A PLAN FOR REFORM

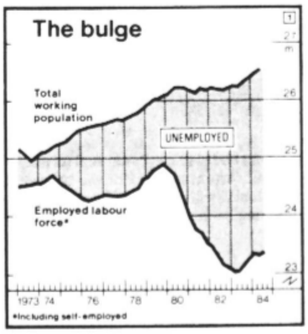
HOW WE CAN RETURN TO FULL EMPLOYMENT

HIGH LABOUR costs are now widely held to be a principal cause of unemployment: hence the talk about the need for wages to fall to "market clearing levels".

The idea is that the unemployed are like unsold fruit on a stall; if the price is reduced, all the stock will go. Professor Patrick Minford of Liverpool University is one of the leading advocates of this theory, and he argues that cuts in the level of welfare benefits would encourage the unemployed to price themselves into jobs.

There is certainly a link between wages and benefit levels, because few people would want to work for less than they could receive in benefit. But other factors also have to be considered, especially since the concept of labour costs obscures the underlying realities.

Wages are normally regarded as a cost of production, and lumped together with the costs of raw materials, fuel and other inputs, under the heading of "expenditure". But this is only an accounting convention, which depicts economic processes from only one point of view.



HENRY LAW

outlines a programme to promote employment in Britain, by cutting taxes on work and replacing the lost revenue with a reformed local government property tax.

A MORE fundamental method of analysis is to consider how the wealth created by a productive enterprise is ultimately shared out.

The distribution is a fourfold one. Part goes to employees of the organisation; this is their net take-home pay, plus pension rights and perks. Another portion goes to those who supply the capital, and a third portion goes to the government. The balance consists of economic rent, which is received by whoever owns the land occupied by the buildings and plant.

This view departs from the conventional one in important respects. First, payments to workers are not seen as a cost of production but as a *share* of production. Secondly, it shows that Corporation Tax and rates (the local authority's property tax) are not the only claims made by government on the wealth that is created; pay-as-you-earn (PAYE) income tax and National Insurance contributions must also be regarded in the same light, the distinction between "employers' contribution" and "employees' contribution" being an artificial one since both come out of the same pocket.

The idea of "gross pay" is an illusion. PAYE income tax appears to be a tax on income based on the "gross pay" figure, but we all know from personal experience that we designate as "wages" only that which is available for us to spend. In reality, gross pay is a purely notional amount, and once tax has been computed, it becomes the liability of the employer. As proof of this, we need only note the number of business liquidations that are initiated by the PAYE authorities.

Effectively, we have a payroll tax disguised under the appearance of employees' income tax and National Insurance contributions. These are all payments which have to be met from the wealth created by the enterprise. Not only is it a burden carried by the employer, but it is one that takes no account of the employer's ability to pay. There is no relief even when a firm goes bankrupt, because the Inland Revenue goes to the front of the queue of creditors.

The destruction of industry

The consequences of this are very serious. Industry which would be viable but for the taxes is destroyed – including, for example, a proportion of Britain's supposedly "uneconomic" coal pits which were the focus of the protracted strike in 1984-85. We have an artificial margin of production imposed by the tax system.

In the public sector, payroll taxes masquerading as taxes paid by employees lead to the revolving money syndrome. The cost of providing services to the public is thereby inflated. Well over a third of the money which local government receives from central government is promptly returned as staff PAYE and National Insurance contributions, at great administrative expense.

The effect on employment is insidious. The concealed payroll tax means that gross labour costs are more than 50% higher than take-home pay. This tax surcharge (illustrated in the graph), is often referred to as the "tax wedge". It means that if the worker is to be left with £50 take-home pay, the gross cost to the employer will be £75 or more.

This makes it difficult for British firms to compete in world markets, and makes nonsense of suggestions that cuts in welfare benefits would help to cure unemployment. The tax wedge would prevent workers from pricing themselves into jobs without pricing themselves out of existence at the same time. This is the principal reason for inflexibility in the labour market.

The initiative for pricing workers into jobs will have to come from the government, but attention must focus on the tax wedge rather than on cutting welfare benefits.

At present, employers have every incentive to get rid of their workers, and there is a barrier against fresh employment. From the point of view of an unemployed worker, it is as if the bottom rungs of the employment ladder have been sawn off.

But if the tax wedge could be made to disappear, the minimum price of labour would immediately drop by one-third. We would then discover what was the "natural" rate of unemployment. Unfortunately, the tax wedge cannot simply be wished away. National Insurance alone raises £22bn a year. Nothing short of major tax reform will solve the problem. On March 19, the Chancellor of the Exchequer, Nigel Lawson, tried to reduce the burden of National Insurance contributions for the lowest paid workers. Unfortunately, the changes he proposed may represent what two professors at the London School of Economics called "a significant deterioration in work incentives for the low paid".[1]

Towards tax reform

In principle, taxes should reflect the ability to bear the tax. In the private sector, businesses which would be viable in the absence of the tax should be allowed to remain viable after they have paid their tax. In the public sector, the tax system should avoid the unnecessary circulation of funds between government departments and between central and local government.

Initially, the tax system should be changed to dispel the present illusions. It would make little difference if PAYE and National Insurance were re-named "Payroll Tax" and openly charged to the employer. Such a change could readily be introduced, with personal allowances being replaced as necessary by changes in the benefits system.

This arrangement would be similar to the practice which already exists in parts of the clothing industry, where workers receive net wages for piecework. Tax is grossed up and paid by the employer according to formulae agreed by the Inland Revenue. Collection is simplified and, psychologically, tax-free wages have the advantage that, with no deductions, effort is fully rewarded.

Replacing PAYE with a payroll tax would also help to banish the notion that wages can be anything other than what is actually paid to workers. It would then become clear that payroll taxes completely disregard the ability of the employer to pay the tax. This would open the way for real tax reform.

Anyone embarking on real tax reforms must first learn the lessons of history. Taxes have been the cause of much strife and insurrection. Wat Tyler's rebellion was sparked off by a Poll Tax, and Charles I's troubles began with a tax called Ship Money. Protests about a tax on tea were the fuse that set off the American War of Independence, and Ghandi gathered mass support by defying a Salt Tax imposed by the British.

Ill-conceived taxes have had disastrous consequences. In 1797, the British government introduced a tax on clocks and watches. It was repealed after a year, but in the meantime it ruined the thriving Clerkenwell clock and watch industry.

Another classic error was committed by the Arab sheik who introduced a tax on date palms. On the face of it, this might have seemed a reasonable application of the "ability to pay" principle – after all, the richest men had the most trees. Unfortunately for the sheik, the farmers (like all sensible citizens) arranged their affairs so as to minimise their tax liabilities. They cut down their trees. Thus the sheik remained short of cash, and dates became scarce.

The old Window Tax worked in much the same way: the theory was that the size of a house could be measured by the number of windows. In practice, people often bricked them up.

THE GENERAL rule is that taxes diminish their own base. A familiar example of this is the disincentive effect, which is illustrated in the extreme case by the apocryphal story about the early days of Soviet Russia.

A party commissar was visiting the collective farms to estimate how much wheat each should send to the nearby towns.

"How much can you grow?" he asked.

"A hundred tons," replied the head of the collective.

"And how much do you need to feed the comrades?"

"Ten tons."

"Very well," said the commissar, "you keep the first ten tons, and I'll take the rest."

This arrangement left the comrades with an effective marginal rate of tax of 100%. Human nature being what it is, they did not bother to grow much more than the ten tons that they needed for themselves. Had the commissar

● VACANT sites such as this one – an area just four miles from London Bridge, which lay idle for 15 years – help to keep rents artificially high and people out of work. Much is said about workers pricing themselves into jobs, much less about getting landowners to price idle property into use!

been shrewd, he might have taken seventy or eighty tons, and allowed the farmers to keep anything more. This would have been much like charging a rent. The commissar would have been assured of his supply, and the farmers would have been paying a zero rate of tax once the "rent" had been collected.

Thus do we find the dustbins of history overflowing with misconceived and harmful taxes. But there is no reason for us to be complacent about our own tax system, for as we have seen, taxes may not be what they seem. Income tax is ostensibly paid by workers, but it is effectively a payroll tax, paid by the employer and serving as a powerful disincentive to employment.

MINDFUL of these cautionary tales, we can begin to think about tax reform. Taxes have to satisfy numerous criteria, of which the following are the most important:-

- **The tax should not discourage the creation of wealth**

The influence of taxes on economic activity is often obvious, as we saw when Nigel Lawson introduced VAT on fish and chips: there was a drop in sales.

But taxes frequently have more subtle economic effects. So-called "neutral" taxes turn out, on closer examination, to have a generalised debilitating effect on trade and industry; it is like lubricating a machine with glue. Neutral taxes also bear hardest at the margin, a fact well known in the oil industry where marginal oilfields cannot be exploited unless the tax regime is favourable.

Much of Britain's regional aid policy serves only to counteract the harm done by a tax system which takes no account of geographical disadvantage.

- **The tax should be fair**

Fairness in taxation is an extremely contentious issue. Books could be written on the subject, yet, curiously, it seems to be little discussed. It is generally assumed that our present taxes are basically fair. Are they?

Taxes on income deprive workers of the fruits of their labour, and taxes on spending rob consumers of the purchasing power of their money. There is a basic unfairness about local authority rates,[2] which penalise those who improve their premises but reward those who allow their property to stand idle and derelict.

A fair tax must leave workers with the full fruits of their labour and allow capital to keep its full earnings, since capital is but stored-up labour. Fairness demands that taxes should be related both to ability to pay and also to benefits received from the community; this latter point is commonly overlooked.

- **The tax should be difficult to avoid, and efficient**

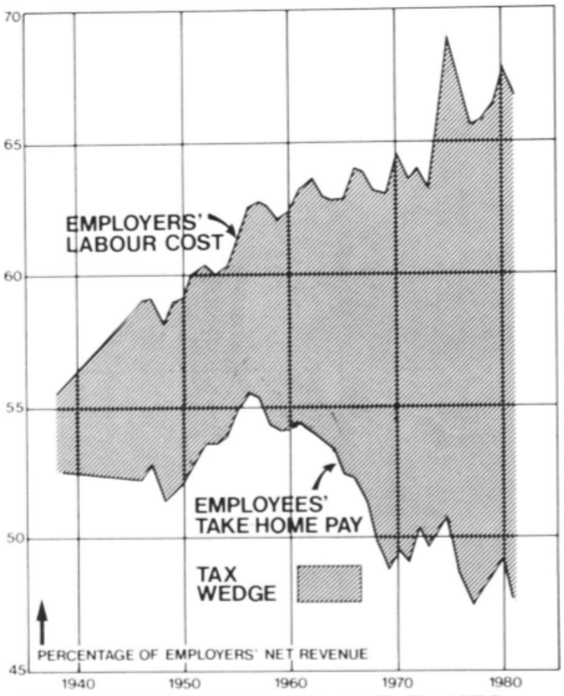
An efficient tax is one which costs very little to collect in relation to its yield. The efficiency of our taxes varies. Development land tax is reputedly the least efficient and was abolished by the Chancellor in his 1985 budget.

Income tax paid by the self-employed costs 6% of the yield, PAYE income tax costs about 2%, and local rates cost about 1.5% in administration. Some excise duties are very efficient, with collection costs of around 1%.

In addition to these amounts, which are the costs to government, there are also the compliance costs incurred by taxpayers. PAYE income tax appears to be efficient because a large proportion of the costs of administration are borne by employers. The self-employed pay the costs in accountants' fees. With local rates, the compliance cost to the taxpayer is minimal unless there is a dispute over valuation.

- **The tax should be certain and should fall on the ultimate payer**

A certain tax is one where taxpayers know in advance precisely what their liability will be.



UK LABOUR COSTS AND TAXES

Many taxes are passed on and it is often impossible to establish who actually bears the burden. Income tax is perhaps the best example, as there is good reason to believe that the burden has been passed on to employers whose workers have sought to maintain the purchasing power of their wages; Adam Smith predicted that this would happen.

Attempts to mitigate the undesirable consequences and essential unfairness of the present tax system have inevitably created loopholes for the ingenious to exploit. This has led to further distortions in the economy, and uncertainty too, as taxpayers can never be sure what their tax liabilities will be.

The least bad tax?

Judged by the foregoing criteria, none of our present taxes shows up in a very favourable light. But there is one form of tax which has at least the advantages of being cheap and simple to administer, and almost impossible to avoid. This is the property tax, which will be familiar to British readers in the guise of local authority rates.

Of all taxes, the property tax can be regarded as the least unsatisfactory. Once the valuation list has been prepared, billing and collection is simple, and rarely disputed.

Almost certainly, the reason why local rates are so unpopular in Britain is because, for most people, they are the only tax which has to be paid directly out of pocket. Contrary to popular belief, rates are quite well related to ability to pay; for 50% of British households, the tax is between 2% and 3% of income, and for 80% of households, it claims between 1.5% and 4% of income.

With commercial properties, the position is, however, far more complex. In the long run, property taxes are passed backwards onto landlords, as the market takes them into account in rent negotiations. The converse applies with equal force. In Britain's rate-free Enterprise Zones, other things being equal, rents are higher than outside the zones by precisely the amount of relief from property tax! This is a practical example of the working of Ricardo's Law of Rent.

There has been growing unrest in recent years because British property taxes have been subject to sharp annual rises, due to a combination of central government policy and local government profligacy. This has squeezed businesses between a growing burden of local authority rates on the one hand, and, on the other, rents with upwards-only revision clauses in their leases.

Rising rates have, then, become a serious burden for business. But given conditions of reasonable stability, they would have less effect on the economy than almost any other tax, and there is no reason in principle why a much higher proportion of public revenue should not be raised from this source.

In Britain, if all local government spending came from rates, the rate support grant could be abolished. This would save the exchequer about £20bn a year, about 60% of the revenue raised from income tax.

If, however, more tax were to be raised from the rating system, the real defects would start to tell. The most serious is that rates penalise improvement and enterprise. A derelict site is not taxed at all; nor is an empty factory. And lower rates are payable on an old building with obsolete machinery than on a well equipped new one. This is, to say the least, unsatisfactory.

Removing the disincentive

One way to overcome these problems would be to change the basis of the valuation to the rental value of the site alone. Buildings and improvements would be de-rated, thus removing the disincentive effects of the present system. A wider base would be used, with all land, whether in use or not, being brought into the tax system. Valuation would be based on the assumption that the site was at its maximum permitted use.

This method of rating is entirely practical, and is in widespread use in the United States, Canada, Australia, New Zealand and Denmark. A rate based on site values is a form of land value tax and as such, it has a number of desirable characteristics:

1. Taxes on land cannot be passed on, so the burden falls at the point of incidence.
2. In striking contrast to all other taxes, the land value tax stimulates the economy; this is in part because vacant land has to be brought forward for development in order to yield the rent with which to pay the tax.
3. Enterprise is encouraged because the marginal rate of tax is zero.
4. Locational disadvantage is taken into account, because land values reflect this.
5. Margins of production fall at their natural point because marginal land has, by definition, no value and is therefore not subject to taxation; businesses at marginal locations would remain viable because they would be operating free of tax.
6. Rents and land prices would fall to competitive levels, because the tax would encourage the owners of buildings and land to ensure that they were priced into productive use.
7. The tax would not diminish its own base because land cannot be shifted to a tax haven. Indeed, new public investment in infrastructure raises the value of sites which benefit from this expenditure, thereby increasing the tax base.
8. The tax would be fair, since valuations would be market values, which accurately reflect the potential of the land to yield the rents with which to pay the tax.

LAND VALUE taxes are also fair in a broader sense. The market value of a piece of land is the value of the natural advantages of the site and the public services that it enjoys. All of these are provided by the community; an individual landowner cannot increase the value of his own land.

Because public spending on infrastructure such as roads, railways, sewers, flood protection, etc., is quickly reflected in land values, the land value tax would serve as a clawback mechanism to ensure that the fruits of public investment were recouped by the community.

Administratively, the site value rate would operate in exactly the same way as the present local property tax, although valuation would be much easier as it would no longer be necessary to inspect buildings and check occupation.

Values would be obtained from current market evidence; even in built up areas, vacant sites change hands quite often, and there are formulae for extracting the value of developed sites.

Within each local authority area, the rate would be set at a single uniform poundage for all categories of land, including vacant land. Billing would be organised in precisely the same way as at present. Responsibility for paying the tax could fall either on occupiers or freeholders; in either case, rules would be necessary to provide for apportionment between tenants and freeholders where the freeholder was not receiving the current market rent from his tenants.

A national tax reform

The introduction of site value taxation could be the cornerstone of a major programme of national tax reform.

In the first stage, the present valuation would be abandoned and replaced by a new one, based on site values. The second step would be to phase out the government rate support grant, and replace it by a national site value rate equalisation scheme.

A uniform national land value rate precept would be levied to provide the funds for equalising finance from those areas where land values were high to those where values were low. The precise formula for allocating funds would be for government to decide, but the overall result would be to transfer resources from the more prosperous to the less prosperous regions of the country, reducing, and possibly eliminating the need for the various forms of regional assistance.

The change from rate support grant to a national site value rate equalisation scheme might be spread over, say, five years. By this time, the national exchequer's saving of £20bn a year would enable the Chancellor to abolish some of the taxes that are ruining the economy – starting with the jobs taxes which are keeping millions of people out of work.

1. Tony Atkinson and Mervyn King, 'Working . . . but trapped in poverty', *The Guardian*, March 22, 1985.

2. British local rates are a property tax based on the value of land and buildings taken together. Vacant and agricultural land is not subject to rates, and vacant buildings are allowed partial exemption. Rates are levied by local authorities and cover about 48% of the cost of local services such as schools, police, highway repair, refuse collection and libraries.

The cornerstone for a major reform of national taxation