Flatter taxes
Rich giveaway or new deal for poor?

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1. Overview

Over the past year, a number of politicians and commentators have raised the idea of introducing 'flat taxes' as a means of simplifying our taxation system and improving incentives to work, produce and to save. While the investigation of this possibility by the Conservative Party may be said to have put the issue on the political agenda, many commentators believe that it will prove to be a political non-starter, because a simple evening up of income tax rates would, other things being equal, require substantial rises in the headline rate for middle earners. Yet even if the 'flat tax' idea proves a short-lived fad, the discussions that it has provoked raise some fundamental questions about the underlying structure of our tax system. Since most of the time we take this structure for granted and only consider changes at the margins, such debate provides a useful opportunity for reflecting on our present system.

What are flat taxes?

Different writers mean different things by this term, but this paper adopts as a definition the central idea, which is a constant marginal rate of tax on income. This does not mean that everyone pays the same amount in income tax, or even the same percentage of their income in tax, but that for all taxpayers the amount that the state takes for each extra pound earned is the same.

A common error is to confuse this marginal rate with the overall proportion of someone's income taken in tax. If the first £10,000 of income is tax free and income is taxed at a flat rate of 25 per cent thereafter, someone earning £20,000 pays £2,500 in tax, an eighth of their total income, whereas someone on £30,000 pays £5,000 or a sixth of all income.

This paper does not attempt to look in the round at the justification or otherwise of flat taxes versus the existing system, but seeks to make some specific points to contribute to the debate:

- Our present system for taxing personal income is already quite 'flat' by historic standards, in terms of the marginal tax rate applied to people at different income levels.
- The most important exception to this is not at the top but near the bottom of the income distribution, where people eligible for tax credits face steep effective marginal tax rates.
- If we really want to flatten and simplify the tax system, and to improve work incentives, we should consider whether the tax credit system could be turned into a 'negative' income tax with a constant marginal tax rate. The 'negative' element would consist of a non-means-tested payment to working families based on composition. It would be offset by a higher basic tax rate than at present, although overall many medium to low earners would be better off.
- The final section of this paper describes calculations of what such a flat tax system might mean for tax rates, and at the effects on net incomes. Researchers at the Institute for Fiscal Studies made these calculations, funded by the Joseph Rowntree Foundation. They show that the main gainers from such a system would be families with children on modest to middle incomes, while the main losers would be the highest earners without children.

2. Arguments and discussion

The multiple objectives of flat-tax advocates

Flat taxation is sometimes presented as a single simple idea. In fact, its advocates tend to have multiple objectives, which could be combined in a single reform, but which also could, in principle, each be pursued separately.

The central feature of flat taxation is the ***adoption of a single marginal rate of income tax***, which may be said to make the system simpler and remove what some regard to be unjustified differences in the rates imposed on people at different income levels. A convergence of marginal rates may potentially reduce work disincentives, but only if we believe that reducing the top rate (for the relatively few) outweighs the effect of raising the basic rate (for the many) in terms of incentive effects.

But many flat-tax advocates also propose an ***overall reduction in tax rates***, either in conjunction with a reduction in public spending or because they believe that the total tax take can remain stable despite lower tax rates. The latter depends on lower taxes improving work incentives and/or compliance, by enough to offset the revenue loss caused by reducing the rate imposed. The extreme version of this argument is that it is possible to lower the top rate to no more than the current basic rate without revenue loss. If lowering the top tax rate really does increase the tax take, it would be rational to do so independently of whether this creates a flat-tax structure.[1]

Thirdly, flat taxes may be designed to ***remove tax exemptions and allowances***, other than personal allowances, and therefore make income tax simpler and harder to avoid. This would also help meet the cost of lowering tax rates. It is not clear why such a policy, if desirable, is necessarily linked to a system of flat tax, although it is compatible with some degree of cut in the rates imposed. A principal objection may be that it reduces government's scope for influencing behaviour – for example, for encouraging pension savings or certain kinds of investment – but some would argue that this should not, in any case, be government's role.

A fourth objective for flat taxes may be to ***integrate more than one kind of tax***. In particular, advocates argue that separate taxes on investments and on businesses mean that investors pay tax twice on the profit earned by a company, first in corporation tax and then in tax on capital gains or investment income. A flat tax could apply to all forms of income, corporate or personal, without charging for the same income twice. Here again, the arguments are not particular to a move to flat-rate taxation: the removal of such 'double taxation', if justified, could be applied to any income tax structure, not just to one with a single flat rate.

Implications of flat taxes for social equity

One thing that many observers have noticed about these arguments is that, with the exception of removing tax exemptions, they all point towards a more generous tax treatment for people on high incomes. They seem designed to limit the amount of tax that high earners or investors pay at the margin, in the hope that this will encourage them to work more and invest more.

This does not prevent a flat-tax system from being 'progressive' – i.e. requiring higher earners to pay a greater proportion of their incomes than lower earners. If personal allowances are set quite high (and some flat-tax advocates suggest raising them), the proportion of all income paid by lower earners is much less than for higher earners (and for some lower earners is nil). Reducing exemptions may also improve the tax take from richer people in particular. In general, replacing a rising marginal tax rate with a flat one, while increasing allowances, tends to help the rich and poor at the cost of people on middle incomes. However, several awkward points for social equity would arise from such a change:

- The reduction among higher-rate taxpayers in the percentage of income paid in tax would be greatest for the very richest. The reduction of top-rate income tax would make most difference for the very highest earners, i.e. those paying the greatest share of their income at the top rate.

- If flat taxes were introduced without changing National Insurance (NI), it is likely that the marginal rate of direct taxation (income tax + NI) would become much higher for people on middle incomes than on high incomes. *The Economist* (2005) recently commissioned a calculation of what a revenue-neutral flat tax would be, with a tax-free allowance of £10,000, and came up with a figure of 30 per cent. This would mean that people earning up to the upper threshold of NI (£32,000), would pay a total of 41 per cent tax and NI at the margin (including 11 per cent NI as now), and higher-rate taxpayers would pay 31 per cent (including 1 per cent NI as now). This is almost an exact reversal of the present rates of 33 per cent for middle and low earners and 41 per cent for higher earners. It is hard to argue that 41 per cent is a punitive, disincentivising rate for a high earner but not for a middle or low earner. The alternative of bringing an uncapped NI contribution into the flat rate would reduce the gain for the better-off. This may seem quite attractive to those interested in social justice, but would do little to serve the flat-tax objective of improving incentives for the most heavily taxed, since a combined NI and flat tax would have to be significantly above 30 per cent, and would therefore not represent a sea change in incentives for the best-off who pay the 41 per cent top rate today.

- While raising tax allowances would take many poorer people out of tax, it is unclear what would happen to tax credits. If these were abolished in such a ‘simplification’, many people on low incomes would become much worse off, since they presently get a net rebate from the tax authorities, so even a zero tax bill would represent a loss.

The remainder of this paper focuses on issues about the tax structure for low income groups, and asks whether the design of a flat tax could be adapted to benefit those presently receiving means-tested tax credits.

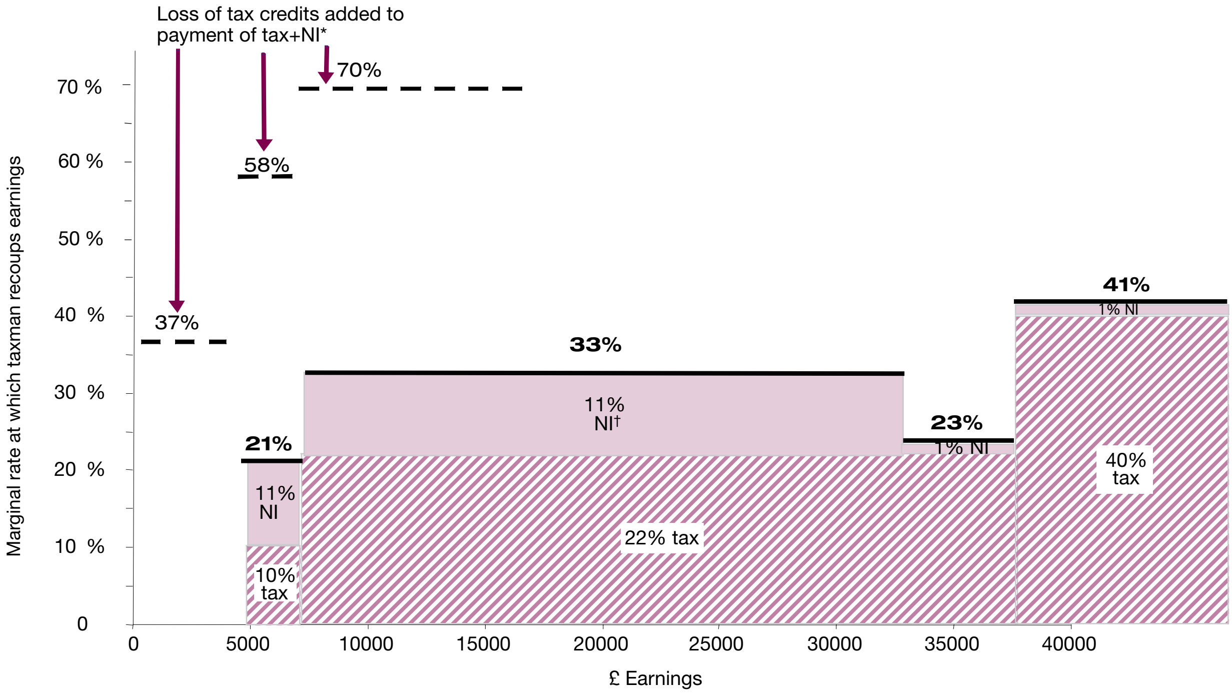
The exceptions to our present flat-tax system

Looked at in terms of marginal rates, the existing UK income tax system is already remarkably flat by historic standards. In 1979, people on the highest incomes paid 83 per cent tax at the margin, and 98 per cent on investment income, compared with 33 per cent for basic-rate taxpayers plus 6½ per cent NI up to a capped amount. So millionaires were paying over twice as much at the margin as people on average incomes. Today, most taxpayers pay a total of 33 per cent in tax and NI, and millionaires pay 41 per cent. As shown in Figure 1, the vast majority of UK taxpayers have earnings withdrawn at one of these two rates at the margin. The main exceptions are:

- a group of fairly affluent people paying only 23 per cent because their earnings are above the upper NI limit but below the higher rate of tax;
- a small group of very low-earning individuals paid just above £5,000 and not entitled to tax credits (e.g. people under 25 with no children), who pay 21 per cent tax and NI at the margin; and
- a large group of people eligible for tax credits because they are on low family incomes and have children and/or are over 25 and working full-time. They lose at least half of any increase in earnings to the tax authorities if their earnings are above the minimum tax threshold. (This effect can be exacerbated by withdrawal of benefits that are means-tested on earned income, particularly Housing Benefit and Council Tax Benefit. However, the present discussion looks only at tax, NI and tax credits.)

One way of flattening this tax structure would be to align the upper earnings limit with the threshold for paying higher-rate tax: this would end the anomaly of relatively well-off people on about £35,000 paying less at the margin than those on middle incomes. However, if the most important concern about high marginal tax rates is their effect on incentives, the most significant improvement would be to lower the steepness of withdrawal of tax credits and/or other in-work transfers to people on low incomes.

Figure 1 **Marginal tax and National Insurance rates**



* Applies to some taxpayers only. Based on family income. Earnings range affected varies by personal circumstances
† Contracted-in rate

3. What would it imply to have a constant marginal rate of withdrawal through the tax system? A simulation

What would it take for everyone's income to be taxed at the same marginal rate, including the effect of any withdrawal of tax credits? A revenue-neutral restructuring of the tax system with this effect would require people on middle incomes to face a steeper rate of withdrawal than the present 22 per cent basic rate of income tax plus 11 per cent NI (contracted-in rate). However, many people would pay less or the same in tax as now, even though their marginal rates increased.

Following a preliminary version of the present paper, the Joseph Rowntree Foundation asked researchers at the Institute for Fiscal Studies to construct an illustrative model of what a single flat-tax structure incorporating tax credits might look like, showing how high a marginal rate would have to be and what would be the effect on the overall tax burden of people at different points in the income distribution. The results are reported in full by Adam and Browne (2006), and summarised here.

What flat taxes incorporating tax credits would look like

The calculation of the effect of a flat tax including tax credit withdrawal is based on a restructuring of the tax liabilities and tax credit entitlements of families of working age. To retain simplicity, the calculation assumes no change from the present system for pensioners, and takes no account of the withdrawal of in-work benefits such as Housing Benefit. A real reform may need to be more complex, but the present exercise is intended as an illustration, not a reform proposal.

In the imagined system, every individual would have a tax-free allowance similar to today, with income above this level taxed at a uniform rate. In addition, every family type currently eligible for tax credits would receive the full credit presently paid to this family type, regardless of income. (Entitlement depends on family composition and working hours with, for example, families without children entitled to the Working Tax Credit only if they contain someone over 25 working at least 30 hours a week.) Thus, tax credits would become 'universal', rather than means-tested on income. This would have considerable benefits in terms of creating a simpler system of administration and payment.

Rather than recoup the tax credit itself from the family as its income rises, the uniform tax rate for individuals would be adjusted so that the total tax take, net of tax credits, remained unchanged, assuming working behaviour did not alter. Such a rate would need to be well above the present basic rate of tax, but well below the withdrawal of additional income for people on low incomes receiving tax credits.

Results

Institute for Fiscal Studies researchers modelled two versions of a flat tax under the above system.[2] One leaves National Insurance contributions in their present form, the other incorporates them into the flat tax system.

If NI is left unchanged, the required flat tax rate is 37 per cent. People earning below the Upper Earnings Limit for NI, currently £645 a week, would continue to pay contributions at up to 11 per cent (if 'contracted in'), and therefore lose 48p for every pound earned at the margin. This compares with 33p today for basic rate taxpayers, before the withdrawal of tax credits.

Arguably a fairer system would be also to flatten the National Insurance contribution rate across all incomes, abolishing the Upper Earnings Limit. In this case the flat tax rate would be 35 per cent, and people paying contracted-in NI contributions would pay a total of 46 per cent.

While these marginal rates would seem high, it is important to remember that they would be compensated for by a large universal tax credit payment for most working families.

Winners and losers

The pattern of winners and losers from this system would be similar under the two versions, with the version incorporating National Insurance being somewhat more redistributive from better-off to worse-off families.

Figure 2 (on page 8) shows examples of winners and losers, and Figure 3 shows more systematically the average gains and losses by income and family type. These graphs show clearly that gains are greatest for families on modest incomes with children, while losses are greatest for those on high incomes without children. For other groups, the change in the net tax bill would be small.

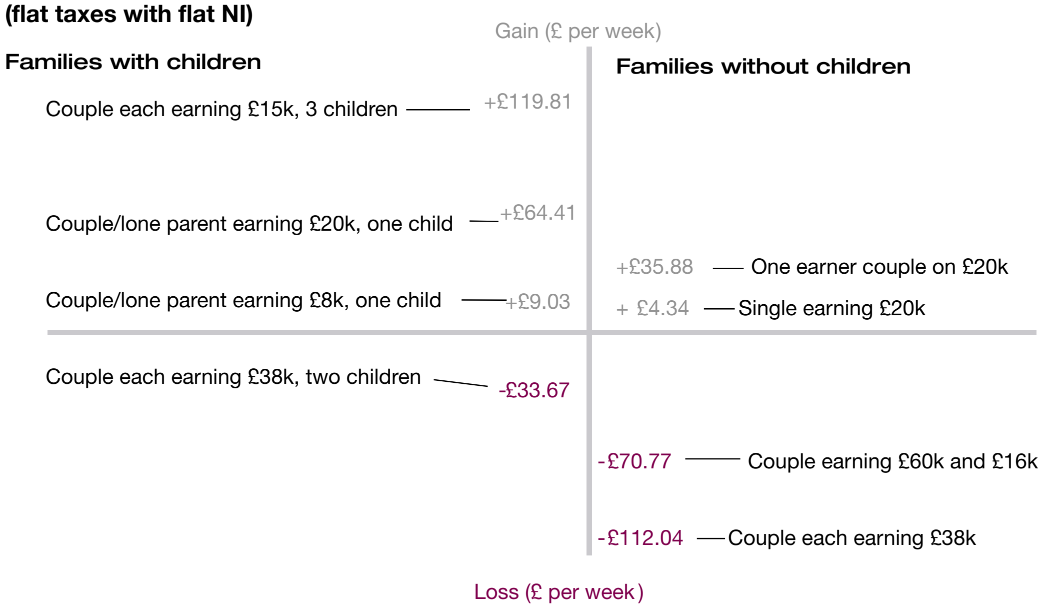
The reasons for these gains and losses are straightforward:

- For people with very low earnings, the changes make relatively little difference, since they receive tax credits as at present, and have little or no taxable income.
- For those with high tax credit entitlements, i.e. families with children, the big gains come at an income level where existing tax credits are being withdrawn, because a flat tax withdraws income more slowly overall.
- The very highest gains are for those who today have incomes just too high to receive the main means-tested tax credits: families with modest but not very low incomes, about a third of the way up the distribution.

- As incomes rise above that point, the gain of being able to keep the tax credit is gradually offset by the higher marginal tax rate in the new system compared with the present basic rate.
- For those without children, who have low or no tax credit entitlements, these higher marginal rates create a net loss on average where income is above the median growing to a loss of an average of 8 per cent of income for those who are in the 10% of all families with the highest incomes. This loss is slightly less, around 6 per cent, if the NI system is left unchanged, since in this case the marginal rate for people on higher-rate tax is slightly lower than at present.

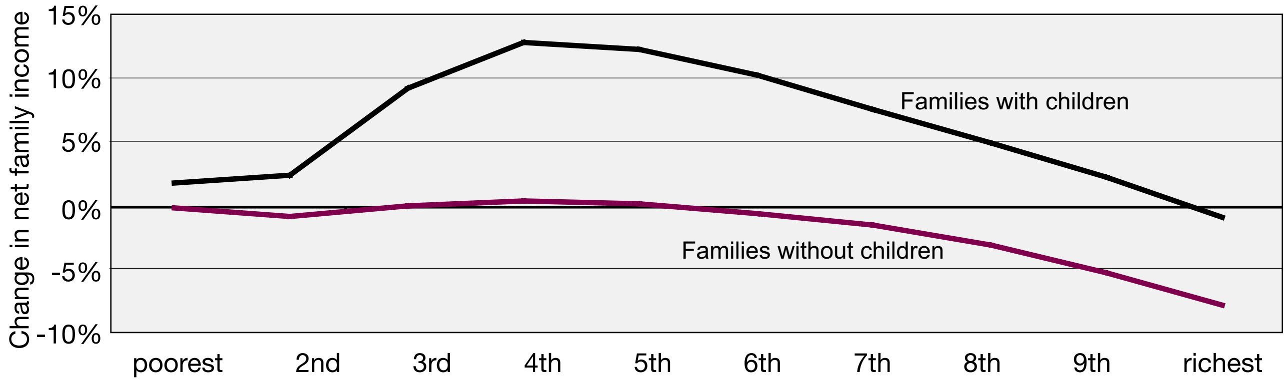
Figure 2 **Examples of gainers and losers**

(flat taxes with flat NI)



Overall, Figure 3 makes it clear that the effect of this kind of flat taxation would be to redistribute income both from families without children to families with children and from people with higher incomes to people with lower incomes. It is important to note that in general those with low incomes would not be worse off, even if they do not have children.

Figure 3 **Gainers and losers by decile group**



Families with children on modest to middle incomes gain over 10%
Families without children in the highest tenth by income lose 8%

Source: Adam and Browne (Families with pensioners excluded from analysis)

Effect on income withdrawal rates for individuals

To what extent might incentives to work be affected by changes in the rate at which additional income is recouped by the state?

The picture is mixed. Some people would face lower rates, others higher rates than at present. The number of people facing very high rates would fall, but more people would have increased than decreased rates of withdrawal. The following calculations apply to the overall rate at which taxes and NI contributions rise, and tax credits and benefits fall, as income goes up.

Under a flat tax system incorporating NI, the number facing at least a 50 per cent withdrawal rate would fall by 70 per cent, from 3.5 million to 1.1 million. On the other hand, the much larger number facing at least a 40 per cent rate would more than triple, from 6.5 million to 22.6 million. In practice, roughly half of taxpayers would move from a rate below 40 per cent to a rate between 40 and 50 per cent. Slightly fewer, but still a large minority of taxpayers would make this move under a system that did not incorporate National Insurance into the flat system.

Commentary

The modelling exercise described above is not intended to present a proposed reform of the tax structure, but to contribute to the debate by showing what kind of change would be implied if the tax authorities withdrew additional income from people of working age at a uniform rate. For most people, marginal rates would be somewhat greater than at present, and the 'headline' basic tax rate would be considerably higher. On the other hand, people who face very high rates that are less visible, in the form of tax credit withdrawal, would see substantial reductions in marginal withdrawal rates.

This paper has looked at who would gain and who would lose from such a system, and concluded that the principal redistribution would be from well-off families without children to families with children on modest incomes (but not the lowest earners).

Thinking beyond this 'winners and losers' analysis, a system of this kind could have a significant, beneficial effect on the economic opportunities of families with children in the lower half of the earnings distribution. Tax credits have helped low earners with dependents to move out of the direst working poverty, but at the same time have created a new kind of 'opportunity trap'. Having been guaranteed more adequate incomes, these families can find it hard to raise their living standards above this still basic level, because for each pound extra that they earn, as much as 70-90p gets clawed back. A flat tax structure of the kind illustrated here would make it easier for such families to raise their living standards by increasing their hours of work, training for better jobs or having more earners in the family.

It is important to bear in mind, however, that this analysis has not considered changes to Housing Benefit (HB) and Council Tax Benefit entitlements. Tenants claiming HB in particular would continue to face high withdrawal rates under the policies modelled – although the abolition of the tax credit taper would help 'float them off' reliance on HB sooner. A system that incorporated withdrawal of these benefits into a flat system would go even further in the directions described, raising further the main tax rate needed and involving more redistribution from people on high incomes to those on modest incomes.

The central purpose of this exercise has been to draw attention to the situation of people on low incomes facing high marginal withdrawal rates, as a consideration in any future reform of taxation and benefit structures. A flattening of rates for the worse-off could have much greater social consequences than a flattening of the already relatively flat taxation system for people on middle to high incomes.

An across-the-board flat tax may not be the best solution, and would be extremely difficult to sell to the electorate in the form shown here. However, the characteristics of a genuinely flat marginal rate at which income is recouped by HM Revenue and Customs serve to illustrate potential benefits of reform, which might be achieved in other ways. It is beyond the scope of this paper to explore details of other reforms that could achieve similar purposes. However, as a final reflection, it is worth noting that a universal rather than income-tested form of tax credits, with income-testing restricted to the levying of the main income tax on individuals principally through PAYE, looks particularly attractive at the present time. It would solve at a stroke the problem of the complexities and administrative tangles that have plagued our present system of tax credits.

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Notes

1 Such arguments rely on the 'Laffer Curve' which shows that above a certain tax level, revenues go down. The difficulty is knowing what this level actually is. The Adam Smith Institute (Grecu, 2004) points out that in the 1920s, 1960s and 1980s sharp reductions in the top rate of income tax in the United States were followed by rises in the tax take in the ensuing years. Whether or not the one caused the other, it is notable that the top tax rates on those occasions (73 per cent, 91 per cent and 70 per cent) were much higher than the 40 per cent top rate in the UK today. In Russia in 2002 a reduction from a 30 per cent top rate to a flat 24 per cent corporate and 13 per cent personal rate was followed by a sharp increase in revenue but this may be largely attributable to the introduction of more stringent enforcement measures (Ivanova et al, 2005).

2 They also calculated two other versions not incorporating rates of tax credit withdrawal, and these are reported in their paper, but not here.

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