

Six economists and \$513,000 could change the way the world thinks about flat tax

By Allister Heath, 19 February 2006

EVERY so often, the world has a Sir Isaac Newton moment: an apple falls from a tree, bounces off somebody's head and our understanding of the universe changes for ever. There have been many similar moments of enlightenment in the hard sciences since Newton expounded on the laws of gravity in his *Philosophiae Naturalis Principia Mathematica*, one of the most brilliant books ever written.

But for politicians and those entrusted with taking decisions about tax, spending and economic policy, lightning jolts of new wisdom are all too rare. Most politicians and policy-makers, including the supposedly top-notch mandarins at UK Chancellor Gordon Brown's Treasury, the European Union (EU) and the US Treasury, remain the economic equivalent of flat-earthers. Wrong and retrograde ideas still dominate their thinking; economic illiteracy is rife and they remain wedded to simplistic and dogmatic views of the world. The result is poverty, misery, unemployment, a lack of progress and an underperforming economy.

Attitudes do sometimes change but usually only in times of deep crisis: after the disastrous 1970s, few still believe that rampant inflation is a good thing. But today most still reject – or at least fail to understand properly – the first law of economics: incentives matter more than anything else. People must be motivated to work, save or invest or else they will sit on their sofas, watch reality television or move to more welcoming shores. To reject this simple law is as silly as to claim that the laws of gravity do not apply to apples. It is therefore remarkable that most British politicians, led by Brown, still operate as if income tax or corporation tax had no bearing on people's motivation to

work, invest, set up a business, make money or locate their companies in Britain – and hence that they can get away with putting up taxes without causing any damage. What makes this even stranger is that Brown and his intellectual allies readily accept that some sorts of taxes can change behaviour, including those on petrol, alcohol or cigarettes; they are also obsessed with the potential for social engineering of tax credits and the welfare system. This attitude was shared with US Treasury officials – until last week when President Bush finally announced a department to examine the link between tax and economic performance.

Brown's reluctance to admit that putting up taxes on work will discourage work is one of his biggest blind spots, his own brand of economic flat-earthism and a strange position for a man who seems truly to believe in the work ethic. As Steve Forbes, the US publisher and former presidential candidate, puts it in a new book this weekend: "Taxes are not just a means of raising revenue for government; they are also a price and a burden. The tax you pay on income is the price you pay for working. The tax you pay on profits is the price you pay for being successful. And the tax on capital gains is the price you pay for taking risks that work out. The concept is thus very simple – when you lower the price of positive things such as productive work, risk-taking and success, you get more of them. Raise the burden and price, and you will get less of them."

Remarkably, the UK Treasury's model of the economy, as well as those operated by private think-tanks, assume that if the top tax rate were to double from the current 40% to 80%, revenues would also double and taxpayers would not modify their lives in any way, choosing to work almost for free for Brown. The truth, of course, is that such a massive tax increase – or even one which took the top rate to 50% or 60% – would trigger economic Armageddon. Millions of people would quit their jobs, leave the country or shift to the underground economy – as Ayn Rand put in her bestselling classic novel, *Atlas Shrugged*, the wealth-creators, thinkers and doers would go on strike. The paradoxical result is that, far from raising more money, doubling income tax would actually cut tax revenues. At the same time, a significant reduction in direct taxes on income or capital would have

hugely beneficial effects, triggering an explosion of entrepreneurial activity and attracting the best and brightest to Britain. In turn, this would increase the economy's tax base and tax receipts would fall by far less than most would expect. Under certain circumstances, tax revenues could even go up rather than down as a result of the tax cuts; the government would get a smaller proportion of a larger pie, but the volume will be higher.

Until last week, the thinking of US Treasury officials on tax matters was just as medieval as that of their British counterparts, despite being nominally controlled by President Bush and a tax-cutting Republican administration. Like all bureaucracies, the US Treasury has always had its own agenda; it has long refused to include in its forecasts that cutting taxes could have a positive effect on the economy. The result has been that it has constantly wrongly predicted US tax revenues; its worst mistake in recent years was its utterly mistaken forecast that capital gains tax and dividend tax receipts would collapse after rates were slashed by President Bush in 2003. Instead, those two taxes have generated hugely more revenue than the official estimates expected, including an extra \$100bn last year alone.

Fortunately, after much tree-shaking from a small band of enlightened think-tankers in the US, led by the Centre for Freedom and Prosperity, the Bush administration has decided to impose common sense on the US Treasury. Last week, buried deep in President Bush's 2006-07 budget is a plan to create a Dynamic Analysis Division within the Treasury's Office of Tax Analysis. This division would advise the President and other key policymakers on how proposed changes to US tax policy would affect economic activity – in other words, how reducing income tax or capital gains tax would boost the supply of labour and capital and in turn increase economic growth. As William Beech of the Heritage Foundation puts it: "Inside the Beltway, this type of analysis is called 'dynamic scoring'. Outside the Beltway, this is called 'economics'."

Despite the budget of the division being a mere \$513,000, the revolutionary implications of President Bush's decision are hard to exaggerate. The six economists who will be employed will have an extremely important job and

could easily lead to a radical shift in US tax policy; and given that US intellectual fashions almost invariably migrate to this of the Atlantic, they could even force Brown to change his tune.

A move towards a more rational assessment of the impact of tax cuts and dynamic scoring will give supporters of a flat tax and other radical tax reforms a huge boost. At present, the biggest argument against cutting taxes is the supposed black hole in the public finances that would be left as a result. But current, static thinking always over-estimates the revenue reduction from tax cuts; an intellectual shift towards a dynamic way of looking at the world would make tax cuts look much more fiscally responsible.

There is much evidence from around the world that cutting tax rates boosts economic growth, reduces tax evasion and increases tax receipts. In Russia, income tax revenues increased by 25.2% in real terms after it introduced its flat rate in 2001, by 24.6% in 2002, by 15.2% in 2003 and by 14.4% in 2004. There have been four big rounds of tax cuts in recent US history and they have all led to positive supply-side effects and higher tax receipts. The Revenue Acts of 1921, 1924, and 1926 slashed the top rate of tax from 73% to 25%. Partly as a result, the US economy boomed. Income tax receipts followed: they surged by more than 61% between 1921 and 1928 at a time of zero inflation. There was a similar response when the top rate was reduced from 91% in 1963 to 70% in 1965: the economy grew extremely strongly and tax revenues surged by 62% between 1961 and 1968.

President Ronald Reagan cut the top tax rate from 70% in 1980 to 28% by 1988. The US economy received its first proper tax cut at the start of 1983. Income tax revenues soon climbed dramatically, increasing by more than 54% by 1989 (28% after adjusting for inflation). President Bush's tax cuts, while not as radical, did include important supply-side elements, including a reduction in the top tax rate to 35% and a halving of the tax on dividends. The result has yet again been a surge in revenues. Despite predictions of disaster, receipts in the 2005 financial year jumped 14.6% year on year, the highest increase in receipts in over 20 years.

Most recently, another tax-cut “miracle” has been witnessed in Australia: the amount of tax paid by Australian businesses has surged to record levels despite (or because of) a cut in the company tax rate four years ago. Since 2002-03, company tax payments have surged from just under A\$33bn to A\$50bn. Payments by the self-employed and investors have risen by 40% to A\$22.5bn over the past three years.

The company tax rate was cut to 30% from 36% as a result of recent tax reforms.

Most astonishing of all is what has happened to Irish company tax revenues since tax rates were cut. In the mid-1980s, when Ireland’s corporate income tax rate was close to 50%, it raised just more than 1% of Ireland’s GDP in tax revenues. However, today’s 12.5% corporate tax raises revenue totalling nearly 4% of GDP. Not only did the massive tax rate cuts not lead to reductions in tax revenue, either in cash term or as a share of GDP, they actually went hand in hand with an explosion in tax revenues. This incredible success story is almost never talked about in the UK.

The need for a more realistic assessment of how taxes cause stronger economic growth will be emphasised by Alvin Rabushka, a fellow of the Hoover Institution at Stanford University and father of the flat tax this week, when he gives evidence to Shadow Chancellor George Osborne’s Flat Tax Commission. It is also the central argument in *flat tax: Towards a British Model*, a book I have authored which will also be published this week by the Taxpayers’ Alliance and the Stockholm Network and makes a fully-costed and detailed case for a flat tax.

Under a comprehensive flat tax, all income earned by individuals and companies, other than a tax-free personal allowance, is taxed at a single, low rate. There are no exemptions or exceptions – and no loopholes – and none of the multiple tax bands and rates invariably associated with traditional tax systems; sometimes, flat tax proposals also include aligning the rate of value added tax with that on income. In its purest, academic form, a flat tax is accompanied by other reforms, such as the abolition of the double taxation of

profits, the ending of inheritance tax and other worthy changes intended to abolish the double taxation of income. Proponents of the flat tax would like taxpayers to pay their taxes using a couple of postcard-size forms, preferably via the internet: one form for personal income; the other for business income.

By getting rid of high marginal tax rates, flat taxes make hard work more rewarding (and therefore encourage it) and increase the opportunity cost of leisure (and thus discourage it). By improving the returns to work, a flat tax can be expected to increase the supply of labour (especially of women and older men), facilitate entrepreneurship, risk-taking and the creation of small businesses, make investment more worthwhile, including spending on human capital (such as education and training), help attract foreign direct investment, overseas capital and migrants (especially skilled, high-productivity workers), and bring part of the grey economy into the official economy because tax rates are kept lower, thus reducing the incentive for avoidance or moving assets into foreign tax havens. A comprehensive flat tax system with low tax rates also has huge benefits in terms of reduced compliance costs. It would broaden the tax base by curtailing the incentive for an underground economy and thereby reduce tax evasion, avoidance and underreporting. Under a flat tax, it would also be easier and cheaper to pay taxes without having to use expensive accountants and advisers, destroying the rationale for tax planning or income shifting; the cost of collecting taxes would also be lower.

Flat Tax: Towards a British Model suggests a first giant step towards a British flat tax be taken by slashing income tax and national insurance contributions and merging the two systems into one, with a single flat 28% rate on income from wages and salaries above £9,000 a year and zero tax on any income below that. All loopholes would be repealed, as would be inheritance tax, capital gains tax, the tax on dividends and tax on interest. Company profits would also be subject to a single 28% rate on profits, also above a generous allowance. Tax credits would be abolished and partly replaced by traditional welfare benefits. There would be only one exception to the 28% flat tax: pensioners would enjoy a lower, 22% rate. This is because income from

pensions as well as the salaries, wages and self-employment income of pensioners is currently exempt from national insurance contributions.

The result would be equivalent to a net tax cut of £59.7bn, measured in a static way. Crucially, thanks to dynamic effects, around 40% of the cuts in income tax, national insurance contributions and corporation tax will pay for themselves via stronger growth and less tax avoidance over three years; the rest would be partly compensated for by keeping nominal public sector spending growth to 2.5% a year for three years and reductions in wasteful spending, including the abolition of the Department of Trade and Industry. Transitional financing would come from an acceleration in the government's privatisation programme, with the Post Office and some land holdings prime candidates for immediate disposal. Finally, a case can be made that a little additional public borrowing during the transition period would not matter – it would be equivalent to an "investment" in a better tax system and better economy, just as Chancellor Gordon Brown is happy to "invest" by spending on the public sector.

Under the plan, at least 8m households would pay no direct tax on their income at all. The poorest three and a bit deciles would see their original income (excluding indirect taxes and benefits) surge by between 13% and 15%; the reform would be tantamount to a pay rise of the same amount and would boost the incentives of those on lower incomes to work and get off benefits. The top three deciles would enjoy an income boost of just 0.5% to 0.8%. Even in cash terms, the second lowest decile would enjoy a boost of that is considerably greater (at £638) than that of the top three deciles (they would gain only by £226 to £563). The direct tax system would also remain progressive, with the first three deciles paying no tax and the next seven paying a progressively higher tax rate.

Fewer people would have to pay direct tax on the one hand while simultaneously collecting offsetting handouts on the other; this would make it easier and more worthwhile for the most vulnerable to extricate themselves from the welfare trap. By boosting economic growth, it would also improve employment and provide more opportunities for the poor. All of

this suggests that the flat tax would do wonders for social mobility in Britain, which has ceased to improve in recent years and may have started to decline.

Versions of the flat tax have been adopted in nine countries, including Russia, Estonia, Latvia, Lithuania, Ukraine, Slovakia, Georgia, Romania and Serbia. As Forbes argues in the preface to *Flat Tax: Towards a British Model*: "The flat tax is indeed an idea whose time is coming – and the global economy – including Britain's – will enormously benefit from it." He adds: "An endless array of "stealth" taxes is starting to clog Britain's economic arteries. The flat tax will clean those arteries and enable the UK. again to grow rapidly." But for that to happen, Britain needs an intellectual revolution and a new Newton who can finally grasp that punishing people for working or making money is a recipe for disaster.