

Fairer, Simpler, Greener

Policy paper 75



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Executive summary

We aim to reform the tax system to make it:

- Fairer:** progressive in relation to income and wealth
Simpler: for individuals and companies: fewer rates and reliefs, more transparent
Greener: taxing environmental pollution and resource depletion and giving bigger incentives to sustainability
More Local: greater freedom for democratic local government to raise (and spend) revenue
More Efficient: recognising the importance of incentives to work and save; and growing global competition

Our package of reforms is tax neutral overall - that is it does not alter the total amount of taxation raised, but raises it in different ways. This does not prejudge decisions which need to be made in future Alternative Budgets and General Election Manifestos on whether we should increase or reduce the total burden of taxation. The thresholds and other figures used below and in the supplement reflect what this package would mean if we were introducing it in 2006/7 values.

This short policy paper cannot cover all aspects of tax policy and there are many issues - such as those surrounding the taxation of land, international tax competition and tax avoidance - which need fuller examination. Nor have we dealt with the overlapping issues of tax credits and benefits which are to be covered by a forthcoming working group on Tackling Inequality and Poverty.

The proposals sketch out what a Liberal Democrat government would aim to achieve in the early stages of the next Parliament but also indicate a longer-term direction of travel. The Labour Government is, additionally, reviewing the system of local government finance (through the Lyons Review) and, pending its conclusions, we re-affirm our commitment to replacing Council Tax with a tax based on ability to pay - Local Income Tax - and our support for returning business rates to local control.

The specific proposals for the national budget in a new Parliament would be to:

- Abolish the existing 10p starting rate of income tax - taking more than two million people out of tax altogether and removing one rate of tax.
- Raise the employee NICs threshold so that NICs begin to be paid at the same level of income as income tax, simplifying the system, and to seek to make employee NICs payable on annual rather than a weekly earnings.
- Raise the starting threshold for the 40% upper rate of taxation to £50,000 pa - taking 1.3 million people out of paying upper rate tax (while raising the upper threshold for the higher rate of National Insurance Contributions to £50,000 pa.)
- Cut the basic rate of national income tax by 2p.

To help fund these changes and make the tax system fairer we will:

- Reform and simplify Capital Gains Tax, in particular by removing taper relief.
- Provide pension contribution tax relief at the basic rate of income tax only.

In the supplement we set out how these changes taken together will affect particular groups of taxpayers and, separately, how these impacts would be changed on the assumption that local income tax were to replace council tax on a tax neutral basis.

To tax environmental pollution and resource usage, and help fund our other reforms, we will make a 'green tax switch' by:

- Replacing the existing Airport Passenger Duty with an Aircraft Tax based on the emissions of each aircraft.
- More steeply graduating vehicle excise duty for new vehicles based on carbon emissions, with a higher level for the highest emissions band.
- Reforming the existing climate change levy, indexing it annually and eventually changing it into a simpler carbon tax.

- Indexing fuel duty to inflation except in periods of oil price spikes.
- Phasing in reform of the basis on which business rates are charged in England to Site Value Rating.

To simplify the tax system for businesses we will:

- Create a simpler Corporation Tax structure, removing complex reliefs and cutting the main rate.
- Repeal most anti-avoidance legislation and use a General Anti-Avoidance Rule to simplify the tax code.
- Give an option for small businesses to be taxed on net cashflow not profit.
- Introduce a small business rates relief as an interim measure before major reforms to the business rate can be implemented.

In the longer term we aim to achieve much more radical change:

- Raise the income tax threshold further - an intermediate objective would be to raise the threshold to around £10,000, the approximate annual equivalent of the National Minimum Wage.
- Enlarge the tax base by developing policies on land taxation.
- Merge the system of employee and employer National Insurance Contributions as the contributory principle becomes obsolete.
- Overhaul the system of taxing transport and congestion to reflect the potential of road user pricing.
- Reform the taxation of assets, notably Inheritance Tax by changing the basis on which IHT is charged so that it falls on accessions, including lifetime gifts in the taxable sum, and raising thresholds and cutting rates.
- Reform Stamp Duty Land Tax into a progressive tax that only charges higher rates of duty on the proportion of the property value above a threshold.

Introduction: Principles and Objectives

1.1 The purposes of taxation

1.1.1 Taxation is a means rather than an end in itself. It also poses dilemmas for those like the Liberal Democrats who, on the one hand, recognise that taxation is a limitation on freedom as it prevents people spending their own money as they would wish but who, on the other hand, recognise that there are some compelling demands for tax-financed public spending. The precise balance to be struck is essentially a political judgement rather than a technical matter.

1.1.2 There are essentially four reasons why taxation is necessary. The first is to finance public goods. It has long been recognised, even by those who are most sceptical of the value of government spending, that certain activities can most efficiently be provided or at least financed by the state rather than markets: national defence, policing, many aspects of the transport system, education and public health. There is debate to be had about the role of user charging rather than taxation in some of these areas, and over which aspects of health and education should be regarded as a public rather than private responsibility; but democratically elected governments will have legitimate calls on the taxpayer in these areas.

1.1.3 The second is for transfer payments. A substantial proportion of public spending involves redistribution of income between generations (pensions), income groups (income support; tax credits), and localities (local government funding); or is targeted to benefit specific groups (the unemployed; disabled people; elderly people). None of these directly involves the provision of services. On the taxation side, much of the tax system is designed to achieve a different post-tax distribution of income and wealth (income tax; capital taxation; VAT exemptions).

1.1.4 The third major purpose is the use of taxation to influence behaviour. There has long been broad support for 'sin taxes' - on alcohol, tobacco and gaming - with the aim of reducing consumption. Petrol taxation has also had this motivation, in part linked to environmental impacts. The taxation system has long encouraged people to save via specific inducements. Aspects of business behaviour - investing in R&D;

training; location in deprived areas - also attract tax incentives. Taxation has been used to influence family structure (married people's allowances) or numbers of children. Excessive and inappropriate use of behaviour-influencing taxes adds to complexity. But Liberal Democrats have been drawn in particular to the idea of using taxes to encourage environmental sustainability, by ensuring that the costs of pollution fall on the polluter - the 'polluter pays' principle.

1.1.5 Finally there is taxation of economic 'rent' or the extra income that arises from resources that are in relatively fixed supply. There is a powerful, long standing argument for the taxation of land. Property tax has its origins here, as does the taxation of natural resources, for example through the licensing of oil and mineral extraction, and charges for radio spectrum permits, airspace rights and other 'commons' for which there are no costs of production - the value of which, ultimately, belongs to the whole community.

1.2 What are the features of a Liberal tax system?

1.2.1 Given these overall objectives of taxation, key Liberal Democrat principles for structuring the tax system include:

- Fairness
- Simplicity
- Environmental sustainability
- Economic efficiency
- Decentralisation

1.2.2 Fairness is necessarily subjective and encompasses such principles as tax not being applied retrospectively. But it also reflects the presumption that tax raised should relate to the taxpayer's ability to pay (vertical equity); and that similar categories of taxpayers should be treated in broadly the same way (horizontal equity). Traditionally fairness in direct taxation has been related to the idea that there should be a rising scale of rates of income tax to ensure that those with higher incomes pay a higher proportion of their income as tax (progressivity). At the last general election, Liberal Democrats advocated introducing a higher rate of income tax at 50% on earnings above £100,000. 'Ability to pay' can relate to income or wealth or both, and so is

relevant to capital as well as income taxation. A sense of fairness can relate to marginal as well as average tax rates.

1.2.3 The idea of fairness is often linked to redistribution. Liberal Democrats have always opposed entrenched inequality, and Britain remains a society marked by greater economic inequality than many other European countries; and there is clear evidence that inequalities of income and wealth have increased in recent decades (see figure 1). However, the tax system in isolation cannot be redistributive, but only when linked to broader tax and spend policies. For example, a tax system could be progressive, but not redistributive if expenditure is skewed in favour of the better-off. Because the poor generally pay very little if any income tax at all, there are limits to how much the income tax system alone can be used to redistribute in their favour.

1.2.4 Another aspect of fairness which has been the subject of increasing debate is fairness across generations. There is arguably inequity between a 'baby-boomer' generation that benefited from a relatively generous welfare state and access to occupational pensions schemes, and were able to enter the property market before the major price increases of the last twenty years; and on the other hand younger adults struggling to enter the property market and pay off student debt, and needing to set aside money for personal pensions. Of course this debate goes much wider than just the tax system, but tax reform should take account of inter-generational issues.

1.2.5 Simplicity: Given that the main purpose of taxation is to raise revenue, it is desirable that taxes should themselves be able to be collected with the minimum of cost. It is also desirable for individual taxpayers to be able to understand the system and manage their own tax affairs with the least resort to professional advice. Complexity breeds avoidance, which breeds more complexity.

1.2.6 Predictability is also important. If the government has long term objectives for tax reform, it is better that these are openly stated and pre-announced even if they are to be implemented over a number of years, rather than introduced piecemeal. The Labour government has produced many examples of tax proposals with unintended consequences having to be reversed (SIPPs;

international tax trusts; film tax reliefs). Especially where tax changes are meant to influence behaviour and investment decisions, evidence of a long term commitment to the direction of reform is important.

1.2.7 Environmental Sustainability: One of the strongest tools available to government to help to change behaviour is the tax system. Liberal Democrats believe that climate change is the greatest threat facing the planet and tax is a policy instrument which we cannot afford to neglect as part of a package of measures to cut greenhouse gas emissions. Taxes have the advantage that they can be used to incentivise environmentally sensitive behaviour in an economically efficient way that goes with the grain of markets. We also support the principle of using taxes on resource usage and depletion to help us cut taxes on wealth creation.

1.2.8 Economic efficiency: a perfectly economically efficient tax system (lump sum transfers independent of economic transactions, taxes on economic rents, etc) is unattainable in practice; and some taxes are designed to change behaviour as with environmental taxes. But the economic impacts (effects on incentives and on resource allocation) of proposals should be addressed and we should seek to improve economic efficiency. In this policy paper, we pay particular attention to tax disincentives to work and to save. Note that economic efficiency is not the same as 'competitiveness' as commonly used, i.e. the ability of companies to compete internationally, although that will need to be taken into account.

1.2.9 Decentralisation: Liberal Democrats are strongly committed to the maximum decentralisation of power to local and devolved tiers of government, believing that local government is closer to the citizen, more readily held accountable, and better able to meet the needs and preferences of local populations. The effectiveness and autonomy of local government depends on having significant revenue raising powers independent of the central government. Liberal Democrats therefore favour a tax system which allows for effective tax raising at local and devolved levels. Ideally each level of government should raise the highest practical share of its own spending.

1.3 How the existing UK tax system measures up

Fairness

1.3.1 The UK tax system is not progressive in income terms, with the bottom 20% of households paying 36.4% of their gross income in taxes, while the top 20% pay only 35.6%. Direct taxation is progressive (the equivalent shares being 9.6% and 24.7%) but indirect taxes counterbalance this. All the major indirect taxes are regressive, the most strikingly so being tobacco duty which accounts for ten times as much of the income of the bottom 20% of households as of the top 20%. However, these figures do not take into account the effect of tax credits. Taking into account all benefits as well as taxes and tax credits, the net effect of government fiscal policy is to narrow substantially the gap between original incomes and final incomes.

1.3.2 The top rate of income tax is broadly in line with those in other developed countries though lower than average (40% compared with a 48% average for the EU and 44% average for the OECD¹). But the starting threshold for income tax is low by international standards at only about 25% of average earnings, and the starting threshold for higher rate tax is also comparatively low.

1.3.3 The effect of the separate National Insurance Contributions system reduces the

progressivity of the direct taxation system, with the effective combined tax and NI basic rate being 33% and the effective top rate being 41% - a gap of only 8 percentage points.

1.3.4 One of the most regressive existing taxes in terms of income is the property-based local council tax, accounting for 5.1 % of the income of the bottom 20% of households and just 1.7% of the top 20%. Council tax benefit alleviates the position but many on very low incomes do not receive benefit. One of the key Liberal Democrat commitments in the last general election manifesto was to replace Council Tax with a fairer Local Income Tax.

1.3.5 Issues of fairness also arise in relation to 'wealth' taxes, in particular Inheritance Tax (IHT). Traditionally this has only fallen on very large estates, however, the IHT threshold has not risen in line with property prices in recent years so many more will be caught in future. Critics of IHT also point out that the very wealthy are able to pay little or no IHT as a result of professional tax planning. While the principle of taxing large inheritances may appear attractive (and is supported by many wealthy people as a way of maintaining incentives to personal effort), in practice IHT is less fair than it may seem.

1.3.6 The 'slab' structure of Stamp Duty makes it burdensome on relatively modest property purchases just above the thresholds.

¹ OECD data for 2004, includes local taxes

Figure 1: Trends in UK Income Inequality
(Source IFS and ONS)

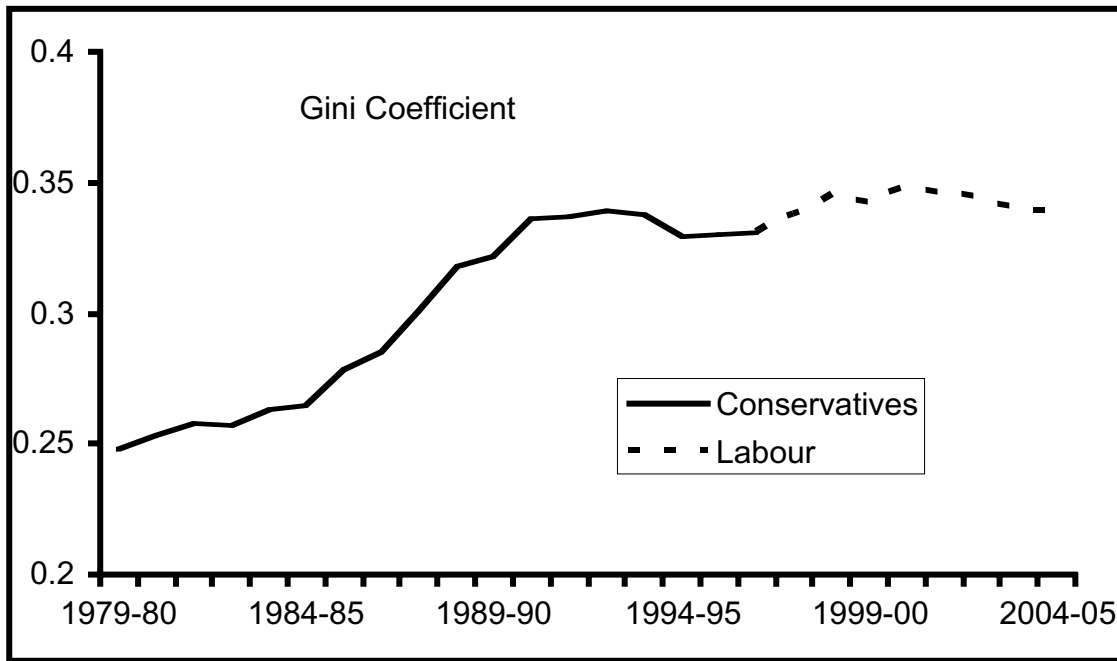
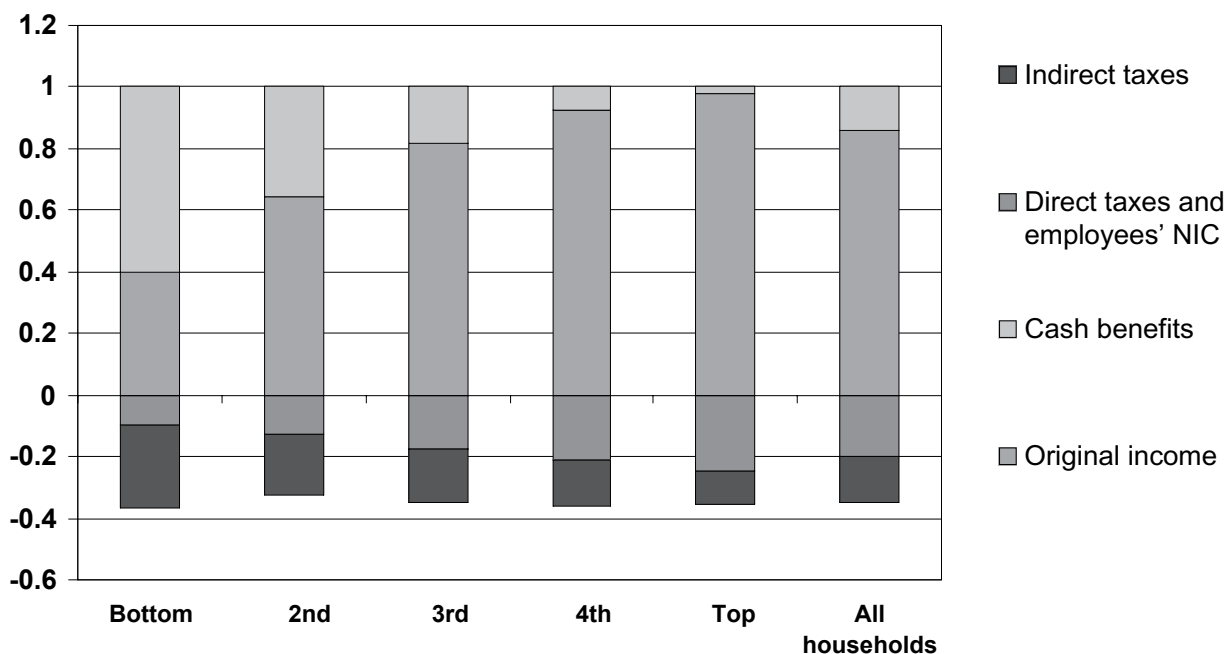


Figure 2: Trends in Marketable Wealth
(Source: ONS)

Wealth owned by	1996	2003
Most wealthy 1%	20	21
Most wealthy 5%	40	40
Most wealthy 10%	52	53
Most wealthy 25%	74	72
Least wealthy 50%	7	7

Figure 3: Share of Taxation by Income Group
(Source: ONS: *The effects of taxation and benefits on household income 2004-5*)



Simplicity

1.3.7 The UK tax system clearly suffers from complexity, demonstrated by the proliferation of tax manuals and tax advisers.

1.3.8 The structure of income tax in the UK has two main rates plus a lower starting rate, with separate tax rates for dividends and some complex reliefs for pension contributions and savings. Some efforts have been made to reduce complexity for taxpayers, for example by ending the requirement that all higher rate taxpayers complete an income tax return.

1.3.9 However, a major source of complication is the separate National Insurance Contributions system. Although this now effectively starts at the same level of income as income tax, it is levied on a different definition of income (earnings only), on a weekly rather than annual basis, has an upper threshold for the 11% rate but not the 1% added in 2003, and also treats the self-employed differently. There is no longer any meaningful hypothecation of National Insurance which was the original justification for the separate system.

1.3.10 One of the sources of complexity is the relatively low threshold at which tax starts to be paid, drawing into the tax net large numbers of relatively low earners - 3.6 million people who earn half of average earnings still pay tax. The Labour Government's response to this - the tax credit system - has in turn created major administrative complications. Low-income families face a very complex procedure to apply for credits. In particular, there has been a problem of major overpayments and underpayments which creates a burden on low-income families and in some cases significant hardship.

1.3.11 Capital Gains Tax (CGT) and Inheritance Tax are highly complex. CGT has numerous different tax rates, notably because of taper relief. IHT is also very complex and each attempt to plug loopholes adds to complexity.

1.3.12 There have been a bewildering number of changes to company taxation under the Labour government, which in some cases have almost ended up coming full circle in their net effects (eg. stamp duty disadvantaged area relief).

1.3.13 On the indirect side, there is one main rate for VAT, although there are lower rates for a small range of goods including domestic fuel and power, women's sanitary products, condoms, children's car seats and some forms of residential conversion. There is also a wide range of zero-rated or exempt goods and services.

Decentralisation

1.3.14 The raising of tax in the UK is extremely centralised. The only tax stream under local control is Council Tax, which accounts for little more than 5% of total tax receipts and around 20-25% of local government expenditure. Even this expenditure is subject to government capping powers. Business rates, which raise a similar total amount, were under local control until 1990 but are now set nationally. The Scottish Parliament has limited tax-raising powers including the ability to vary the basic rate of income tax up or down by up to 3p in the pound. It has not yet used this power and without further tax raising powers, it remains predominantly reliant on a grant transfer from Westminster which varies according to the Barnett formula.² The Scottish Parliament does have the power to vary business rates in Scotland and has recently used this power to reduce rates to a similar level to England. Other devolved bodies including the Greater London Assembly rely on precepts. One factor which needs to be taken into account is the role of equalisation to level out inequalities in service provision caused by the smaller tax base of poorer areas.

Economic Efficiency

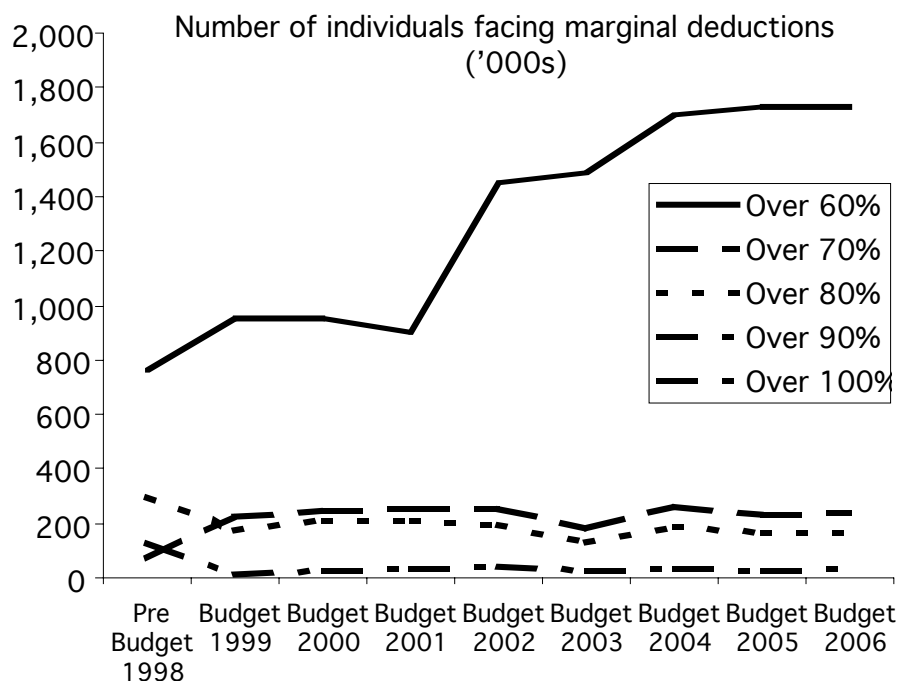
1.3.15 Obviously there are some ways in which the tax system is designed to 'distort' behaviour by creating incentives, for example there are a number of explicitly environmental taxes such as the climate change levy. However, there are a number of ways in which the system creates perverse incentives which are accidental or arbitrary. For example, the fact that building renovation and repairs are subject to the full 17.5% of VAT while new build is exempt creates a bias towards new build. The impact of some taxes is disproportionate on some categories of

² The Barnett formula allocates increases in central grant to Scotland, Wales and Northern Ireland by taking the total increase in England expenditure and then giving the other states an equivalent amount per capita of population.

taxpayers (e.g. Council Tax in relation to people whose property values are high relative to their incomes), and capital gains tax, IHT, corporation tax reliefs and the different treatments of savings all potentially change behaviours in unintended ways. The most serious way in which the tax system changes behaviour in economically damaging ways is to create - in combination with

means-tested benefits - very high marginal tax rates, discouraging work and savings. The introduction of tax credits has removed some of the highest withdrawal rates, however, there remain very high effective marginal rates and withdrawal rates for those on low and middle incomes.

Figure 4: Illustration of Numbers of People on High Marginal Rates
(Source: Various Budgets)

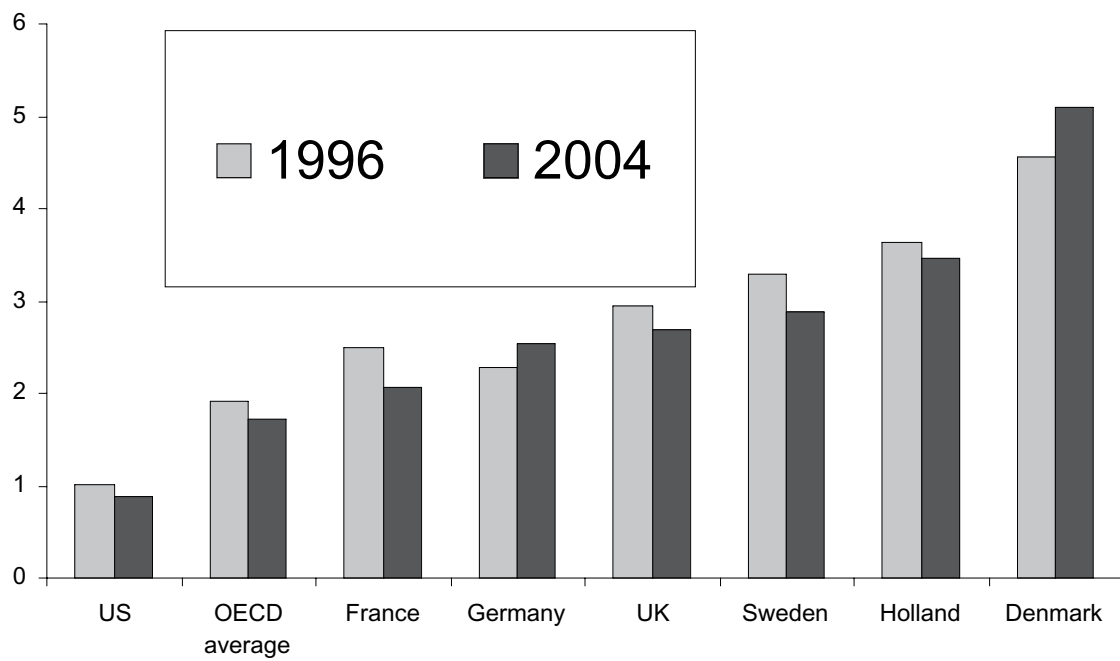


Environmental Sustainability

1.3.16 There is no doubt that environmental taxation can be used successfully to achieve environmental objectives. The Nordic countries have pioneered the introduction of carbon and energy taxes. The National Environmental Research Institute in Denmark has found that in Finland, CO₂ emissions would have been 7 per cent higher at the end of the Nineties if the taxes had not been introduced, while in Denmark the tax-subsidy scheme on industrial emissions caused emissions to decline by 23 per cent in just

seven years. There is even a 'double dividend' with positive environmental effects and benefits for employment and competitiveness. The proportion of Britain's tax take from environmental taxes is above the OECD average but the average is pulled down by the low proportion in the US; and the UK is well behind leading European countries such as Denmark. Despite the Labour government's nominal commitment to environmental taxation made in 1997, the proportion of GDP accounted for by environmental taxes has in fact fallen since then.

Figure 5: Environmental taxation as a share of GDP: International comparison
(Source: OECD)³



³ Actual figures from HM Treasury Show a fall from 3.35% to 3% over the same period

Personal Taxation

2.0.1 Direct taxes - whether income tax or national insurance - are the closest approximation to a tax based on ability to pay. For this reason they are broadly perceived as 'fair'. They are also buoyant, growing as the economy grows, and at least for those in paid employment, are easy to collect. For these reasons the Liberal Democrats argued in the 1992, 1997 and 2001 general elections that a moderate increase in income tax was the fairest, and most transparent and appropriate, way to raise extra revenue to fund public services. Following the large expansion of public spending by the Labour government, that policy objective has been met. The concept of ability to pay also lies behind our longstanding commitment to replace a regressive local property tax with Local Income Tax.

2.1 Income Tax and National Insurance Thresholds

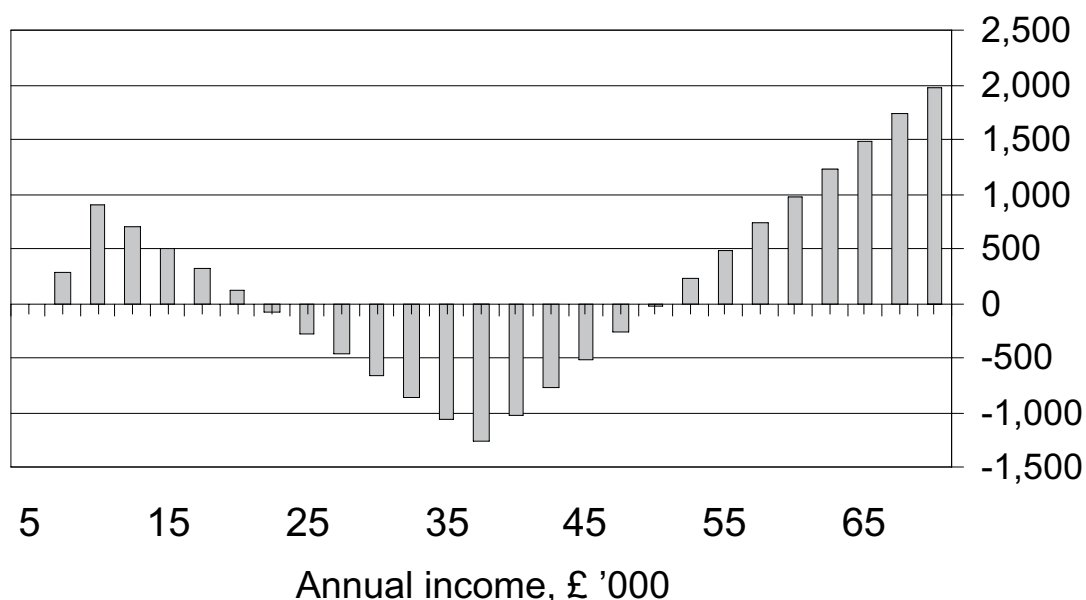
2.1.1 Many have questioned recently the way in which income tax operates. It has become complex with multiple rates and exemptions (like the age allowance and for various forms of savings). There are separate rates for dividend

income. Fiscal drag as well as economic growth has increased the number of taxpayers from 14.5 million in 1948 to 29 million in 2005. Many poor people, earning below the level of minimum wage on an annualised basis, now pay income tax. There is an additional layer of complexity from national insurance, particularly the anomalies created by different thresholds and the upper earnings limit (see figure 8). All this has raised further questions about the distinctive effects of high and idiosyncratic rates of tax, particularly on work and saving. Radical reforms have been proposed, including a 'Flat Tax' (though this means different things in different contexts, its proponents usually envisage a flat rate of income tax). We have looked at flat tax proposals carefully. We concluded that, by removing a progressive tax from a mix of taxes, the consequences would inevitably be adverse in distributional terms. If there were a large basic allowance to lift those on very low earnings out of tax, the rich and very low earners would benefit but those in the middle would be penalised (see figure 6). For this reason we reject a flat tax though we see the merits in greater simplicity.

Figure 6: Flat Tax gain or loss compared with today

(Source: PricewaterhouseCoopers)

Based on £10,000 Personal allowance, 30% flat rate on taxable income



2.1.2 The existing starting points for both Income Tax and National Insurance are set at levels which catch many low earners. At the same time, the top rate of tax starts at a relatively low level of income by international standards, and there are now 3.29 million higher rate tax payers as against 2.08 million in 1996-97. The different thresholds for income tax and NICs also produce an anomalous dip in the combined marginal rate of taxation for those earning just below the current top rate threshold. To lift millions out of paying tax, and to make the system simpler and more smoothly progressive, we propose:

- Abolishing the existing 10p starting rate of income tax so that no tax is paid on incomes below £7,185 pa;
- Raising employee NICs threshold so that NICs begin to be paid at the same level of income as income tax;
- Raising the starting threshold for the 40% upper rate of taxation to £50,000 pa;
- Raising the upper threshold for the main rate of National Insurance Contributions to £50,000 pa.

2.1.3 To really help low paid workers and tackle very high marginal tax plus benefit withdrawal rates, raising income tax thresholds has to be combined with reforms both to the administration of tax credits to address the obvious problems of the current system, and to benefit withdrawal tapers. However, detailed policy on these issues is beyond the scope of this

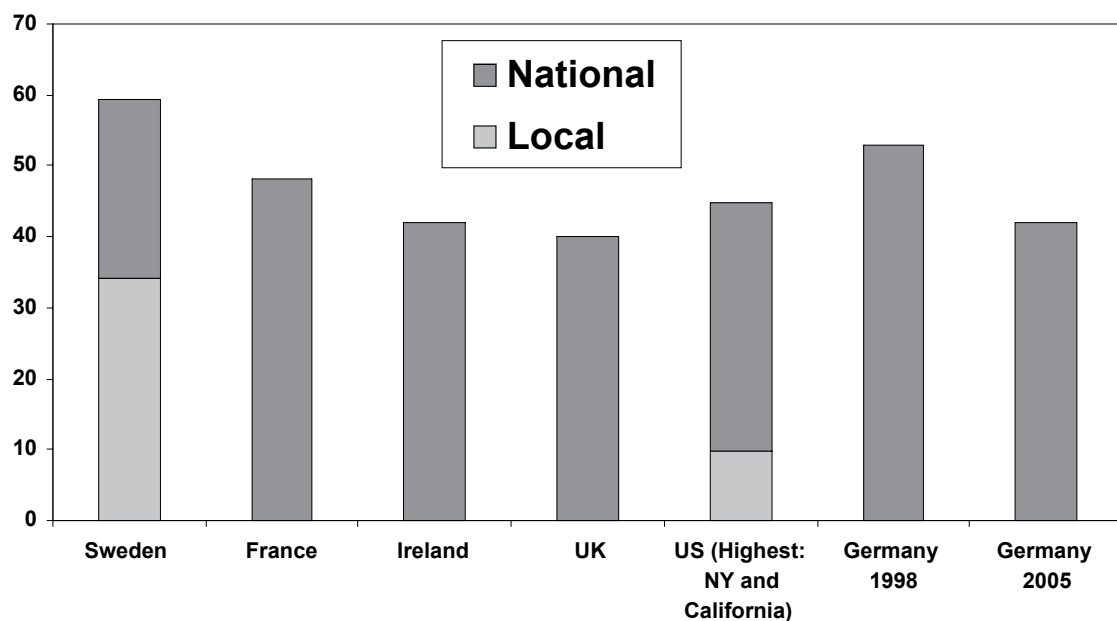
report and will be addressed in the planned Inequality, Poverty and Opportunity working group.

2.1.4 Even at a higher starting threshold of £7,185 per year, people will still be paying income tax on earnings well below the level of earnings implied by the National Minimum Wage (NMW). It is difficult to see how there can be any justification for income tax being paid on incomes below the minimum wage which is supposed to be a 'living wage' sufficient to afford the necessities of life. It is therefore our aspiration to raise the income tax and NI thresholds gradually to the level of the NMW; however, we recognise that this is an expensive objective since allowances are paid through the range of incomes. As noted above, in the short term we are looking at means of improving the benefits and tax credits systems in the Inequality, Poverty and Opportunity working group.

2.2 Rates of Income Tax

2.2.1 In addition to lifting the starting threshold for Income Tax, we also propose that the basic rate of Income Tax should be cut by 2p in the £ to 20%. This will substantially assist low and middle-income earners. Combined with our policy of replacing Council Tax with Local Income Tax, a cut in the basic rate of income tax is also part of a strategy to shift the basis of taxation from national to local.

Figure 7: Top Marginal Rates of Tax



2.2.2 At the last General Election, the Liberal Democrats proposed a new higher rate of income tax on incomes over £100,000 pa - this would have comprised a 49% income tax and 1% NI. It was combined with a pledge to cap Local Income Tax at £100,000 so that top total marginal rates could not go above 50%. The 50p rate would have raised approximately £5 billion in gross revenue, or £3 billion net of the transfers required to cap Local Income Tax; and along with the replacement of Council Tax with LIT, was the main proposal in our last Manifesto for making the overall system more progressive and increasing the proportion of taxation paid by the rich.

2.2.3 However, we no longer believe that a higher rate on income tax is necessary. We have now identified alternative ways of making the overall tax system more progressive by raising money from the well off (see 2.3 below) These measures will raise net approximately three times as much money from this group than the 50p rate proposed in our last Manifesto, so the 50p rate is not necessary to our aim of making the system fairer overall. The proposals in 2.3 also have the advantage that they fall on *wealth* as well as on *income*.

2.2.4 There are also some practical reservations about a 50p rate. Concerns were expressed by some commentators at the last election that such a

steep rise in the marginal rate would increase tax avoidance, and that the higher rate would, therefore, not raise the expected revenue in full. Although a 50% top rate would not put the UK at the very top of the international range of income tax rates, it would move us significantly upwards at a time when the general trend in developed economies has been to bring down top rates.

2.2.5 As a corollary to dropping the 50p rate, we would not need to cap LIT at incomes of £100,000 pa, strengthening the decentralisation aspect of our LIT policy. This would mean that the effective combined top marginal rate of tax would be 40% income tax, plus 1% NI plus LIT - giving a likely figure in the mid-forties which would be somewhat higher than at present in the UK but still very competitive by international standards. Figures 8 and 9 show current marginal tax and NI rates, and those that would apply under our plans.

2.2.6 In the last Manifesto costings package, some of the revenue from the 50p rate was earmarked to pay for policy commitments on long-term care and higher education. Our commitments to these policies are not affected by a change in policy on the tax rate - we are committed to finding £15 billion of savings from existing low priority or wasteful spending to fund our spending priorities, and these existing commitments will be funded in this way.

Figure 8: Current combined marginal rates for Income Tax and National Insurance

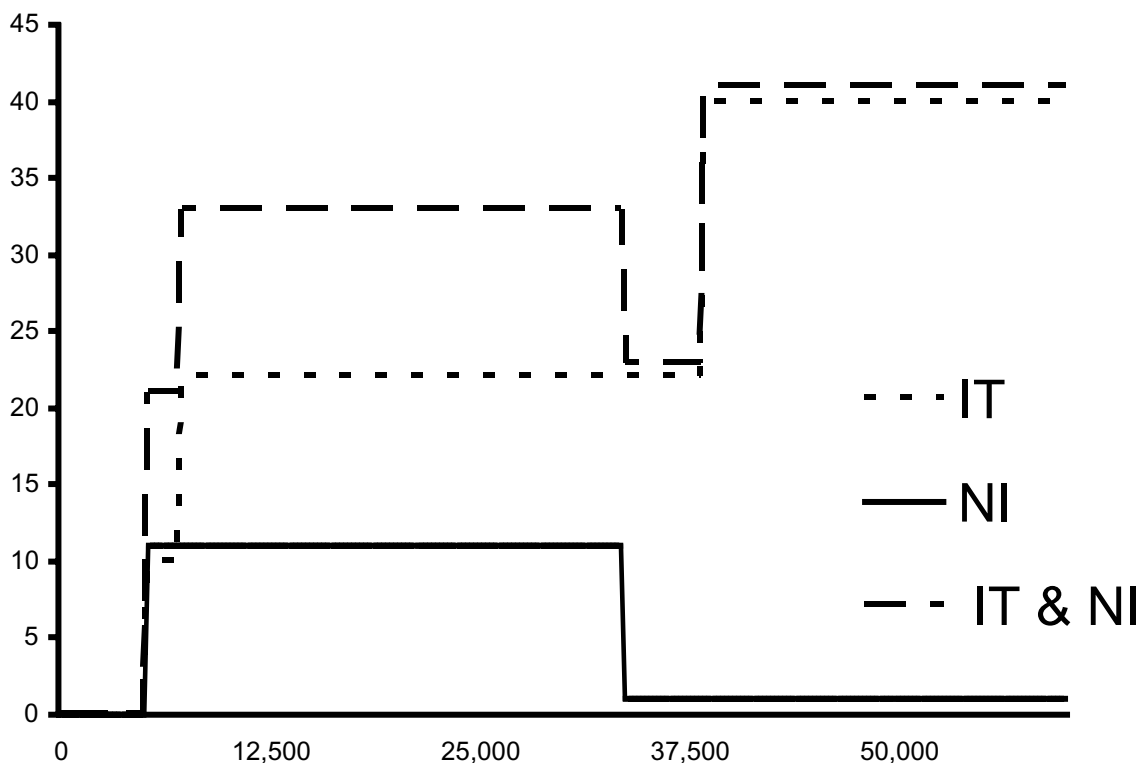
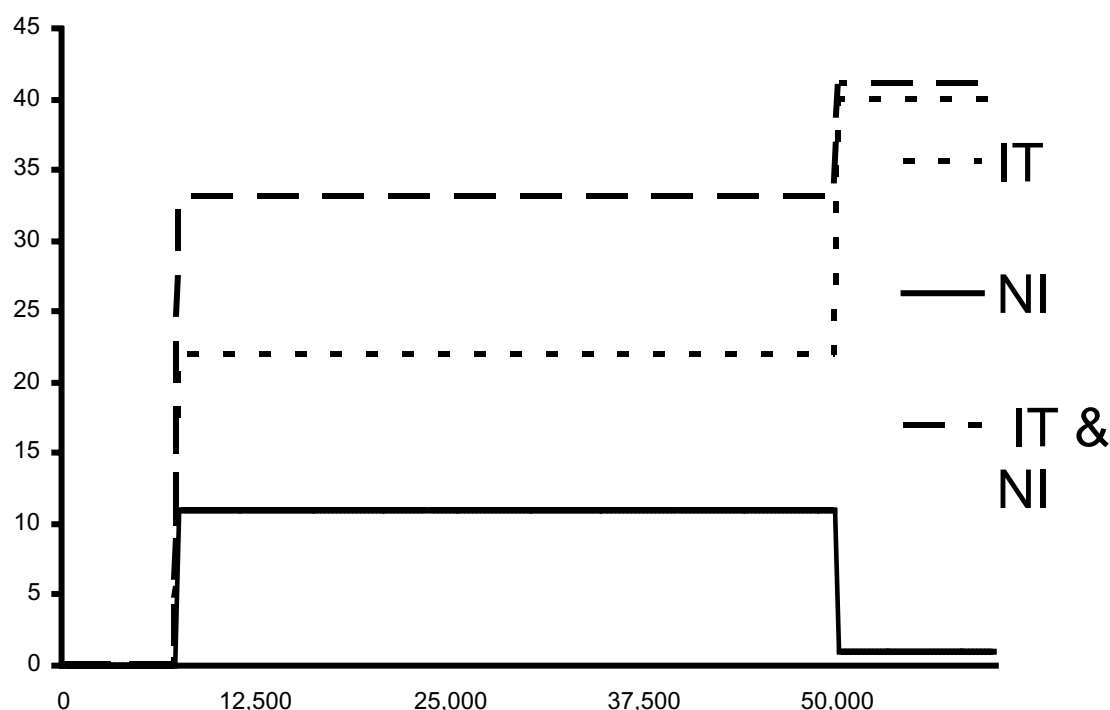


Figure 9: Combined Marginal rates for Income tax and National insurance under our plans



2.3 Reducing tax advantages for the well-off

2.3.1 The proposals for raising thresholds in section 2.1 obviously have revenue implications, and in accordance with our general approach of making taxation more progressive we plan to raise the money needed from the better-off.

2.3.2 Capital gains tax is the primary source of tax complexity and - somewhat arbitrary - mechanism for taxing wealth. It is important to have a system of capital gains taxation since, without it, income taxation is avoided by transferring income into capital. That incentive currently exists: it is possible to pay capital gains tax at as little as 24% for individuals and 10% for business investments while income tax applies at 40%. We recognise that some Capital Gains Tax reliefs are essential. Rollover relief is necessary for the functioning of family businesses and farms, and also provides an incentive to successful entrepreneurs to plough back capital gains into new business ventures.

2.3.3 Our main proposal is to end taper relief, which stems from the Government's belief that personal investment behaviour should be changed to encourage long term holdings of assets. It is far

from clear that there is a serious economic rationale for what is a very expensive tax relief costing £4.5bn in 2005/06. There is also a CGT allowance of £8,800 for individuals (and half that for trusts) which in total costs £1.85bn - we believe that this could be reduced. We do not propose to remove any other CGT reliefs; or to change the basis of calculation. There is a theoretical economic argument for the indexation of the CGT base; but there is less case for that when inflation is low and there is little indexation elsewhere in the tax system. This is something we will keep under review. The effect of our proposals will be to increase taxation on the wealth which accrues from appreciating property investment (as with second homes) and large shareholdings.

2.3.4 We support the principle of tax relief on pension contributions, in order to avoid the double taxation of both contributions and pensions themselves. Such relief is a feature of most pension systems. However, the existing structure of UK pension tax reliefs has been widely criticised as being unfair. Half of the total benefit of pension tax relief goes to the top 10% of income earners, and a quarter goes to those with incomes in the top 2.5%. This is particularly unjust, as many of the higher earning

beneficiaries of this relief will benefit from upper rate relief on contributions, while only paying the basic rate of tax on their pensions (many MPs will be in this group). Part of pension tax relief is therefore a direct subsidy to higher earners, rather than simply being a way of avoiding double taxation. This subsidy seems particularly difficult to defend when the levels of pensions savings for those paying upper rate tax is already high, meanwhile those on lower incomes have their private savings devalued by the taper on Pension Credit.

2.3.5 As acknowledged by the Pensions Commission, we believe it is far more equitable to have a single rate of tax relief at the basic rate of income tax rate. We will consult further on some of the more technical details of this proposal including the administration aspects of defined benefit schemes. Although the benefits of saving linked to a pension for high rate tax payers will be reduced, those with large pension pots will benefit from our proposal to end compulsory annuitisation of pension funds at age 75. We are also conscious more broadly of the desirability of creating an environment in which savings are encouraged. We propose no changes to the existing reliefs such as ISAs and will maintain no incremental taxation of dividends for basic rate taxpayers. All future tax reform should, however, address the complexity of the system and the fact that at present many small savers earn negative real returns post tax.

2.3.6 Taken together, these measures to reduce tax breaks favouring the well-off will raise approximately three times as much net revenue as the 50p rate of income tax on incomes over £100,000 per year proposed by the Liberal Democrats at the 2005 General Election, but the incidence will be substantially different.

2.4 Local Income Tax

2.4.1 Liberal Democrats have long believed that the Council Tax is an unfair and inefficient tax which does not sufficiently reflect ability to pay. In 2004/5, Council Tax accounted for 5.1% of the gross income of those in the bottom 20% of incomes, but only 1.7% of the gross income of those in the top 20% (though Council Tax benefit does partly alleviate the problem). We have therefore proposed to replace Council Tax with Local Income Tax. To replace the revenue currently raised by Council Tax, LIT would need

to be set at on average across England between 4.0 and 4.5 %. We note however that the Government's Lyons Review on local taxation is to report shortly and we shall await its findings with interest. It will hopefully find ways of addressing the issue of ability to pay. Should it not do so we will proceed with our original intention.

2.4.2 Councils would set their rate for local income tax and this would be added to the national rates of income tax. The Inland Revenue would administer and collect LIT, with national income tax, passing the money to councils depending on their rate. This could be done using the existing PAYE system for employees and the existing self-assessment system. The switch means we could get rid of the bureaucracy of council tax and council tax benefit, saving taxpayers around £300 million a year, net of the costs of collecting LIT.

2.5 National Insurance Contributions

2.5.1 By far the most unsatisfactory aspect of the direct tax system is the system of national insurance contributions by employees. It is regressive at the top end of the income scale as earnings above £32,760 are largely exempted. It is paid by workers but not pensioners and is subject to widespread abuse as it affects the self-employed. Most important, the contributory principle has become seriously eroded, though the less satisfactory aspects of the principle remain, notably the treatment of women pensioners with insufficient NI contributions. Our proposal for a Citizens' Pension removes a large part of the rationale for the contributory principle in any event.

2.5.2 We propose to remove some of the complications of the dual Income Tax and National Insurance systems by raising the starting threshold for both Income Tax and employee NICs to £7,185 per year. We will also harmonise the upper threshold for 11% NICs with the upper rate of income tax.

2.5.3 There would also be many advantages to making employee National Insurance Contributions payable in relation to annual rather than weekly income as at present. Such a reform would bring NICs into line with income tax, and would in particular benefit those with irregular incomes such as seasonal workers. The detail of this change requires further research but this is

the direction in which we would like to move. In the longer term, we would also seek to merge the separate employers and employees NICs systems into a simpler, unified payroll based system. Since the economic impact of the two types of payments is fundamentally the same, there should be no adverse effects of such a change and substantial administrative savings. But to avoid the perception, however wrong, that such a change would increase labour costs, we recognise that it has to be discussed with the business community.

2.6 Non-Resident and Non-Domiciled Status

2.6.1 One aspect of the tax system that is routinely mentioned in any discussion of fairness is the treatment of individuals that are classed as ‘non-resident’ or ‘non-domiciled’. Simply stated, residency is where you live and domicile is where you consider your permanent home to be. Labour was apparently very keen on reform of this area some years ago, but has subsequently shied away from it. In the 2003 budget a formal period of consultation was launched over proposed changes.

2.6.2 One reform often put forward is to limit the numbers of years that an individual can

remain resident in the UK without being domiciled for tax purposes. This reform has received some support, even from some people in the tax consulting and accountancy professions, who see it as a way to simplify the domicile rules.

2.6.3 Other reforms to the treatment of non-resident taxpayers have been suggested. These include limiting the number of allowable days in the UK still further or including days of travel in the allocation.

2.6.4 Estimates of the revenue to be gained from such moves are around £1bn but they do not take into account the effect of wealthy foreigners moving abroad in response. This is clearly an area that deserves greater investigation and research and we intend to take this work forward.

2.6.5 Another area for further consideration is the treatment of capital gains arising from property in the UK sold by non-resident taxpayers. Property in the UK, especially in London, has always been very popular with overseas investors. The UK’s position here is somewhat at odds with other countries. For a person who is non-resident in the UK, there is currently a protection from Capital Gains Tax. Where most countries look at the location of the capital gain, the UK tax system does not.

Land, Property and Wealth

3.1 Introduction

3.1.1 It is one of the central principles of liberal economics over many generations that land should be taxed in preference to labour and capital. While there are dangers of disincentive effects from taxing the fruits of labour, or entrepreneurial risk-taking or capital accumulation through deferring consumption, there is less concern about land which is in fixed supply. Indeed, properly applied such taxation encourages the conservation and efficient use of finite resources. Economic rent, the income which accrues from the ownership of resources beyond the cost of bringing them into productive use, of course represents a much wider concept than rent and income from land literally defined, and encompasses for example the excess profit of low cost oil producers, the value of holdings of scarce radio spectrum or airport landing slots, and site value gains from infrastructure improvements. Each of these specific examples raises complex policy issues and we cannot do justice to them all here beyond acknowledging the principle.

3.1.2 On the issue of land in the physical sense, there has been a remarkable degree of acquiescence in the idea that those who are blessed by birth or accident with scarce land holding should enjoy appreciating wealth as a consequence of entirely fortuitous developments. Many of Britain's wealthiest citizens are dynastic landowners such as the Duke of Westminster rather than successful entrepreneurs. Lloyd George's attempts to tax land values, and subsequent efforts by Labour governments, came to nothing in the face of fierce resistance by landowning interests. There are some genuine difficulties with establishing accurate current site values. But useful studies have been conducted, notably in the Vale of Oxford, to demonstrate how the principle could be applied in practice. We believe that in the long term, this is how the tax base should be developed. One immediate issue is the Government's proposal to tax the value of land appreciation resulting from planning permission, the proposed Planning Gain Supplement. The proposal, which focuses only on transactions, is to replace locally negotiated Section 106 agreements with a national tax (which applies over and above Capital Gains Tax). A simpler, less centralist

solution would involve reforming Section 106 into a transparent, local system of tariffs as applies already in Milton Keynes and the City of London.

3.1.3 Property taxation is frequently used as a proxy for land taxation and in practice for most properties there is a very strong link between land value and property price.⁴ But although it might be necessary to introduce a property tax on the basis of existing property prices initially, in the longer run it would be advantageous to base a property tax on the unimproved land value of the site. Eventually the system for valuation of domestic land could be integrated with that for Site Value Rating of business properties in England.

3.2 Domestic property

3.2.1 Council Tax has many defects as a property tax, quite apart from unfairness. Council Tax bills bear only a tenuous relation to property values since they are the residual element in local authority financing after redistribution, have not been updated for 15 years, and are capped for high value property. The tax also acts as a disincentive to home improvements, as occupiers may well move themselves into a higher tax band by adding value to their property.

3.2.2 Liberal Democrat policy has the effect of removing the main tax on domestic properties (Council Tax) and replacing it with a non-property tax (Local Income Tax). While we are persuaded of the strong arguments in favour of Local Income Tax, in particular it is much more progressive and administratively straightforward, this will leave the UK in a unique position internationally of having no direct taxation of property at all. There are good reasons in principle why taxation of property should be retained if a better mechanism can be found:

- A property tax acts as an 'automatic stabiliser' tending to damp down house price bubbles nationally - land prices drive property prices (land accounts for 60% of new house prices; the figure was only 13% in 1965);

⁴ There is a close correlation between the recent, extraordinary bubble in property prices in the UK (175% since Labour came to power) and the value of land.

- It taxes the most important form of personal wealth which is otherwise mainly addressed through the very unsatisfactory IHT with widespread evasion (and indirectly via CGT);
- Property taxes are particularly difficult to evade - a growing concern for many other forms of taxation, including income tax and IHT;
- The property market would suffer far fewer distortions and be less divisive socially;
- It taxes 'economic rent' which is unearned, hence allows taxes on productive enterprise and earnings to be reduced.

3.2.3 There are satisfactory models elsewhere, notably Denmark where a national 1% property tax (with an allowance for low value property) has operated for 80 years.

3.2.4 We recognise that any property-based tax can cause problems for the 'asset-rich, income poor', a minority of householders who live in a high value house but have a relatively low income. Several types of mechanism could be employed to assist this category of people. Firstly, equity release provides a valuable mechanism. But the market is very underdeveloped, mainly because of lack of providers, following a bad history of misselling. Issue of a suite of low cost, properly regulated 'stakeholder' products might help. Secondly, there could be a 'homestead allowance' below which the property tax would not be payable. The level of this allowance might be variable geographically. Thirdly, there could be an arrangement to allow pensioners to postpone payment of the property tax, with the unpaid tax becoming a charge upon the owner-occupier's estate. This could be recouped by the Revenue when the house was sold. A zero real interest rate would apply to such unpaid tax.

3.2.5 There are a number of practical issues which would have to be resolved to make a property tax workable - for example arrangements for valuation and subsequent uprating of values over time. There are also questions over whether such a tax would be limited to owner-occupied properties and how rented accommodation, especially in the social housing sector, would be treated.

3.2.6 We believe that land taxation potentially has an important part to play in a balanced overall tax system, and in our broad agenda of shifting taxation off work and wealth creation and onto

resource use and depletion. However there is work to be done on the important questions raised here which it is not possible to cover within a broad-ranging paper on the tax system as a whole. The party will therefore set in train further work on these issues, including consideration of the Lyons Review report after its publication.

3.2.7 Stamp duty is a tax on property and other transactions, and as such both creates obstacles to the working of the market and acts also a barrier to entry for families with low equity. The problems associated with stamp duty are compounded by a slab system which charges the relevant rate of duty on the full price of the house not only the proportion in excess of the relevant threshold. We favour a graduated structure that only charges higher rates of duty on the proportion of the property value above the threshold.

3.3 Inheritance Tax

3.3.1 Inheritance tax is one of the most unsatisfactory aspects of the current tax system. It is meant to tax unearned, inherited wealth of the very rich, but in practice it is widely avoided through lifetime gifts by those wealthy enough to afford professional tax planning services, and often falls on those of more modest means who face a large tax bill on the family home. It is clear that IHT must be reformed. However we uphold the principle that the route to success should be through personal effort and not simply inheriting wealth. Given the rising levels of inequality of wealth in the UK, much of it a result of unearned increases in property values, we need to address the faults of IHT while still keeping a mechanism for taxing inherited wealth.

3.3.2 There are two complementary ways in which we would approach this problem:

- Returning to the system in which lifetime gifts are included in the taxable sum. As the tax was broadened in this way, thresholds would be raised and rates cut.
- Changing the basis on which IHT is charged so that it falls on accessions - that means the tax would not relate to the size of the estate, but to the circumstances of each recipient. There are a variety of ways in which this could be done, for example through a personal allowance for bequests. This would have the advantage of encouraging testators to spread bequests over a larger number of legatees.

3.3.3 Our reforms will protect the existing exemptions from IHT for legacies to registered charities. We believe that specific details on how such reforms would change rates and thresholds are best left to future Liberal Democrat Alternative Budgets and the next General Election Manifesto. As part of any reform, the existing Capital Gains Tax relief on death would need to be reconsidered.

3.4 Taxation of business property

3.4.1 At present, the non-domestic rate is set nationally, and then distributed on a per capita basis to local authorities. We propose that the non-domestic business rate should be returned to the control of local authorities.

3.4.2 The argument for pushing non-domestic rates back to local authorities is that the change would effectively double the local proportion of authorities' own revenues, and it is proper that they should have control over this revenue source given the local economic development function that they exercise. The original reason for taking the non-domestic rate away from councils was the irresponsibility of some councils in raising business rates at the expense of the domestic rate, which seemed a politically attractive option to the councils concerned as businesses do not have the vote. However, there were few such cases, and they tended to result in part from the consequence of first past the post elections applied to local government. That is an argument for greater democracy and contestability in local council

elections by introducing proportional representation as will occur in Scotland from 2007. It is not an argument for retaining centralisation. Moreover, non-domestic rates have shrunk from 29 per cent of council spending in 1990-1 to 22 per cent by 2003-4 as they have been tied to retail price inflation. The income from the business rate varies greatly between local authorities, so equalisation is an important issue - at the same time we want to maintain incentives for councils to benefit from attracting businesses into the area.

3.4.3 As part of the reform in England, we propose to restructure the non-domestic rate to ensure that the rate is applied only to land values, not to the total value of the property including the structures on the site. This shift in the tax base has two effects. First, it would better capture increases in land values that result from improvement in transport and other facilities. It therefore would have a desirable influence in helping to fund infrastructure developments such as Crossrail in London. Secondly, it provides owners of sites with an incentive to build quickly to the permitted degree, since they will reap extra revenue through sales or rental but will have no increase in tax to pay. This can be an effective tool in helping to regenerate blighted areas and inner cities. This change also extends the NDR tax base significantly, to property currently exempt because it is vacant or derelict. Total yield of SVR levied on owners will be greater than NDR on occupiers, without increasing the tax on most property.

Decentralisation

4.0.1 Freedom for devolved and local government is ultimately dependent on freedom to raise and spend money. Until parliaments, assemblies and local authorities have control over their purse strings, central government will continue to call the shots.

4.0.2 On taxation, Britain is the most centralised of all the member states of the European Union: 94.3 per cent of taxation is raised by central government. Of all 25 EU member states, only Malta raises a higher proportion through central government - 100 per cent - but its population is only a little larger than the London borough of Croydon.

4.0.3 Local government in England only raises about 25% of its money locally. That leads to problems with gearing, where small budget increases lead to huge tax rises. And it gives Whitehall the authority to micromanage and interfere, simply because it pays the bills.

4.0.4 Liberal Democrats propose the radical decentralisation of power. That means councils taking responsibility for a far higher proportion of public spending. If that responsibility is to be meaningful, a higher proportion of revenue raising should be transferred from national to local government. Greater powers for local authorities must be combined with greater local accountability, in particular through electoral reform.

4.1 Local taxes in England

4.1.1 Liberal Democrats would aim to ensure that local government is responsible for raising the majority of its spending locally. The policies already set out to relocalise business rates, replacing them with Site Value Rating, and to introduce a Local Income Tax based on the ability to pay in place of the unfair and regressive Council Tax, will raise the proportion of revenue raised locally from approximately 25% to 50%.

4.1.2 As powers devolve from national to local government, for example by giving it powers over local health commissioning, we would wish to see parallel devolution of tax-raising powers to local government. Our long-term ambition would be to

increase the level of revenue raised locally to 75%. The main mechanism for achieving this over time would be further localisation of income tax, with equivalent cuts in the level of national income tax. Shifting, say, 6p of income tax from national to local government would take us close to the target of 75%.

4.1.3 The current system of ring fenced national grants does not reflect local priorities. Our aim would be to give councils powers to vary the taxes assigned to them. But only directly elected authorities should have the power to levy taxes - not joint boards or authorities that have appointees as voting members.

4.2 Equalisation in England

4.2.1 England is a diverse country in terms of wealth, income and need. If we are to transfer a greater proportion of revenue raising to local government in order to fund local services, equalisation systems are required so that poorer areas are not forced to have either punitively high tax rates or sub-standard services.

4.2.2 Equalisation grants are a vital part of local government finance. But England's existing system is possibly the most impenetrable, opaque and confusing grant mechanism in the world. We need a simpler, more transparent grant system. In the long-term when councils are raising the great majority of their revenue locally, the purpose of the grant system should be solely equalisation, not revenue support.

4.2.3 While the total amount of money available for equalisation is a central government decision, the equalisation formula for allocating this funding should be decided by a committee of local government representatives. The committee would take into consideration both resources and needs in allocating funding. The formula will include the redistribution of business rates, while retaining incentives for councils to attract business investment into their areas.

4.3 Fiscal federalism

4.3.1 Just as within England we believe that local government should raise a higher proportion

of its own funding, so we think that in the long run the devolved parliaments and assemblies should have greater autonomy in revenue raising. We endorse the principles of 'fiscal federalism' set out in the Steel Commission report *'Moving to Federalism - A New Settlement for Scotland'*. We also agree with the conclusions of the Steel Commission that consideration of further devolution of tax powers to Scotland has to proceed hand in hand with further work on reforming the Barnett formula and moving to a needs-based assessment. Furthermore we agree that further research is required on exactly which taxes are appropriate to be devolved and that this should be considered alongside further work on the legislative and policy powers of the Scottish Parliament. Similarly, proposals for greater devolution of legislative and policy powers, tax-raising powers, and reform of the central grant allocation system should as far as possible proceed hand-in-hand in Wales.

4.3.2 Together with changes to the fiscal powers for the nations and regions of the UK, there will be a requirement to reform the distribution of central grant funding within the UK. The current system based on per capita annual adjustments to the historic funding position (the so-called Barnett formula) preserves

a number of anomalies and does not take sufficient account of need. This has given rise to growing problems, especially in Wales, known as 'the Barnett Squeeze'. The system should be replaced with a new Revenue Distribution Formula, which would take into account factors including geography; rurality; distance from markets; health; state of infrastructure; housing; crime and law and order; education; poverty and deprivation; employment levels; and the cost of delivering services.

4.3.3 This Revenue Distribution Formula (RDF) would be drawn up by a Finance Commission of the Nations and Regions (FCNR). The FCNR would be comprised of representatives of the UK government, representatives from the National Assembly for Wales, the Northern Ireland Assembly and the Scottish Parliament, as well as the London Assembly and those representing English 'city regions' or other devolved units if they are established. Its recommendations should be reached by consensus and ratified by the respective executive bodies.

4.3.4 In addition to agreeing the RDF, the FCNR would also be charged with developing work on the whole agenda of Fiscal Federalism.

Environmental Taxation

5.1 Introduction

5.1.1 Liberal Democrats have always placed the environment at the heart of our thinking. That is why we were the only party with a Green Action section in every chapter of our last General Election Manifesto, integrating environmental thinking into every area of policy. This also reflects our belief that environmental policies are essential to enhancing the general standard of living, for example by reducing poverty and improving health.

5.1.2 A key aspect of this integrated approach is using economic incentives which go with the grain of markets to influence behaviour in the most cost effective way. The tax system is one important way of doing this. An alternative form of economic instrument is a ‘cap and trade’ approach in which overall emission levels of a pollutant are fixed and then progressively reduced, with individual companies allowed to buy and sell permits within the overall cap. Of course, we recognise that other policy instruments such as regulation will also be needed to ensure a sustainable future. Producer responsibility regulations will be essential to achieving our goals on waste reduction, for example.

5.1.3 There have been two major problems with past efforts at so-called ‘green taxation’. The first is that so-called green taxes have often been used as stealth taxes to boost general government revenue, rather than used to cut other taxes. An example of this would be the Tories’ Aircraft Passenger Duty, which was introduced as a panic measure when government had lost control of the public sector borrowing requirement. The second is that they have been tried piecemeal with no overall coherence of approach.

5.1.4 A central dilemma in approaches to green taxation is how to target behaviour effectively and how to achieve long-term strategic change in the way the economy is organised. Considerable skill and judgement is required to identify the key decision-making points at which a tax or other intervention will be effective. As with other policy interventions, green taxes should aim to make individuals and companies take account of the environmental effects of their economic activities, wherever private or corporate action affects the common good.

5.1.5 Some say green taxes would shrink with changes in behaviour, thereby undermining tax revenues. But that is to misunderstand the economics: it depends on exactly how different individuals respond; demand for many goods and services is fairly inelastic, so an increase in price will reduce demand but not to the level that no extra revenue is generated. In any case, as incomes tend to rise, even a successful environmental tax which is holding down demand for a polluting activity may well need to be regularly raised above the rate of inflation to maintain downward pressure. London’s congestion charge has had to be increased to maintain the reduction in the level of congestion that it first bought about. Taxes on fuel, cars and planes are no different. The object is to steer emissions to sustainable levels through tax incentives, not to eliminate the behaviour altogether.

5.1.6 Despite the Labour Government’s commitment to environmental taxation, the proportion of GDP accounted for by environmental taxes has in fact been declining from a peak of 3.6% in 1999 to 2.9% today. This is not as a result of reduced pollution, but rather decisions to freeze fuel duties and the climate change levy in a number of budgets since then.

5.2 Overall framework

5.2.1 To ensure a coherent overall approach to environmental tax reform, we propose to launch a Treasury-led Environmental Incentive Programme, examining tax reforms and other economic instruments that will reduce pollution and protect the environment. These reforms will be about taxing differently, not taxing more.

5.2.2 However, we are also committed to increasing the share of total tax take and GDP represented by environmental taxes - with offsetting tax cuts in other areas as set out elsewhere in this paper. In the course of a four year Parliament we will increase the level of environmental taxation to at least the 3.6% of GDP figure achieved in 1999. This means raising approximately £8 billion in current values. This will come from three principal sources - aviation, vehicle excise duty, and fuel duty.

5.3 Aviation

5.3.1 At present, charging for aviation does not remotely reflect economic or environmental costs. Landing charges at airports like Heathrow are cross-subsidised. Landing rights are handed out free on a grandfather principle regardless of scarcity value. There is no duty on aviation fuel. In many ways a fuel duty would be an attractive way of accounting for the environmental costs of aircraft emissions, but this would require international agreement. We wish to pursue this as long term option, but recognise there is unlikely to be agreement in the short term. The only existing tax is Airport Passenger Duty, a per passenger tax which gives no environmental incentives and raises less than £1 billion a year. A range of studies suggest that the full costs of aviation run to several billions - for example, using data from 1995, the European Environment Agency calculated the external costs of transport to be 8% of Europe-wide GDP, with air transport being 6 percentage points of that. On a simple pro-rata basis this would mean that the total external costs of aviation would have amounted to £5.4 billion in 2005 alone. This figure suggests that significant demand management measures are required to meet these costs. Even this higher figure does not account for all external costs. The House of Commons Environmental Audit Committee's recent report *Budget 2003 and Aviation* called for the Treasury to carry out "thorough valuations of all the environmental impacts of an expansion in aviation - including impacts on landscape, biodiversity, tranquillity and heritage". There is a particular issue of congestion at busy London Airports (especially Heathrow). A rational system would allow auctioning of landing slots and we support that principle. However, there would need to be changes in the EU legal framework before auctioning could take place.

5.3.2 The joint HM Treasury and Department for Transport publication *Aviation and the Environment: Using Economic Instruments*, 2003 lends support to our argument for a per plane rather than per passenger tax. It states: "In practice, charges are more likely to be applied per air traffic movement (ATM), thus giving an incentive to use planes at a higher load factor and to bring forward potential supply side improvements".

5.3.3 We will therefore replace the existing Airport Passenger Duty with an Aircraft Tax based on the emissions of each aircraft. This will cover freight aircraft as well as passenger services, and will be charged on each departing flight scaled by the emissions capacity of the aircraft rather than individual passengers. However we recognise that current exemptions on APD, in the Islands and Highlands, are necessary so would continue on this basis.

5.3.4 We will increase the revenue from the new Aircraft Tax to approximately £3 billion above that of the current APD to account for general environmental effects and to account for congestion where this is a serious problem. This means the Aircraft Tax will be higher on flights taking off from busy airports. While this is a considerable increase in the total tax take, because the new tax will apply to freight and transit flights, and will apply to flights at the same level whether they are empty or full, the impact on passengers flying on heavily used services will be limited.

5.4 Vehicle Excise Duty

5.4.1 We will reform Vehicle Excise Duty (VED) on new cars purchased in future so that it is much more sharply graduated according to CO₂ emissions, with the most highly emitting vehicles paying £2000 per year. The new rate would cover high emission vehicles (emitting more than 225 grammes of carbon per kilometre). The proposal for a dramatically more progressive Vehicle Excise Duty will shift patterns of car buying and tackle the source of greenhouse gases from transport.⁵ The table below (figure 10) shows how new VED rates on new cars could be set. On this basis, VED would cumulatively raise an extra £750m per year, taking account of likely movement by consumers to purchase cars in lower bands (based on MORI research we assume that 72% of consumers in the top three bands would move down one band).

⁵ Research from the Energy Savings Trust and the Department of Transport shows that a top rate of £2000 a year would help change behaviour and cut CO₂ emissions. At present nearly 200,000 cars - or some 8 per cent of the total - are sold in this category. Where the purchase of a new 4x4 is necessary, for example by a farmer, options do exist that mean avoiding the top rate of VED. There are 4x4 working vehicles that have lower emissions than the top category, and would therefore avoid the full tax.

Figure 10: New VED rates

£ per year	CO₂ (g/km)	CURRENT RATES	NEW RATES
A	100 and below	0	0
B	101 to 120	40	0
C	121 to 150	100	100
D	151 to 165	125	150
E	166 to 185	150	850
F	186 to 225	190	1500
G	226 and above	210	2000

5.4.2 We recognise a variety of special circumstances in which vehicles are used for occupational and residential reasons and, in practice, accept that some flexibility will be required. Where cars are essential for the survival of communities in sparsely populated rural areas (defined by the Countryside Agency as the least densely populated five per cent of the country), the first car for a household (excluding second homes) would benefit from a 50 per cent discount in VED for all bands but the top band.

5.5 Fuel duty

5.5.1 Fuel duty should rise in line with inflation, so that there is no real decline from year to year. Gordon Brown's failure to index fuel duty in Budget 2006 led to a cost to the Exchequer of £625m in 2006/07. In the event that oil prices decline significantly from their current high levels, we will use fuel duty to remove some of the drop in final prices which would otherwise occur. We recognise that in some remote rural areas, local people are badly affected by a combination of lack of public transport alternatives and higher than average prices at the petrol pump. We will therefore examine the viability of obtaining a derogation under Article 8, Paragraph 4 of EU Directive 92/81/EEC to permit variable rates of duty for specified remote rural areas, as currently happens in some remote parts of France, Portugal, and Greece. These would be used to bring down the price of fuel at the pump to that available in other parts of the UK.

5.5.2 We remain committed in the long term to the development of a scheme of National Road

User Pricing. This is already being applied on a limited scale to tax congestion in big cities and we support the principle as well as local experimentation. In the long term technology might advance to the point at which it would be possible to incorporate both the costs of congestion and pollution and replace fuel duty in whole or in part.

5.6 Climate change levy and the European emissions trading system

5.6.1 We will reform the existing climate change levy on business use of carbon fuels, which is over-complex, and has not been indexed. Initially we will index it annually to inflation, then reform it into a simpler carbon tax which would apply upstream to primary fuels.

5.6.2 We do not recommend a change in the main tax affecting domestic heating - VAT. An increase in the current rate would have an impact on the problem of fuel poverty. Domestic consumers have recently faced 30% increases in bills as a result of gas and fuel oil price increases. In 2001, Labour promised to take all vulnerable households in the UK out of fuel poverty by 2010, but the 2006 Energy White Paper has admitted that there may still be one million vulnerable households in fuel poverty by 2010. Tools for tackling this problem include the Warm Front programme and its equivalents in Wales, Scotland and Northern Ireland. It is existing Liberal Democrat policy to review and strengthen these programmes, and a range of other policies for tackling fuel poverty have been set out in Policy Paper 58 *Conserving the Future*.

5.6.3 An important economic instrument for pricing carbon and giving incentives to minimise its use is the EU Emissions Trading Scheme (EUETS). We believe in principle that the distribution of permits under this scheme should be on the basis of an auction rather than free allocation. Under existing rules, a maximum of 10% of permits in Phase 2 of the scheme (starting in 2008) can be auctioned. The Labour Government proposes to auction only 7%, but we would auction the maximum 10% (this might raise approximately £65m). In the long term as the EUETS becomes established, we will consider whether there should be rebates on the climate change levy (or in future carbon tax) for firms participating in the scheme.

5.7 Other proposals

5.7.1 In addition to these measures, we support other proposals including:

- Increasing the escalator on landfill duty;
- Equalising VAT on new build and renovation;
- Reducing VAT on energy saving materials.

5.7.2 Our support for the principle of land value taxation is also a form of environmental taxation, as it gives incentives for efficient use of a valuable and finite natural resource, land.

5.7.3 A number of other green taxes have been proposed, including for example a plastic bag levy on in the first instance refer such proposals to the Environmental Incentive Programme (see 5.2.1) for consideration. We would also expect the EIP to review existing environmental taxes to consider if they achieve their stated objectives.

5.8 Auctioning of rights for resource usage

5.8.1 There are many other possibilities for levying a tax on the use of natural resources, the 'commons' that ultimately belong to all of us, through auctioning of the rights to use these resources, rather than allocating them free on an administrative basis. A recent example of such a charge was the auction of the third generation mobile phone licences which allowed the purchasers freedom to operate within certain bandwidths of the radio spectrum. The lease of these bandwidths is for a period of 25 years and the auction raised £23bn for the Treasury. In 25 years time it can repeat the exercise. We believe

EU carbon emissions permits should be auctioned as far as permissible under the regulations. All such permits and licences have a value demonstrated by the way they are subsequently traded between corporations and other businesses. This value should ideally be recaptured for the community that created it through a charge on the value or via an auction process, which can determine value where this is not clear or unknown. As referred to in 5.2, perhaps the biggest opportunity for an auction of a common resource is that of airport take-off and landing slots. It is already policy to auction all new slots at the main London airports, subject to resolving EU regulatory issues.

5.9 Personal carbon trading

5.9.1 An alternative mechanism to taxation in the longer term which is increasingly favoured by environmentalists is the tradeable Personal Carbon Allowance (PCA). This could also be used as a complement to a carbon tax. PCAs would work by allocating everyone with an equal annual carbon allowance which would then be 'spent' whenever the individual undertook a transaction falling within the activities covered by the system. The system would require everyone to have their own carbon card - in effect, a carbon credit card - that would be loaded with their annual allowance and which could be topped up by purchasing additional allowances through the trading system from people not requiring their full allowance. PCAs have a number of advantages, including that less-well-off people would benefit, as most would not use their full entitlement and could sell their surplus allowances; and that they would make clear to every individual the carbon impacts of their activities, enabling them to choose which activities to moderate to best match their allowance to their own priorities.

5.9.2 Several organisations are continuing work on PCAs (the RSA is undertaking a 3-year programme and the Environmental Change Institute is continuing its research). No-one is suggesting that PCAs could be introduced quickly. But we wish to make a commitment to further work on developing a PCA system as a potential part of a medium-term programme to tackle climate change.

Business Taxation

6.1 Introduction

6.1.1 Business currently contributes a significant proportion of the total tax take, although we need to be clear that tax does not fall on legal abstractions called companies - as business lobbyists often imply - but on their owners, workers and consumers. The most significant business taxes are corporation tax, business rates and employers' national insurance contributions which account for over 20% of tax revenue between them. Business also acts as collectors of tax - particularly VAT, income tax and national insurance.

6.1.2 In recent years, the biggest single area of criticism of the business tax regime has been its increasing complexity, as evidenced by record-length Finance Bills. There have been a number of changes to corporation tax, especially for small businesses, which had not been well thought through and some have ended up being partially reversed (eg. the 'non-corporate distribution rate'). Administering both tax collection and the tax credit system is a significant burden on small firms in particular.

6.2 Simplification

6.2.1 Simplification of the business tax system must be a top priority. This is not only desirable in itself, but would also be compatible with moves towards the harmonisation of the EU tax base.

6.2.2 At present there are at least 25 different tax regimes prevailing in the different member states. Each country not only sets its own rate of tax but also has a different set of rules to determine what profits and transactions are subject to tax, what expenses are tax-deductible and what reliefs are available.

6.2.3 Businesses seeking to expand into other EU countries are faced by widely different tax regimes and these act as an impediment to the operation of the Single Market. This exacerbates problems such as the recent Marks & Spencer case on losses incurred in other EU countries.

6.2.4 On the other hand, there is a tax avoidance industry based around exploiting

asymmetric tax rules that might apply to cross-border business transactions (so-called "tax arbitrage"), and this results in significant loss of tax revenues.

6.2.5 The introduction of a standard set of tax rules in the EU is currently being considered by the European Commission. Larger businesses are already moving towards a common set of International Accounting Standards. We support the desire of many in business to have a standardised set of tax rules across Europe, based on these accounting rules.

6.2.6 Introducing a harmonised tax base would assist companies which wish to operate in a number of EU countries; avoid inadvertent double-taxation and, conversely, make it more difficult to avoid tax through complex cross-border tax arbitrage arrangements. It should not be confused with any suggestion of harmonised tax rates, which would reduce competition and which we have consistently opposed.

6.3 Corporation tax reform - towards a flatter structure

6.3.1 There are a wide range of reliefs from Corporation Tax. The largest single cost to the Exchequer is that in relation to the Research and Development Tax Credit. Liberal Democrats strongly support government investment in science, since the market will not fund basic research unless it has clear commercial objectives and returns, even though there may be wider benefits. Commercial R & D is somewhat different since companies have access to shareholders funds and capital markets and there may or may not be a wider social benefit. It is not clear to what extent R& D tax credits are of value in increasing or maintaining business R & D in the UK, which lags behind that of other countries as a share of total R & D. We recognise that R & D tax credits are particularly important for small, high risk, innovative UK firms, and would want to ensure that their position is safeguarded, especially given that many do not pay corporation tax and could not benefit from a reduction in that. However, some large companies, which are now among the main beneficiaries, receive generous tax allowances for conducting commercial R&D which would probably have been undertaken in

any event. We therefore believe that the current R & D tax credit system is flawed and will focus it more clearly on where it has the potential to be effective. In terms of other reliefs, only where there is demonstrably a wider public good (eg. the development of AIDS vaccines) combined with evidence that a tax allowance or subsidy is necessary and effective in leveraging private sector investment, expertise and/or innovation, would we keep the relief in place.

6.3.2 The other major category of reliefs is on employee share ownership schemes. Liberal Democrats have a strong commitment to promoting employee involvement in companies and would, therefore, wish to maintain the tax advantages of these schemes. However, we would also review the schemes to ensure they are effective in promoting share ownership by ordinary employees and not simply a tax efficient way of rewarding directors and senior management.

6.3.3 Even leaving the employee share ownership schemes alone, recognising the special position of small innovative companies in respect of R&D tax credits, and maintaining effective allowances for initiatives with clear public benefit which are seen to work, removing other Corporation Tax breaks would free up around one and a half billion pounds. This is enough to cut the main rate of Corporation Tax by a percentage point. Subject to the assessment of the R&D Tax Credit advocated in 6.3.1, we therefore propose to make a major step towards simplifying Corporation Tax by removing most reliefs and cutting the rate by 1p.

6.4 Consultation and tax legislation

6.4.1 One of the main reasons why the tax system becomes overcomplicated and ends up being changed so often is that tax measures are pushed through by the government without proper advance consultation with business and outside experts. Liberal Democrats support the principle of pre-legislative scrutiny, and tax is an area where this is particularly vital.

6.4.2 We therefore propose a major change to the way the Budget and Finance Bill process works. We would split the Finance Bill into two separate pieces of legislation. Every year a much shorter Finance Bill would be published as part of

the budget process, covering basic tax changes for the coming year (eg. rates and thresholds), and this would be debated and voted on by the House of Commons as at present. However, at the same time a draft Tax Reform Bill would be published which would cover technical reforms to the tax system and long-term proposals for reform of the tax system over a period of years. This draft bill would then be subject to full consultation with interested parties before being debated and voted on in Parliament later in the year. Various stakeholders such as trade bodies, unions, professional advisers and lobby groups would be invited to play a full part in this process (rather than questioning via MP proxies, as at present). The objective of this procedure would be to prevent fiascos such as the Government's December 2005 reversal of policy on tax breaks for residential property in Self-Invested Pensions Plans, where an obviously damaging policy was introduced in the 2005 Finance Bill without proper consultation and had to be withdrawn a few months later when the consequences emerged, but only after millions of pounds had been wasted on abortive schemes.

6.4.3 Obviously if a loophole was causing a pressing short-term problem then it might be necessary to close it urgently in the Finance Bill (though this is likely to be less frequent with a GAAR in force - see below), but in most cases splitting the process into two should lead to better tax legislation.

6.4.4 We also propose establishing an independent Tax Law Commission, modelled on the existing Law Commission, to review existing tax legislation and make recommendations for reform.

6.5 A general anti-avoidance rule

6.5.1 Tax avoidance by business has been a concern of the present government, who have suggested that there is a £5 billion 'gap' between projected and actual receipts. The British approach to tax avoidance has been to try to close down particular schemes rather than the general anti-avoidance rule (GAAR) adopted in countries such as Australia.

6.5.2 A general anti-avoidance rule would mean that if the main purpose of any arrangement was to avoid tax then the tax advantage would be

cancelled. This rule would be accompanied by a comprehensive and speedy pre-clearance procedure so that companies can check that transactions will not fall foul of the rule. There are 3 main advantages to such an approach:

- (a) Introducing a GAAR would allow for a massive simplification of the system for businesses, cutting hundreds of pages out of the tax code;
- (b) The pre-clearance system and absence of detailed anti-avoidance rules would make life easier for good corporate citizens that are planning innocent transactions and at present face the uncertainty that they might inadvertently be caught by complex tax rules, even though there is no ‘mischief’ or tax motive; and
- (c) This ‘purposive’ legislation would make it harder for professional tax-avoiders who currently seek to exploit loop-holes in the existing anti-avoidance rules and develop new schemes every time the rules are changed.

It is important that the pre-clearance procedure is fast, reliable and “business-friendly”. It must be free from government interference and retrospective changes in legislation or interpretation, to give businesses certainty over the treatment of their transactions.

6.6 Taxing small businesses on net cashflow

6.6.1 We would reform the system for determining corporation tax to allow small businesses to pay corporation tax based on their net operating cashflows as opposed to their accounting profits (as adjusted for tax purposes). This would be an entirely voluntary system - and broadly revenue-neutral, but would have three principal advantages:

- (a) It better reflects small businesses’ ability to pay corporation tax. Most small business failures are caused by cashflow problems rather than an inherent lack of profitability. It is often the need to pay Corporation Tax or VAT which forces a profitable business into insolvency. Taxing net cashflow means that

businesses are more likely to have the funds available to pay their tax bills;

- (b) It is a major simplification of the present system. At present small businesses are required to draw up accounts that form the starting point for calculating the tax that falls due. That can involve, for example, recognising income in respect of invoices that are yet to be settled and capitalising assets that have to be paid for up-front. These accounts are not only complicated but also obscure to many small business owners. Once those accounts have been prepared, they still require further adjustment for tax purposes for disallowable expenditure, capital allowances, general provisions etc. By contrast, taxing net cashflow might be as simple as taking the year’s bank statements and “crossing off” a few inflows and outflows;
- (c) It makes tax avoidance more difficult. For small, owner-managed businesses it is relatively easy to manipulate accounting profits as accounts may fall below the threshold to be independently audited and the *profit* recognised in those accounts has little relevance. By contrast, small businesses rely on cash liquidity and cash receipts are already visible to the Revenue in VAT returns.

6.6.2 Small businesses are still required to produce annual accounts for Companies House. This requirement might also be relaxed if these tax changes were introduced, so that they might instead file a simplified document, based on bank statements and cashflows. These proposals, taken together, would offer a more attractive, less highly regulated business environment within which small businesses may prosper.

6.7 Small business rates relief

6.7.1 Many small businesses pay a disproportionate amount in rates - as much as 35 per cent of their profits. The burden of business rates is far greater on smaller concerns. To a business just starting out, or established firms with a small workforce, the rates can often be one of their biggest non-labour overheads. Yet the same business system impacts relatively lightly

on large businesses based in large premises. As an immediate measure to help small businesses, we will reform the business rates system to allow firms with a rateable value of less than £25,000 to claim a business rate allowance of up to £1,500. This would represent a saving of over £600 a year for the majority of small businesses.

6.7.2 A certain amount of a business' rateable value would be discounted in calculating a final bill for a business. This allowance would only be available to the 1.39 million businesses in England with a total rateable value below £25,000. The threshold of £25,000 is in line with that which has been called for by the Federation of Small Businesses following the recent revaluation of business properties, which has seen many small businesses face a steep rise in the value of their premises - an increase which will lead to a corresponding rise in their rates liability.

6.7.3 The impact on revenue would be made up by a corresponding rise in rates liability for businesses with a total rateable value above the allowance threshold. This would be applied by adding a supplement to the rate paid per pound of rateable value for larger businesses (it would be around 1p on the amount paid per pound of a business' rateable value). Adding a supplement to the poundage would ensure that the supplement would be proportionate to the size of the business, so those falling just outside the £25,000 threshold would face less of a liability than the very largest businesses.

6.7.4 A similar scheme to the above has already been introduced by the Scottish Executive.

6.7.5 Our policies for longer term reform of business rates are set out in Chapter 3.

6.8 A Tobin Tax or stamp duty on sterling

6.8.1 For a number of years a proposal has been under discussion to tax foreign currency transactions to fund international development. It was originally propounded by Professor James Tobin with a view to reducing volatile foreign currency trading and at the same time raise funds for development. It was to apply to all major foreign currency exchanges. Since every major foreign exchange trading centre would have to agree to implement such a tax for it to be effective, it is not a realistic option in the short term, but we believe that it merits further study.

6.8.2 This ambitious international proposal has recently been superseded by a proposal for the UK unilaterally to introduce a stamp duty on sterling foreign exchange transactions. The proposed tax rate is low, 0.005%, but even so up to £3 billion could theoretically be raised - which would increase UK development aid by 50%. It is argued that such a tax is technically capable of being introduced and that, because the tax rate is low, it would have no substantial distorting effect on the foreign exchange market in the UK.

6.8.3 The Liberal Democrats remain in the lead in calling for increased resources for international development. We are not convinced, however, that the sterling stamp duty is the best way forward. The tax bears little resemblance to Tobin's original proposal, which was for a global source of revenue for development. There is no evidence that any other major country would adopt it. It is a hypothecated tax which would be subject to the vagaries of the foreign exchange markets. And we are unconvinced that a tax which raised £3 billion from the City would not result in changed market behaviour. We have initiated a debate between the principal proponents and opponents of this proposal to gain a better understanding of its likely consequences. At this stage we are unpersuaded of its merits.

This paper has been approved for debate by the Federal Conference by the Federal Policy Committee under the terms of Article 5.4 of the Federal Constitution. Within the policy-making procedure of the Liberal Democrats, the Federal Party determines the policy of the Party in those areas which might reasonably be expected to fall within the remit of the federal institutions in the context of a federal United Kingdom. The Party in England, the Scottish Liberal Democrats, the Welsh Liberal Democrats and the Northern Ireland Local Party determine the policy of the Party on all other issues, except that any or all of them may confer this power upon the Federal Party in any specified area or areas. The Party in England has chosen to pass up policy-making to the Federal level. If approved by Conference, this paper will therefore form the policy of the Federal Party on federal issues and the Party in England on English issues. In appropriate policy areas, Scottish, Welsh and Northern Ireland party policy would take precedence.

Many of the policy papers published by the Liberal Democrats imply modifications to existing government public expenditure priorities. We recognise that it may not be possible to achieve all these proposals in the lifetime of one Parliament. We intend to publish a costings programme, setting out our priorities across all policy areas, closer to the next general election

Working Group on Taxation

Note: Membership of the Working Group should not be taken to indicate that every member necessarily agrees with every statement or every proposal in this Paper.

Mike Williams (Chair)

Paul Marshall

Tessa Munt

Vince Cable MP

Dick Newby

Gareth Epps

Matthew Oakeshott

Arnie Gibbons

Andrew Stunell MP

Duncan Greenland

Tony Vickers

Julia Goldsworthy MP

Steve Webb MP

Chris Huhne MP

Stephen Williams MP

Susan Kramer MP

David Laws MP

Staff

Justine McGuinness

Christian Moon

Dominic Mathon

Will De Peyer

Comments on the paper are welcome and should be addressed to:

Policy Projects Team, Liberal Democrats, 4 Cowley Street, London SW1P 3NB

ISBN:

1 85187 755 X

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Liberal Democrat Image, 61a Cove Road, Cove, Farnborough, Hampshire, GU14 0EX

Tel: 01252 510 005 Email: libdemimage@ldimage.demon.co.uk

Printed by Contract Printing, 1 St James Road, St James Industrial Estate, Corby, NN18 8AL.

Cover design by Helen Banks

