future, the advantages of UK citizens putting funds into Swiss bank accounts will be greatly reduced. There is a danger, of course, that UK citizens with bank accounts in Switzerland will move them to other less reputable tax havens. However, this is not an argument against ending their Swiss tax perks, but for moving on to deal with other tax havens, particularly those which are British Crown Dependencies and Singapore, the new Switzerland of the Far East. HMRC has recently and very belatedly created a dedicated team of investigators to catch those hiding money overseas. These efforts now need to be redoubled and HMRC incentivised to make them successful (see 'Making sure we collect tax due' below).

Many tax abuses still exist and no-one but a fool would believe that the government can reduce the tax gap to zero. However, there are several relatively simple things which could be done which would make a big difference. Here are four:

Non-doms.

The very phrase non-doms has become a byword for tax avoidance. A non-dom is someone who lives in the UK, but who was born – or whose father or grandfather was born – outside the UK and who claim they intend at some point to return to their country of origin. Such people can opt not to pay tax on their worldwide (non-UK) earnings unless or until they remit these earnings to their UK bank account. There are a lot of them. Estimates vary, but a recent conservative figure was 120,000. Not all of them have significant income outside the UK, but many do.

The Labour government for most of its term ignored this issue behind the smokescreen of endless Treasury reviews. Following the dramatic intervention by George Osborne at the Conservative Party conference in 2007 proposing an annual levy on all those who chose to remain non-doms, Labour hurriedly introduced such a levy – of £30,000 payable by all those non-doms who had been resident in the UK for at least seven years. In this year's budget George Osborne amended the scheme so that the £30,000 levy would apply only for those who had been in the UK for between 7 and 12 years, after which the levy would increase to £50,000.

This approach is sadly inadequate. First, it means that many non-doms, even after paying the levy, are paying much less tax than they should. If their foreign earnings are in a tax haven which has no income tax (eg Bermuda and the Cayman Islands) and if they are top rate taxpayers in the UK and have lived here for more than 12 years, they would only need to have foreign earnings greater than £100,000 to be paying less than their due. Many non-doms have foreign earnings higher than this.

Secondly, the policy seems to have had an extraordinary and implausible effect on the number of declared non-doms. A recent conservative estimate of non-doms was 120,000. Yet in answer to a parliamentary question on 4 July 2011, Treasury Minister David Gauke said that the number of individuals estimated to pay the annual charges of £30,000 or £50,000 in 2012-13 was a mere 6,300. Where are the other 114,000? It is completely unclear from the parliamentary answer. It could in theory be that they've nearly all decided to relinquish non-dom status and simply pay UK tax in their worldwide earnings. This seems unlikely.

There is fortunately an easy way to resolve this problem and the more general one of wealthy non-doms avoiding tax. It is simply to say that once people have lived in the UK for seven years, they must account for tax like the rest of us. For those who divide their time between the UK and other jurisdictions, they would start paying full UK tax once they had accumulated seven years' stay in this country. George Osborne has said that there will be no more changes to non-dom taxation during the lifetime of this parliament. The figures quoted in the parliamentary answer however, suggest that the policy is in disarray. In these circumstances, it should be changed – and without delay.

High value properties

As explained in the context of the mansion tax, owners of very expensive houses do not pay a proportionate annual tax on them. In many cases they also do not pay stamp duty on them

when they're purchased. Given that for residential properties over £1 million the rate of tax is 5%, this is a very significant sum. The principal way in which they do this is to put the property in a company – which typically has no other assets. The property remains the asset of the company when the ownership of the property changes. In this way, the stamp duty payable on the sale falls from 4% or 5% (the property rate) to 0.5% (the rate on shares) if the company is UK based. For foreign owners, the company is often registered offshore,

in which case no stamp duty at all is paid This practice is undoubtedly legal – we are talking about tax avoidance not tax evasion. It is however blatant avoidance.

It is very easy to get advice on how to do this. Simply google 'avoiding stamp duty' and a whole list of companies appear offering to "mitigate" stamp duty if the value of the property is greater than £250,000 – not exactly a lot in today's housing market. I would refer any curious readers to, for example www.avoidstampduty.org.uk. This company – strapline "the stamp duty mitigation experts" – explains how, if the property is worth £1 million they can "eliminate" the £50,000 stamp duty due, for the modest fee of half the amount saved, a healthy £25,000.

This practice does not just apply to residential property. Tesco received considerable unfavourable publicity in 2008 when it was revealed that the company was using a complex procedure involving UK limited partnerships with Cayman Islands registered partners to avoid stamp duty on the sale of some of its stores. At the time it admitted that it had avoided some £23 million of stamp duty and was likely to save between £30 million and £40 million on planned future store disposals. The company argued that it was acting in the shareholders' best interests to minimise its tax liabilities, and if anything seemed proud rather than abashed by this activity.

The government should move in the next Finance Bill to outlaw this practice. It is possible that it would be caught by a General Anti-Avoidance Rule (see below), but specific legislation may be needed to require changes in the beneficial ownership of properties to be registered at the Land Registry, whether held in a company structure or not, and for stamp duty to be paid.

An anti-avoidance rule.

One problem about tackling tax avoidance is that the accountants are often one step ahead of HMRC in putting in place complex avoidance schemes. When such schemes are identified, there is then, typically, highly complex legislation

in the following year's Finance Bill. Some 300 targeted anti-avoidance provisions now form part of UK tax law. This helps explain why our tax code is now the world's longest at over 8000 pages.

There is an alternative way of dealing with the problem. It is to introduce a General Anti-Avoidance Rule (GAAR). The Rule would prevent any tax benefit accruing where the avoidance of tax is the main reason for the transaction. A similar system has proved effective in a number of countries, including Australia, where artificial tax planning has become much more difficult. Such an approach would allow for the abolition of many of the existing specific anti-avoidance rules and would make redundant hundreds of pages of tax legislation.

There is concern within the accountancy profession that such a rule would bring a damaging degree of uncertainty into tax planning. How could one be sure that the latest wheeze wouldn't fall foul of the GAAR? The answer to this is that HMRC should establish a fast and efficient pre-clearance system, allowing taxpayers and their advisers to gain the certainty they need before entering into a transaction. This should be done on a cost-neutral basis to HMRC. Those asking for such advice should have to pay for it.

The government is in the process of reviewing the case for a GAAR. A panel chaired by Graham Aaronson QC has been appointed and will report to the Chancellor by end-October 2011. Aaronson recently described the panel's aims as follows: "We are interested in seeing if we can develop an anti-missile system with the missiles being these egregious or wholly artificial tax schemes. It would be a deterrent, people won't bother to fire the missiles, and that's what we really want to stop. We could end up with a much simpler and better expressed tax code."

This is potentially a big prize and it is crucial, if Aaronson achieves his aim of identifying how a UK GAAR might work, that the government proceeds with it without delay.

Making sure we collect tax due

As mentioned above, the tax gap, the difference between tax collected and the tax which would be collected if everyone paid what they should, is some £42 billion. This is roughly 9% of total tax liability and this figure has been relatively stable over a number of years.

The gap varies significantly from tax to tax. HMRC estimates that, at the top end, some 49% of duty due on hand rolled tobacco was uncollected in 2008-9, whereas 100% of petrol duty was successfully collected. The biggest elements of the gap are in VAT, where some £15 billion goes uncollected, income tax, NI and capital gains tax (£14.5 billion) and corporation tax (£6.9 billion)

There are many reasons for the gap. Smuggling accounts for a large proportion of the failure to maximise excise duty revenue. Inaccurate returns account for much of the income tax loss. And the black economy hits VAT, income tax and NI payments.

But in every area of tax there is a correlation, however imprecise, between the effectiveness of the tax collecting machinery and the proportion of tax collected. This in turn depends in part on the detailed procedures followed and in part on the human resource deployed to ensure that they are being correctly followed. Here there is cause for concern.

The number of people employed in tax collection by HMRC has fallen precipitously in recent years. In 2004-5 some 99,000 were employed. In 2010-2011 it was down to 67,500. More reductions are envisaged. Part of this fall can be justified by the efficiencies achieved by the merger of the two departments to create HMRC (Inland Revenue and Customs and Excise) and the computerisation of large parts of the tax collection system (where, incidentally, HMRC's performance has been quite good. Some 78% of self-assessment income tax returns are now completed online, up some 7% on only a year earlier).

Part of the reduction in numbers has however been the result of a Treasury and politically driven move to ensure that, as

other departments lose staff, HMRC are seen to "take their share" of the cuts. This is illogical and counter-productive. To a certain extent this has been accepted by the coalition, which is reinvesting some £917 million over 4 years from the overall HMRC budget into staff who will tackle evasion, avoidance and fraud. Whilst this is welcome, it fails to counteract the hollowing out of staff which has occurred across the department, and which, whilst not all employed in chasing tax delinquents, has played a major part in ensuring that taxpayers paid the correct tax in the first place.

The extra spending has however already had some positive effects. In the year to 31 March 2011, the number of criminal convictions for tax evasion rose by 38%. This is a direct result of the tougher approach which HMRC are adopting, backed by the extra spending.

It would be naïve to think that there is going to be a spontaneous rethink of HMRC staffing during the remainder of this parliament – although that would be an extremely sensible course. However, one innovative change, which should endear itself to the government, would be to incentivise HMRC staff to exceed tax collection targets, not by promising higher pay, but by allowing a proportion of any tax collected above target to be reinvested the following year on additional staff. There is a precedent for such an approach. Under the Asset Recovery Incentivisation Scheme, half of all assets recovered under the Proceeds of Crime Act, are returned to the law enforcement agencies involved. Such money returned is intended primarily to be reinvested in asset recovery resourcing. The other half is retained as core Home Office funding. So, for example, Greater Manchester Police recently received £1.17 million as its share of a successful criminal asset recovery operation.

The land

Land – or more accurately the value of land – is a very strong candidate to form the basis of a significant element of overall taxation. It can't move offshore, it is easily identified and ownership of it – and the property on it – is strongly

correlated to wealth. There are also strong economic arguments for taxing land values (ie taxing rent) because such taxation does not distort market incentives. It is not surprising therefore that Liberals and subsequently Liberal Democrats have for generations supported the concept of land value taxation. The sometimes extravagant zeal with which this view has been held by many in the party has not borne fruit. Even Lloyd George was defeated in his attempts to impose a serious land tax. Since then no government has really tried. Why?

Go back a century and it's possible to argue that the big landowners had the clout to prevent it, but that's not been the case for many years. There are technical issues about valuing land, but the real problems are political. When land values in a particular area rise more than elsewhere, and particular groups are required to pay more, they tend to object strongly. And as so often happens with changes in the incidence of tax, those who benefit relatively from a revaluation keep quiet. Understandably, no governing party has been keen to incur such homeowners' wrath. This is why the residential property values used for calculating Council Tax have not been revalued since 1991. It is also why, taking a charitable view, it would be possible to argue that Eric Pickles' objections to a mansion tax are actually more to do with the prospect of a politically unpopular general revaluation than to the mansion tax itself.

The failure to revalue properties for Council Tax purposes, and the shortcomings of Council Tax itself as a revenue raiser from all properties up the value scale, are strong grounds for now working out detailed proposals for site value ratings for residential properties.

This paper however focuses on possible tax changes during the lifetime of this parliament and there is zero possibility of the coalition looking at site value rating for residential properties before 2015.

The taxation of businesses could, however, be a different story. Like residential properties, commercial property

attracts a local tax – the uniform business rate (UBR). This is based on the officially estimated market rent ('rateable value') of the property. Revaluations take place every five years – unlike rebellious homeowners, businesses take a more measured view about business rates (although it doesn't stop complaints). The level of rates is set nationally, but, after 20 years of being collected locally and remitted to a central pool, the coalition now plans to allow councils to keep the rates which they collect.

This is a significant and beneficial change, but there remain strong arguments for changing the basis of these rates to reflect the value of the land on which the buildings sit. Firstly, by being based on the site value, the tax captures any increase in land value which results from transport of other infrastructure improvements and provides an ongoing revenue stream from these improvements for the local authority. Second, it provides the owners of sites with an incentive to build on them rather than leave the land vacant or undeveloped. As the population of the UK rises inexorably over the decades ahead, the need to bring non-agricultural land into use will correspondingly grow and so this argument will become increasingly powerful in the future.

It would be perfectly possible for the coalition to begin a move towards site value rating for business properties during the lifetime of this parliament. How this can be done was set out in the Liberal Democrat tax policy paper "Reducing the Burden", adopted in 2007. The essential steps are:

- An immediate freeze on work by the Valuation Office Agency (VOA) on maintaining uniform business rate assessments and a switch of resources to preparing for Site Value Rating (SVR);
- An invitation to local authorities to be pilots for SVR. Pilots should be selected to cover a range of types of area (eg north, south, rural, metropolitan). Local authorities would be allowed to retain all the revenue generated during the pilot phase and would be reimbursed for any additional local costs of administration;

- Defining and mapping valuation zones;
- Introducing SVR in pilot areas at a level of, say, 25% of the area's current UBR revenue with an equivalent reduction across the whole area on UBR;
- Revaluing the pilot areas after 2 years. Increasing SVR in year 2 to 50% of UBR. Evaluating the pilot in year 3;
- Completing national land valuation within 5 years. A threshold for liability of SVR would be set to exclude all land outside settlements unless outline planning permission had already been granted;
- Introducing the system nationally, at which point local authorities could set their own SVR rates. Undertaking annual or biennial revaluations thereafter;
- Putting in place for the first full year of operation an equalisation mechanism to redistribute some of the proceeds from those local authorities which have a high preponderance of high value commercial properties (most obviously the City of London) to those which have relatively little.

The environment

The coalition has pledged to be the greenest government ever. Whilst in some respects it has made good progress – not least in energy policy and the setting of a floor price for carbon – on taxation the position is rather more mixed.

The 2011 Budget decision to reduce petrol duty was understandable politically, but sent an unfortunate signal. The abolition of the fuel duty escalator and its replacement with the fair fuel stabiliser was announced at the same time. The stabiliser envisages fuel duty increasing by RPI when oil prices are high (ie higher than $75 per barrel) and RPI plus 1 penny per litre when they are lower than this trigger price. In reality, it looks unlikely that oil prices will fall below $75 per barrel in the foreseeable future and so it is unlikely that the stabiliser will be used.

The government has however probably reached the limit of what is politically acceptable in the short term in respect of

fuel duties (and it will be interesting to see what the public reaction is to the planned increase of 3.02p per litre in January 2012). In the longer term, it needs to look at a combination of sticks and carrots to deliver lower aggregate carbon emissions from individuals' travel. Road pricing should play a major part, but how and when this is achieved is beyond the scope of this paper.

In the case of aviation, the government has mistakenly chosen not to adopt a long standing Liberal Democrat policy to switch from a per passenger to a per plane basis for Air Passenger Duty (APD). This decision appears to be irreversible for the lifetime of the parliament. One element of APD is being reviewed however, and a change on fairness grounds is necessary.

At present, the duty is banded based on the distance of the flight. This principle is unobjectionable. However, the boundaries of the bands follow national boundaries and the relevant distance, for deciding which band a country falls into, is the distance from London to that country's national capital. This normally works fine, but in at least one case it does not. Because Washington is nearer to the UK than the capital of the Caribbean countries, all flights to the US – even to Hawaii – have a lower rate of duty than flights to the Caribbean – which are literally thousands of miles shorter. This puts the Caribbean tourism industry at an unfair disadvantage against that of Florida and also constitutes an unfair impost on families of Caribbean origin flying between the UK and the Caribbean. The government is currently consulting on a revised banding structure which could remove this anomaly. It should do so in next year's Finance Bill.

Promoting growth

Although this pamphlet is concerned with fairness and responsibility in the tax system, and is not seeking to re-open the coalition's overall fiscal policy, there are two tax changes which should now be considered with a view to promoting growth, namely:

- Extending the national insurance holiday currently available to business start-ups in the less prosperous regions to existing small firms. This relief enables new companies in all regions except London, the South East and the East to employ up to 10 people for 3 years without incurring national insurance contributions. It was estimated, when it was introduced in 2010, that some 400,000 firms would benefit. It is now clear that this was a wildly optimistic estimate. The concept should therefore be extended so that existing small firms in the qualifying regions can take on up to an additional three employees and still qualify for the NI holiday. Given that provisions had already been made for the NI foregone, this should have, at worst, a negligible impact on NI receipts.
- Introduce a lower rate of VAT for repairs and refurbishments. There is currently a major anomaly in the VAT system, under which new houses do not bear VAT, but repairs and refurbishments have to pay the full 20%.

  The housing and construction sectors have suffered particularly badly in the recession. Non-tax measures are needed to encourage house building, but the introduction of a 5% VAT rate for repairs and refurbishments would help kick-start the small scale construction activity which would not only help improve the quality of the housing stock, but also generate employment in the sector.

Conclusion

This paper has limited itself to looking at those changes to the tax regime which would help the coalition meet its priorities of fairness and responsibility, whilst protecting individual freedom. There are many other changes which could and should be made to our tax system which would not only safeguard revenue, but also help deliver other government priorities on climate change, enterprise and public health. These will be the subject of a further publication.

In the meantime, if the coalition implemented the changes set out above over the course of this parliament, it would be better placed to argue that it had met its declared overall goals.