# Reconnecting Taxation

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DEMOS

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*Public finances are one of the best starting points for an investigation of a society. The spirit of a people, its cultural level, its social structure, the deeds its policy may prepare – all this and more is written in its fiscal history, stipped of all phrases. He who knows how to listen to the message here discerns the thunder of world history more clearly than anywhere else.*

Joseph Schumpeter, 1954

# The gathering crisis of tax

Throughout the world taxation has come back to the centre of the political stage. Over the last two decades, the irresistible upward pressure of public spending has set off a succession of tax revolts, from California's Proposition 13 and the Progress Parties of Norway and Denmark, to rebellions against value-added tax in Japan and the poll tax in Britain. Tax-raising governments have lost elections and oppositions that promise new taxes have failed to win them.

Some expected that the backlash against tax would give governments a clear mandate to break the inherited welfare consensus and to cut taxes and spending. The Thatcher and Reagan governments interpreted their election victories in this way, and Britain in particular has seen a profound revolution in government. But in spite of the cuts, the closures and the privatisations – measures which became common in the West, irrespective of party – tax continued to go up. In Britain it rose from 34.1% of GDP in 1980 to 35.6% in 1990. In Italy the rise was from 20–29%, in Canada from 30–37%, in Ireland from 34–43%, and in Sweden from 55–67%. All but three OECD countries shared in this relentless historical trend.

It is now apparent that the new right's reforms have at most slowed the growth (indeed UK welfare spending is now at an all-time high of 26% of GDP), and they have done so in ways which are ever more restricted in scope. Many of the marketable public assets have already been sold. Charges for some public services are approaching market prices. Social security benefits have been squeezed, and eligibility narrowed. Public sector pay curbs have already critically undermined the quality of staff and thus of services.

At the same time the demands on government are increasing. In Britain the NHS needs an annual real growth of 2% to survive even at current levels, personal social services require 2.5%, and education will need an extra 0.5–1.0% of GDP to bring post-school education up to European standards.[1] Everywhere there has been a steady increase in the number of people dependent on those in work – those staying on longer at school, living longer as pensioners, and above all those who are unemployed. In the OECD area there are now five workers to every old age pensioner. By the year 2000 this will have fallen to 4.5, to less than three in 2040, and in Switzerland and Germany it will be down to two. Nor is there any sign, even in boom times, that full employment will return.

Governments find themselves at an impasse. On the one hand there is the resistance to tax, on the other a continuing demand for expenditure. Electorates say they want better public services, particularly health and education,[2] yet they consistently vote against the means of delivering it.

Much of the political debate has focused on the spending side of the impasse: which services should be provided for whom and in what way. This debate has already changed much of the political and administrative landscape. But there has been less advance on the other side of the equation, that of tax and revenue raising. The argument remains locked between parties favouring low taxes for low spending, and those favouring high taxes for high spending. The former have proved incapable of cutting taxes, while the latter have proved incapable of cutting taxes, while the latter have proved incapable of winning elections. Both are caught within an old tax regime and the quantitative alternatives it generates. They are thus forced to replay earlier battles – but on a playing field that has radically changed.

This pamphlet is about changing the nature of the debate. It seeks to shift the axis of discussion away from the levels of tax, to the nature of the tax relationship itself. It suggests that the current fiscal crisis is a crisis of how tax is raised, its link to spending, and of the state's relationship to its citizens. It is a crisis of how society makes and remakes itself, and how the modern nation–state relates to other states in an increasingly global economy. As such it reflects a wider set of tensions – economic and social, global and local – which are the source of the present thunder in the air.

## The eras of tax

They key point about tax is that it is a relationship of forced exaction. As such it stood at the economic heart of earlier despotic and feudal regimes, and of all colonialisms. Their histories were full of tax revolts which gave us such folk heroes as Lady Godiva, John Ball and William Tell.

The modern era began with a wave of rebellions against tax, sparked off when the rising cost of warfare drove taxes up right across Europe. Some were unsuccessful, as in Austria and Ireland. Others became historical turning points. The American War of Independence was sparked by the battle over customs and contraband. In France it was tax that brought to a head the great class conflicts of the 1789 revolution, with the popular sacking of customs posts, the burning of tax registers and the declaration by the third estate that all existing taxes were null and void.

But the development of capitalism and liberal democracy did not mean the end of tax. Early capitalist states found that they too needed taxes, but their forced character was at odds with the culture of free exchange. Ever since, tax has been a channel for wider discontents. The Poujadist movement of the 1950s in France, for instance, started in a village in the Lot region, as a protest against the visit of a tax administrator. It represented a refusal by small farmers and shopkeepers to accept the impositions of a bureaucratic state, which they saw as allied with the forces of impersonalisation – large trusts, big shops, and high finance. And it focused on tax because it is such a pure expression of the state's absolute power.

Even in the most benign democracies there have always been tensions around the legitimacy of taxes. The politics around that legitimacy, the way revolts were managed and new compromises reached, provide the spine of tax history. They mark its eras and points of transformation.[3]

In the modern period, there have been two historic moments of transition. The first in the late 18th and early 19th centuries replaced an absolutist tax regime with a capitalist one. Under absolutism, taxes had been mainly paid by traders and the poor. The nobles, clergy and the wealthier urban class were largely exempt except in times of war. The political economists and enlightenment thinkers campaigned against such privileges, arguing that all should pay their share. Internal tariffs should be dropped, and revenue raised from rents and wealth. This was the programme of financial ministers and enlightened despots, but it took the French revolution – and the fear of its spread abroad – to deliver it in Europe.

The new order was marked by five features: an end to privileges and feudal dues; the growth of indirect taxes on foreign trade and domestic consumption, with a lightening of the burden on necessities (like salt) and an increased dependence on drink and tobacco duties; a readiness to tax rents and wealth, with the help of improved cadastral surveys; the growing centralisation of finance and spending decisions in national treasuries, and the establishment of direct tax administrations; and the subordination of public finance and expenditure to parliamentary control through the medium of the budget.

These took effect at different times according to national and political circumstance. But together they constituted a new fiscal order, a new settlement, which filled out and developed as the 19th century progressed.

## The rise of income tax

The second turning point came in the 1890s, in responce to a sudden expansion of public spending and the growth of the labour movement. It involved a shift from tax neutrality to tax progression, and centred on a new role for income tax.

In Britain indirect taxes accounted for the great bulk of tax revenue during the 18th and 19th centuries. The first income tax had been raised by pitt in 1799, and became permanent from 1842. But its yield was modest. In 1872 it raised only £7 million compared to £47 million from customs and excise. It was seen primarily as a convenient tool of revenue raising, and was never intended to be progressive. Gladstone said that the principle of graduated income tax tended to communism and fought the 1874 election on a platform of abolishing income tax altogether.[4]

But within twenty years Harcourt had introduced a budget with progressive income taxes and death duties. By the turn of the century the yield from direct tax surpassed that from indirect tax, and in 1909 Lloyd George's 'war budget against poverty' not only endorsed progressivity but included a supertax and a form of capital gains tax on land values. In paying tax, he said, people ought to contribute in proportion to their means. For his prime minister, Asquith, progressive tax became 'a mark of the democratic neo-liberalism of the twentieth century (which) had little in common with Gladstonian liberalism.'

There was a parallel timetable elsewhere. Income tax was introduced into Sweden in 1861, Italy in 1864, Japan in 1867, and in many of the German states in the last decade of the century. The principle of progressivity was adopted in conservative Prussia in 1891, in liberal Belgium in 1893 and in democratic America in 1894 (before being declared unconstitutional by the Supreme Court). By the time of the first world war, progressive direct taxes had become the norm. What marks their development in the twentieth century is the steady growth in the number of direct tax payers and the rise in yield. In Britain in 1909 only one million paid income tax. By the second world war the number had risen to 4 million, by 1948 to 14.5 million, by the mid 1970s to 21 million, and by 1990 to 25 million. Deducted at source by the large employers after the second world war, income tax became a mass tax to fund universal services. It fitted well with the new forms of mass production. It contributed not only to public revenue raising but also to redistribution and, from the 1930s, to the regulation of the macro-economy. It depended on a dominant formal sector, a distinct national economy, households supported by a male earner[5] and the social consensus of the welfare state.

By the 1970s income tax and social security contributions made up the majority of tax revenue in all major OECD countries. In many it contributed two-thirds of all tax. Those countries where industrialisation occurred later – Ireland, Spain, Portugal and Greece – rapidly caught up both in terms of the significance of income tax and the overall size of tax revenue. The spread of mass production appeared to bring with it a complementary set of public institutions to finance and service the elements of a social wage.

If there are clear contrasts between 19th and 20th century taxation, there are also continuities. There is a pattern of movement away from feudal regressiveness to liberal and social democratic progressiveness. There is the importance of the nation–state as the boundary for both fiscal rights and obligations, and the justification for them. There is also the continuing drive for the centralisation of revenue-raising and expenditure approval, and the growth of representative government as the key channel for democratic control over tax. Representation and taxation are the twin pillars of the new form of government which emerged in the late 18th century, grew in scale and scope, and is still the dominant democratic model today.

During previous periods of transition, the need to finance higher government spending exposed the limitations of the inherited tax regime. In the late 18th century the growth of spending was the result of the external costs of war. In the late 19th century it was due to the internal costs of peace. Today it is caused by the rising relative costs of maintaining labour-intencive public services and the growing number of people dependent on the state.

As before, this pressure has revealed the system's deeper flaws. Today two stand out:

- first, the size and complexity of modern state functions have meant that the institutions of representative government have proved too blunt an instrument to link taxation and spending in a way which commands popular acceptance.

- second, the internationalisation of the economy has weakened the nation–state as an instrument of taxation.

It is these changes which must be addressed if the simmering crisis of tax is to be brought to an end.

# Disconnection

The first major development we term disconnection: the separation of the tax bill from the benefits it finances. Traditionally, taxes were largely raised for specific ends: above all, warfare. In the 18th century war and the costs of war debts accounted for 85% of state spending in Britain. The connection between tax and spending was evident to all. But with the growth in the size and complexity of the state this link has been lost, principally because of the centralisation of tax collection and disbursement.

The vast multiple service system of the modern state is still organised largely on the models established in the 19th century. In the UK tax money is pooled into the central treasury and distributed to spending departments, according to a budget and subject to approval by parliament. Local government has adopted a similar model. Where once local services were financed through separate rates, by the 1930s these had been combined into a single rate to cover all services.

When there was a consensus on state spending, such as in wartime or in the postwar period of rebuilding and funding the welfare state, central pooling was not problematic. The shared sense of purpose helped to legitimise higher taxes: the end justified the means. In the early years of this century central pooling also fitted well with prevailing administrative wisdoms: it enabled government to plan and prioritise.

But as the welfare consensus started to break down in the 1970s, the political foundations of pooling began to crack. Cuts provoked a widespread, and often divisive, debate about priorities. A more confident consumerism demanded greater transparency and accountability in the use of state finances, particularly as the sheer complexity of modern government was making it far harder for the average citizen to understand. And a generation more sensitive to choice and identity was becoming less deferential towards government and more suspicious of handing over blank cheques.

The administrative centralisation that once seemed so eminently sensible has lost much of its authority. The separation of tax collection from service provision has left the links to be made through cost budgeting by senior civil servants and politicians in invisible procedures, according to scarcely visible criteria. Levels of finance are shaped by departmental and ministerial rivalries rather than by popular support. No attempt is made to consult with electors. Public debate about tax is diverted onto the spectacle of the annual budget, which springs new taxes on a passive population (after a secrecy far in excess of what can be justified by the need to restrict price-sensitive information). Nor has electoral politics done much to assist public understanding, for recent election campaigns, both in the UK and elsewhere, have tended to obscure far more than they have clarified.[6] To the outsider government appears as a black hole into which resources disappear.

This image has not been helped by recent policies.[7] Since the poll tax, Whitehall has reduced the local contribution to local services to under a fifth and replaced it with even greater central control and funding from the central pool. At a national level the trend towards less visible taxes on expenditure (and gambling) has had the desired effect of making the tax relationship less transparent, while a sometimes piecemeal approach to cutbacks has made the overall pattern of spending even harder to discern.

The breakdown of the link between taxes and benefits now threatens to go a step further with the targeting of benefits. On one level it appears rational to use scarce public resources for those in most need. But abandoning the principles of universality means that the middle class will be left paying for benefits they no longer receive. Today it is estimated that the average taxpayer receives back in benefits 62% of what he or the pays.[8] Targeting would sharply reduce this percentage, threatening to exacerbate the resentments dividing a privileged top, a tax-paying middle, and a dependent bottom stratum. It would finally destroy the remaining links, carefully designed by Beveridge and others, between the forms of social insurance payment and welfare benefits.[9] and the benefits and pensions which they finance. And it would hasten that wider disconnection, the fragmentation of societies into mutually insulated worlds, which one sociologist has called the loss of connexity – of shared experience.[10]

For all of these reasons, the ways in which taxes are raised and spent make it peculiarly difficult for electorates to support them. Each tax is merely one of many tributaries to the centralised pool.[11] There is no clear link between taxes and services, no consultation beyond occasional elections, and little if any reference to public views. The budget process is preceded by little debate and involves no test-marketing. Instead the predominant forms of tax still carry the trace of an era when tax was the prerogative of sovereigns who set taxes at whatever level they could get away with and for whom the legitimacy and ethics of taxes mattered little.[12]

# Globalisation

The second great development is globalisation. Over the past 25 years the growing internationalisation of economic life, and the twin pressures of tax competion betweeen nations and the spread of offshore tax havens, have sharply eroded national governments' power to tax. More mobile production and more open markets mean that firms can simply relocate if taxes rise. Even if they do not, the main producers and repositories of wealth – multinational companies – have increasingly been able to adjust their accounts and the prices of their internal international transactions so that their profits are declared in low tax countries, while they continue to operate in high tax ones.[13]

A recent report by the House of Representatives Ways and Means Sub-Committee estimated that the US Treasury has been losing up to $35 bn a year through transfer pricing.[14] A similar study for South Africa found that accounting manipulations of this kind help explain the illicit outflow of $34 bn between 1970 and 1988, or just under $2 bn a year.[15] The sheer scale of the funds that are now beyond the reach of national authorities can be gauged by the recent estimate that 60% of the world's private banking is held in trust in offshore unsupervised tax havens: in other words more money is now held offshore than onshore. The Cayman Islands alone has over $500 bn under management, more than all of the New York banks combined.[16]

It may be asked why major western governments allowed offshore finance to expand in this way. The main reason is that it is the leading international financial centres like the US which benefit from an inflow of capital that has been routed through tax havens from high tax and high barrier countries.[17] Britain has a similar interest, and Customs and Inland Revenue have only small units dealing with transfer pricing because they say that Britain on the whole benefits from the practice.[18]

Viewed internationally, these transfers of profit have a double fiscal consequence. On the one hand they remove a significant part of the national tax base from the reach of national taxation authorities. On the other, in order to attract foreign investors and their annual profit declarations, governments have had to cut taxes competitively with the result that the overall rate of tax (net of allowances) on multinational corporations has declined.[19]

The resulting limits for national tax policy are exemplified by the case of Ireland. Since 1958 successive Irish governments have used among the most generous incentives in the western world to attract international capital. Their open door policy did indeed attract capital, but it replaced the traditional tax base of Irish industry with new international industries which paid no tax, and in many cases constituted a net drain on the exchequer because of the cost of initial grants and associated infrastructure. According to Rudiger Dornbusch, "large segments of the potential tax base [are] almost completely excluded from taxation. As a result labour and consumption are the main targets of taxation, with taxation of corporations and capital, including land or wealth, practically non-existent."[20] The burden of tax falls squarely on labour, either driving down real wages or, if organised labour is strong, forcing up real wages and discouraging new investment.[21] Both factors help explain the 20% level of unemployment in Ireland and its apparently permanent fiscal crisis.[22]

The problems of taxing global industry have been matched in the case of individuals.[23] As far as income taxes are concerned, there has been a domino-like reduction in top rates throughout the world. Governments feared that if they did not cut rates they would lose their wealthiest, most entrepreneurial and skilled citizens.[24] The trend was rationalised by the argument (represented in the celebrated Laffer curve) that lower top rate taxes would provide incentives, increase growth, and expand the fiscal yield, an argument which is correct less because of the incentive to work harder than because of the reduced incentive to declare income offshore.

The result is that the great majority of governments have had to adjust their tax rates in line with declining global levels. Marginal rates on both income and profits have converged and fallen sharply in almost all the leading economies of the world. In the 12 main industrialised countries corporate tax rates fell an average of 9% between 1984 and 1990. Top income tax rates fell an average of 16.5% between 1975 and 1989, with the greatest cuts being in the US and UK. There has been a shift in high income tax countries towards indirect taxes, and a more general convergence within the OECD towards a wide portfolio of taxes rather than an over-reliance on any one form.

This interdependence is one of the iron laws facing tax policy-making in the 1990s. It explains the connection between the freeing of the exchanges and the cutting of net corporate and upper income tax levels.

The result, however, is less a cut in overall tax than a shift in its incidence from the mobile to the immobile. It is now national companies and the immobile middle and working class which shoulder a growing proportion of direct taxation. This was the conclusion of a two year study by the Ontario Fair Tax Commission, and it is one that we suspect applies this side of the Atlantic.

In the UK the extent of the shift awaits detailed research. We know that some multinationals pay substantial corporation tax.[25] But we also know that many large companies have tax haven subsidiaries, and that many pay little if any tax in the UK.[26] One study of the top 20 companies in the early 1980s found that only two paid tax. Another study with a larger sample found that 40% paid no corporation tax in 1980, and while that figure fell to 22% in 1985, it has again risen substantially in the early 1990s.[27]

As for the immobile, some can escape through their own privileges – tax allowances, under-reporting, and the informal economy. Modern professional labour and the burgeoning world of small-scale sub-contractors have used Schedule D to minimise their taxable income (there are now nearly 4 million people in the UK classified under Schedule D and many other self-employed who are unregistered). But for most the escape is only partial, and for the great majority on PAYE there is no escape at all. It is on them that the burden is increasingly falling, and it is they – particularly those in the private sector – who form the backbone of tax resistance.

## The new right's response

Political debate over the last 15 years has been dominated by the new right's response to western electorates' renewed hostility to tax. Their theorists made two decisive arguments. The first was that the state was soaking up too much wealth and crowding out private investment, and thus in the long-run undermining its own sources of income. High tax was threatening economic growth and the well-being even of those who were supposed to benefit from fiscal redistribution. The priority was a sharp reduction in the quantity of tax being raised from all sources, to be achieved by encouraging people to take greater financial responsibility for their own education, health, housing and transport.

In parallel, there was a second, micro-economic argument that high marginal rates of tax on income and profits damaged incentives to work and invest. From this it followed that there should be lower top marginal rates, greater rights to inheritance and capital gains, and a shift to non-progressive expenditure taxes.

For a period this seemed to be the basis of a new consensus, as the weakening of labour movements reduced the pressure that led to the introduction of European welfare states in the first place. It seemed as if the conservative governments of the 1980s were going to turn back the course of 20th century tax development with their renewed emphasis on indirect taxes, the decisive move against tax progression, and the radical deconstruction of the welfare state. The next steps in this historical retracing would be further to simplify the tax system, to cut pensions and benefits, and to raise VAT on necessities, and charges for the health service. Such is the outline of a possible tax regime for the 21st century.

But in the countries which first implemented the new right model its flaws soon became evident. As we have seen, the most obvious was that the promise of lower taxes and public spending did not materialise. In the 1980s, in the words of Sir Douglas Hague, a former adviser to Mrs Thatcher, 'her government was mainly engaged not in reducing public expenditure but in containing it … a case of running fast to stay in the same place …' Revenues exceeded 40% during only three years in the 1970s, but in the 1980s 'despite the rhetoric of tax cuts, general government revenue never fell below 40%,'[28] and in 1993/4 the share of public spending in GDP will be back over 44%, a higher proportion than in 1979.

There has been a similar story in the USA and Germany. In each country the conservative government discovered that there was no stable consensus around lower taxes and lower spending, no political eldorado waiting to be found. In each case politicians succumbed to temptation and postponed their problems through mushrooming debt.

These setbacks have sapped the new right of much of its confidence. It is now far from clear whether its base is broad enough to sustain the momentum of reform. Despite incentives to opt out, overwhelming majorities continue to be dependent on state provision of health and education. Shifts in demography and employment are increasing the numbers who are dependent on benefits, reducing the electoral rewards for parties which argue too fiercely for the rights of the working taxpayer relative to those who receive benefits and depend on services.[29]

At the same time fears of social disorder hold back middle class support for truly far-reaching welfare cuts. And while high unemployment tempts many governments to cut back on benefits, most fear that this will simply lead to higher costs of policing and security as the system loses legitimacy for a significant swathe of the population. It has not been lost on other countries that in the UK the two fastest growing areas of expenditure in the 1980s were social security and law and order.

The economics of the new right's tax programme has also lost conviction. Despite some evidence that cuts in marginal tax rates do improve productivity[30] the story does not end there. Competition for footloose industries depends not only on low wages and taxes, but also on the balance between costs and the quality of the economic environment: the provision of education, infrastructures and social stability. Excessively low tax rates can frighten off investors as effectively as high marginal rates if they result in disorder and under-production of public goods.

The key point is that today's economy is increasingly systemic: the whole depends on the effective functioning of each of its parts. Transport, good schooling, and healthcare, cities without bombs, neighbourhoods without fear – all these are part of modern production and all require effective public provision. Ford's recent decision to invest $1 bn in a lorry plant in Ontario – in spite of the cost disadvantages relative to the US and Mexico – reflects the point. Canada's higher wages and social provision appeared to offer better conditions for the kind of 'total quality' production which its rival Toyota was achieving in its Canadian plant, the most productive car factory in North America.

But although the new right agenda has reached an impasse, in part because of its failure to develop a more systemic way of looking at the world, there is at present no other strategy offering a convincing alternative.

Instead there is stalement. Socialist, centrist and conservative parties alike are left bemused, caught between insistent demands for public provision and their fear that even a hint of tax increases loses elections.

For all sides the only way through, we believe, is to confront the two key problems that have caused the crisis – disconnection and globalisation.

# Reconnecting taxes

We earlier argued that one of the causes of the tax crisis is its loss of legitimacy. We traced this to the breakdown in felt connections between taxes paid and what they were spent on. Between payment and receipt is the black hole of treasury administration and budgetary politics. It is one over which even elected politicians – quite apart from the wider public – have too little purchase. We have also suggested that disconnection is not only an issue of policy details but also a wider, societal issue.

In what follows we set out an alternative. It is designed not only to solve immediate policy problems but also to establish the framework for a new relationship between governors and governed and a new structure of accountability. Its central argument is that the system's crisis of legitimacy can only be resolved by remaking connections in new ways.

It should be clear right from the start that this is a project which involves nothing less than a change in the very conception of the state. For at the moment our tax system is shaped by the inheritance of despotism. The political model is that of Hobbes, with governments having the right to collect whatever level of tax they deem necessary, and to use whatever powers they regard as appropriate to the task. It is a top-down model, which begins with the needs and interests of the government rather than with the directly expressed needs and interests of the citizens.[31]

But there is another tradition which has always been suspicious of the state, tracing its roots to a fiercely anti-monarchical democracy. It can be found in Jeffersonian liberalism, Catholic social thinking and in more recent years in feminist and green approaches to government. This tradition works from the ground up. It sees sovereignty shared between elected representatives and citizens, and emphasises the richness of the channels of communication between governors and governed. It is in the light of this tradition that we now need to find the elements of a new alternative of reconnection. Its starting point is a set of three general principles:

- the first is the principle of hypothecation, that is to say wherever possible directing earmarked taxes towards specific ends, and reversing the trend towards pooling and consolidation.
- the second is the principle of democracy, wherever possible making the tax authorities and service providers directly accountable to the constituencies they serve.
- the third is the principle of subsidiarity, bringing tax-raising more closely into line with the appropriate levels of service provision, and reversing the trend towards national tax collection for local service delivery.

All three build on the premise that in sophisticated modern societies legitimacy needs to be built from the ground up, through a multiplicity of relationships between payers and providers rather than through a single line of accountability passing through parliament and cabinet. Legitimacy, in other words, comes from connections.

Some elements of this agenda are not unknown. Many US states require voters to approve increases in local property tax rates, known as the millage, and new bonds. In some states such as California, voters themselves put issues on the ballot. In Switzerland, too, there is a long tradition of direct democratic control over taxes at a cantonal and communal level.

But these practices have scarcely begun to renew the tax relationship. The time is ripe for a much bolder and more imaginative period of experimentation and it is to this that we now turn.

## Hypothecation

There have been a number of examples of hypothecation, the transfer of taxes from a specific source to a related purpose, during the course of British tax history.[32] One is the TV licence fee, which is levied on sets and goes directly to the BBC. Another was the Eady levy on cinema seats introduced by Harold Wilson in the late 1940s to fund the British film industry. These types of earmarking are most common in the early stages of tax development. In developing countries it is common to find airport and hotel bed taxes used to finance tourist development. Petrol tax is often used to finance road building. Just as winding country roads reflect strong local property rights and a weak state, so hypothecated taxes reflect the need for emerging states to win popular consent. And just as winding roads are replaced by the motorways of strong states, so hypothecated taxes are replaced by pooled collection and the assertion of treasury control over administration.[33]

We are suggesting a return to hypothecation, as a way of restoring people's sense of connection. There are three approaches to be considered:

The first is **functional hypothecation**, where a tax is used to finance another part of the same functional system. Transport is a good example of how this could work. There is a widely acknowledged imbalance between road and rail transport, and a lack of integration between different transport modes which has been exacerbated by misconceived models of funding and accountability. Hypothecation could put things right by imposing more appropriate incentives and signals.

The simplest approach would simply be to pay a proportion of the road fund licence, or of the revenue derived from urban road pricing, into rail. But a more promising approach, which demonstrates the wider potential of hypothecation, would be to introduce an annual public transport fee, similar in principle but not in form to the BBC licence fee.[34]

This would fund a public transport agency which would in turn finance railways, buses, cycle hire groups, franchised taxis and other transport providers. It could be financed out of a range of sources, the most appropriate of which might be taxes on fuel: the important issue is that its level should be clearly visible to the public so that, as with the BBC, the level of finance would become a matter of public debate, dependent less on the decisions of cabinet committees and more on transport operators' ability to generate popular support through the quality and extent of services. Each would therefore have an incentive to maximise usage within the overall budget constraint, just as the BBC has an incentive to keep its ratings high. The key indicator for the railways, for example, would not be the financial deficit but rather the cost of each passenger mile.

Hypothecated funding, dependent on public support, and directed to an agency responsible for the overall system of transport, would then lead to a very different approach to transport provision. By giving a new incentive to maximise usage it could encourage transport integration, the re-opening of stations, the return of free carriage for bicycles on trains, the adoption of the French system of cheap bicycle hire at stations, and the use of railway property for transport intensive activities like supermarket shopping or leisure. It could encourage more systemic thinking, such as improved containerisation and luggage handling to encourage the integration of driving and long distance rail travel. And it could foster integrated ticketing and an expansion of information systems, such as electronic bus availability data at stations and bus stops.

Forced to justify a transport fee, the transport agency, and those seeking its funds, would have to consider the interests of all potential users. Financial efficiency would still count, because a higher fee would reduce public support. But finance would no longer be the sole criterion.

This is just one example of functional hypothecation. There are many others: pollution taxes to fund environmental programmes, taxes on graduates' income to fund universities, taxes on child benefits to fund creches, taxes on cigarettes to help finance the health service, and taxes on air travel to fund urban infrastructure and open air arts. Tourism is particularly open to functional hypothecation since effective management of tourism relies heavily on urban and rural facilities which cannot adequately be charged for (thus the Swiss have maintained subsidies to small farmers as a means of sustaining their tourist industry).[35]

The point in each of these cases is not merely that there is an explicit spotlight thrown on systems of provision and how well they interconnect, but that the recipients of funds are required to justify themselves publicly rather than just to ministers.

A second example is **temporal hypothecation**: the transfer of earmarked taxes to different stages of the life-cycle. Insurance of this kind has been one of the central principles of 20th century welfare and underpins the British system of national insurance and social security contributions. Although the contributions and payments flow not through insurance funds but through the central Treasury pool, many people still prefer to think that their contributions are directly related to benefits.

Recent debate has tended to see links of this kind as a thing of the past. But there are many new areas where these may turn out to be better solutions than the available alternatives.

One example is the shift from reactive to proactive insurance. The 20th century tradition of insurance was restricted to temporary or low risk dangers. But with the growth of sustained high unemployment, work-related health problems, and regular demands for reskilling the workforce, there is a strong case for shifting the balance of social security provision towards tackling the roots of the problems rather than compensating for the consequences. It is often wiser to invest in reskilling rather than unemployment benefit, in preventative healthcare rather than curing, in pre-school education rather than heavy policing of teenagers.

Free markets do not usually encourage this kind of proactive investment.[36] But collective insurance systems could be extended to protect against potential common threats. Their managers could be given incentives to invest in ways that reduce future payouts. Training and continuing adult education is an obvious example which could be funded by a distinct charge (part employer and part employee) and treated as an insurance against future unemployment. As with the French training levy, funds could be jointly controlled by employees and employers, rather than passing to the state. Another example would be prevention of work-related illnesses (both old ones and new ones like repetitive strain injury). In each case the effect would be to foster new mutual interests in prevention rather than cure. Instead of seeing social security as a social wage which is bound up with a wider distributional struggle between employees and employers, the insurance system would instead become a means of funding common benefits.

Another example of the new forms of temporal hypothecation is the use of insurance to support flexibility in working time. Rather than insuring against the risk of brief and occasional periods of unemployment, the insurance system could instead help employees plan working lives with more flexibility, both short-term (part-time work, flexitime, length and timing of holidays) and long-term (maternity and paternity leave, sabbaticals, and time for reskilling). It could help remove the traditional sharp distinction between full-time employment, unemployment and retirement and replace it with a more variegated system where national insurance payments provide rights for all classes of employees to take time off. This would not only help people manage the more 'lumpy' working lives which are becoming increasingly common, but could also help dampen the business cycle. Higher national insurance contributions during booms could be matched by incentives to encourage employees to take their time off during recessions, for example seeing them as an opportunity to reskill. Between full-time work and complete dependence there would be a continuum of packages mixing work and funded time off in varying degrees.[37]

These are just two indicative examples. But they show how the concept of insurance, the earmarking of payments to future uses, could become more important in the 21st century, whether or not it is the state, or more likely trusts of one kind or another, which are charged with managing payments and provision.

The last category is **distributive hypothecation**: the earmarking of tax payments from one group to finance benefits for others. One of the tenets of 20th century taxation was that it allowed a redistribution from rich to poor. Subsequently most of the debate about redistribution has focused on this type of subsidy, and whether it still has public support. This debate has often been somewhat misleading, since the opacity of the budget hides many different types of redistribution, not least the huge subsidies for mortgage-holding homeowners, car users and the university-educated.

The virtue of hypothecation is that it could help to make these transfers more explicit. The annual budget could be required to show the tax source of each area of spending: revealing for example how much of the income tax bill pays for mortgage tax relief and how much for pensions. The virtues of providing free university education could more clearly be weighed against the virtues of training single parents. The aim would be to place a stronger pressure on recipients to justify their subsidies to a wider public.[41] Greater budgetary transparency about who benefits from public spending, would create the conditions for a more informed debate about priorities.[42]

Information of this kind would haveve precisely the same value as sound accounts for a shareholder: it would show the public what their assets are doing.

But hypothecation could also have a profound effect on attitudes. At the moment those who vote for tax cuts can be among the first to contribute to Comic Relief. They do so because in the latter case there is a clear link between action and effect, and because they trust the body concerned. Tax pooling prevents these connections; hypothecation would remake them. For example, a government committed to greater redistribution might earmark a tranche of top-rate income tax for action against poverty by not-for-profit organisations. It is one thing to evade tax when the only loser is the Treasury, another when the losers are the homeless in the town centre or a disabled neighbour.[43]

These three forms of hypothecation, functional, temporal and distributive, are about the making of connections. They render services more independent of central budgetary processes. They encourage providers to look outwards – to the publics they have to convince, and to the funding sources on which they depend. This is why the Treasury and many senior politicians are so hostile to hypothecation. It weakens central control by making lateral connections.

But the political advantages should also be recognised. Clinton's recent decision to earmark increased taxes on the wealthy to a trust fund to pay off the deficit immediately defused the growing opposition campaign which claimed that his administration was following in the high tax/high spend/high deficit tradition of his predecessors. Elsewhere governments of both left and right could also benefit greatly from the greater legitimacy which hypothecation tends to bring with it.

## Democracy

The second means of restoring connections is direct democratic consent. This is the simplest way to bring government to account and to determine which services voters value.[44]

Health is a good example of an area in which this could work. In the UK polls have consistently shown public support for higher health funding. These demands will almost certainly intensify over the next few decades, not only because people will generally choose to spend a higher proportion of rising incomes on health, but also because of the effect of an ageing demographic structure. But fiscally constrained national governments will continue to find it hard to secure additional funding for health. A direct democratic choice on health funding would separate the problems of health funding from the legitimacy problems of government as a whole.

### A referendum on health funding

Rather than setting the level of health spending through the horsetrading of department and Treasury, electors could be offered a series of options for the national (or regional) health budget. Each option would specify a level of real funding to be guaranteed for the NHS, such as a 2% real increase or decrease.[45] The ballot paper description of each option would spell out the annual cost to the average tax-payer of the health tranche of income tax. It would also set out performance targets which would need to be met for funding to be released. Citizens' responsibilities to pay would be balanced by public sector responsibilities to perform. Subsequently tax bills would set out how much was going to health.

This is just one example. But there are many other cases where direct democratic choice could resolve problems which governments and parties have failed to tackle, such as reducing poverty (and testing the true extent of altruism[46]), transforming the basic structures of taxation[47], or boosting investment in education[48] from an earmarked slice of income tax or national insurance.

### A referendum on investment in London's underground

Direct voter consent could also help solve problems at the level of the city or region. We have already shown how the financing of transport could be modernised at national level. At city-level a good example of direct democracy would be a referendum on the rebuilding of London's Underground network. This has fallen far behind not only Paris or Tokyo but also other metropolitan systems in the UK, such as Newcastle's Metro. It is now facing further severe cuts because of national public spending pressures.

London Regional Transport estimates that the cost difference between achieving a world-class underground system by the year 2000 and bare maintenance of the existing, inadequate system is roughly £300 million per year. A referendum could offer the citizens of London a chance to vote for a premium to be paid on their council tax bills for the next eight years to finance an agreed programme of additional investment.[49] If Londoners had to bear half of the total cost this would amount to £150 million per year, or an average of approximately £54 per household per year: roughly £1 each week. A similar contribution from business, bringing the total up to £300 million, could be financed by a 6% premium on the uniform business rate in London, and could be made contingent on a poll of rate-paying businesses. Alternatively the contributions of both citizens and business could be reduced by a government commitment to provide matching funds, on the grounds that the capital's transport infrastructure provides benefits far beyond the citizens of London (not least for those who commute into London for work). The figures to be paid by each taxpayer would be substantial, although far from excessive. A referendum would provide a clear idea of how much Londoners value their transport system. It would also test the spin-off values of a good transport network, since many who do not use the underground would nevertheless be prepared to pay for emptier roads and a more efficient city.[50] But the crucial point is that responsibility and choice would lie where it should: with the users and beneficiaries of London's transport network.

### Who chooses the questions?

Each of these examples raises the important issue of who decides the questions. Referenda are a renowned tool of dictators. They can easily become just another tool for governments to manipulate opinion.

In democracies there are three main options. One is to vest the power to determine questions with representative institutions, such as parliaments (or, in practice, with the cabinet, as is currently the case in the UK). In the same way it could be vested with local authorities in the form of a general power to hold referenda, subject to the oversight of the Audit Commission to ensure that this power is not used at too great an expense.

The second option is to grant the power to a semi-independent institution. Questions to be placed before electors could be made subject to approval by a semi-independent Public Choice Commission, established on a similar basis to the Boundary Commission. Within the UK's unwritten constitution a commission would necessarily be appointed by, and accountable to, parliament, although the inclusion of judicial and lay members, and a statutory responsibility to respond to public wishes, could ensure that it was able to resist party political pressures.

But in our view the best option in the long-run is the third one: to vest power directly with citizens, by requiring a fixed number of signatures to place a question on the ballot, as in Switzerland, Italy and much of the USA.[51] Direct choice is the only way to ensure openness and to guarantee an active public debate about priorities.[52] It is sometimes messy and unpredictable, and sometimes unsettling, but it has no real substitute.[53] To limit its deficiencies there is a strong case for requiring a high number of signatures to place questions on ballot papers so as to prevent voter overload,[54] and for limiting campaign spending. But the time is ripe for an expansion of direct choice. The mounting calls for referenda on everything from European treaties to electoral reform confirm that they are the least unattractive option if governments and parliaments are no longer trusted to resolve problems on their own.

## Subsidiarity

Our third principle is subsidiarity: the idea that the power to raise and spend tax should be devolved to the lowest appropriate level. In most of Europe and North America this is not an unfamiliar idea. Local and regional governments have considerable taxing and spending powers and can set specialised taxes of their own on such things as heavy goods traffic, tourism and dogs. Most overseas local authorities depend on local income taxes or property, both of which provide a strong tax base. This is one important reason why they are better able to experiment and innovate than British local government. In the UK, by contrast, Whitehall has progressively taken powers away from local government, which has lost both public respect and the capacity to act.

Whoever provides funds is always likely to demand control. Subsidiarity therefore depends first and foremost on the existence of a local tax base and powers to tax it. But this is a necessary and not a sufficient condition for efficient and responsive provision of services. To achieve that we have to go further, making more explicit links between the tax relationship and the ballot box, not only for local government but also for the many intermediate bodies such as Training and Enterprise Councils and health authorities.

Because although there is now a wide consensus in favour of revitalising local government, few believe that a simple return to the past will prove successful. Instead the challenge is to find new forms of local decision-making and accountability which give substance to the idea of subsidiarity without overloading an inadequate political system.

A first step would be require local authorities to hold referenda on budgets set in excess of government limits. This would be a counter both to local profligacy and to Whitehall authoritarianism. It is not a new idea. It was proposed by Michael Heseltine in 1981 and has been put into practice by Tower Hamlets in London: in both 1992 and 1993 voters chose the highest taxing and spending option on offer.[55] To generalise their approach, councils would need an explicit legal power to hold referenda of this kind. This would be a modest first step along the road to local tax autonomy.[56]

Consent for general spending packages would then need to be supplemented by giving voters powers to decide on more specialised taxes. At a regional level funds could be earmarked for infrastructures: for example the Welsh Development Agency might seek an initiative to finance an accelerated programme of fibre-optic cabling in Wales. In Northern Ireland, spending packages could be made to require two-thirds support, so as to foster negotiation between the Catholic and Protestant communities. At a more local level backing for the provision of nursery places, a plan to save a football club, or an Olympic bid could be tested through the ballot box by asking voters whether they are prepared to pay the necessary taxes; spending could then be monitored by a consumer audit.

Local connections can also rest on voluntary forms of payment. Treasury rules could be adapted to allow local authorities to raise voluntary bonds for a project such as a creche, a swimming pool, a traffic safety scheme or a job creation project. A health authority could raise a bond to finance a new gym. In each case citizens would be asked to provide cheap capital, knowing that their money was being used for a good end.[57]

The link with voluntary action could also be taken a step further by using local taxes to fund initiatives beyond the boundaries of the state. Instead of giving local government a monopoly over local tax receipts, voters would be asked to allocate a percentage of local tax revenue to not-for-profit projects[58] such as a theatre, a drugs rehabiliation project or a community radio station.[59] Any scheme which gathered a sufficient number of signatures would be listed on ballot papers for approval or rejection.

Each of these measures would introduce a quite new discipline into local government. Services would have to be argued for and justified. Inefficient, corrupt and unresponsive ones would soon suffer. Entrepreneurial managers and workforces who identified new needs and met them well would be rewarded. The crude centralist disciplines of the 1980s would be replaced with a tougher, but much more relevant discipline. And, perhaps even more important, local civic life would be revitalised with a more varied set of connections than is offered by an occasional vote at local elections.

These proposals go with the grain of change. Before the early 1970s, councils were allowed to hold referenda: Brighton's poll on its marina in the late 1960s is one example. During the 1980s and 1990s, despite the lack of an explicit legal power, dozens of councils have been seeking new ways to gauge public opinions and priorities. They have recognised the deficiencies of party and representative structures as channels of communication. Some have simply held regular opinion polls, while others have held formal votes on everything from wheely bins (in Luton) to boundary commission proposals (in Herefordshire). These councils are stretching the very limits of legislation. In our view they now need to be seen as pioneers of a more pluralistic set of relationships between providers and citizens.

# Tackling mobility and globalisation

The second great question to address is globalisation: the task of taxing global companies and increasingly mobile high income individuals so as to protect national and small business, and the less mobile middle and working classes, from an ever-rising burden. As we have shown the problem is that a substantial proportion of the economic activity within any nation's boundaries is now beyond the reach of national tax authorities (the world's largest 300 firms, the great majority of which are multinational, now account for roughly 25% of all productive assets). Whereas in an earlier period privileges were internal to states, they are now external in a world where states are rivals competing for footloose economic activity.

Governments which want to avoid the spiral of competitive tax-cutting now have only three broad options, each of which could either be used to increase the tax take or as a fiscally neutral means of reforming business taxation.

## The California option

The first is the simple assertion of economic power, the purest example of which is California. The state of California calculates the share of a company's international business that takes place within the state, and taxes profits proportionately. The technical term for this is apportionment. As a result California's revenues are not affected by transfer pricing or offshore declaration of profits. This so-called unitary taxation is vigorously contested by multinationals operating there. Barclays has for the past ten years been conducting a suit against the California Franchise Tax Board and is currently seeking to take the Board to the Supreme Court over the issue, arguing that unitary taxation is illegal because it interferes with the federal government's sole right under the US constitution to regulate foreign commerce. The Canadian company Alcan has taken legal action on the grounds that their Californian operation was losing money and that they should not therefore be taxed on profits made elsewhere in the world. The significance of these issues can be judged by the finance at stake: $4 bn in the case of Barclays, and $3.2 bn in a parallel case brought by Colgate Palmolive.[60]

Unitary taxation is by its nature a fairly crude method, although some would argue that its very simplicity is a virtue in an age when complexity has been used to avoid tax.[61] When introduced unilaterally, it can lead to double taxation.

It would clearly be preferable to negotiate an international agreement on apportionment, overseen either by an existing institution like the OECD or IMF or by a new, more representative body. This would help economically weaker states that lack the economic muscle to go it alone like California. It would also reduce the anomalies that arise from a multiplicity of different accounting and taxation regimes.

A rapid move to a genuinely global tax regime is unlikely. But there have been some faltering steps in this direction. In the developing world the most ambitious initiative was the six nation Andean pact in Latin America, which was undermined by the relative weakness of the economies concerned and their indebtedness. A more likely candidate for setting the pace is the European Community. At the moment Community policy has been largely confined to tax harmonisation, which does little to address the issue of the effective administration of tax on multinationals. There has been little attempt to harmonise personal income tax for a more integrated Community. The Commission has simply proposed that there should be maximum and minimum rates for corporation tax.

But tax harmonisation could in time evolve towards a common European policy of unitary taxation and apportionment. Such a policy could initially work with tax collection entirely in the hands of national authorities. The danger, however, is that there would still be incentives for governments to engage in competitive tax-cutting. A more stable solution would be to establish a common European corporate tax collected by an agency modelled on the US Internal Revenue Service. Firms would pay a tax centrally on net income in the proportion of world turnover represented by the firms' European sales. The agency would focus at first on the top 100 firms whose sales account for 40% of Community GDP, and would build on the experience of the European Commission's competition agencies, which have extensive powers to investigate and act. It would accelerate the process of accounting harmonisation and offer a model for other regional blocs to copy.

It is important to emphasise that centralised tax collection does not imply federal government (although it is significant that many federal systems use some form of apportionment). A tax collection agency could report to the Council of Ministers, to national parliaments, or to a strengthened European parliament. Its funds could be apportioned directly to national governments on the same unitary principle, or redistributed, or used to fund Community budgets. The key point is that the assessment and collection of tax would be centralised at the European level.

Until now there has been a remarkable silence on tax during the Maastricht debate. European governments have been willing to contemplate major concessions of sovereignty to a European central bank overseeing a single currency. But as yet they have not been willing to share sovereignty in relation to tax, although the case for internationalising tax is arguably stronger than the case for internationalising money or social regulation. For although national authorities can gain most of the benefits of a single currency by tying their currencies together, in the case of tax, the weaker option of harmonisation is not a convincing alternative to the power of a single agency.

The case for a new approach to tax is in this respect similar to the widely accepted case for the European Commission to act as a centralised agency in policing competition policy: national authorities simply lack the scale, authority and independence to investigate global companies. But in the realm of tax, perhaps because it is so intimately bound up with sovereignty, national governments have been reluctant to come to grips with their waning authority. They have been unwilling to admit that as far as mobile capital is concerned there is increasingly little they can do.[62]

## Taxing rents

The move to a common system of unitary taxation is the best long-term means for reducing the imbalance between the mobile and the immobile. In the meantime, however, governments do have other options. One is to tax immobile resources like labour or materials, which mobile companies have to buy. This is what has happened in Ireland. The problem, however, is that any rise in underlying costs will undermine a nation's competitiveness as a location for investment.

The better alternative is to target monopoly profits, or rents as classical economists would call them. Rent is the amount by which the money paid to a firm or individual exceeds the minimum necessary to induce them to perform the function concerned. The beauty of rent from the viewpoint of taxation is that it can be taxed without affecting production; investment and prices will remain unchanged. Only the unproductive lose.

This is the advantage of property taxes. Unlike a tax on labour, a tax on property does not drive the land price up. The land price stays the same, and it is the rent of the landlord which is cut.[63] This is why on at least three occasions since 1945 there have been special taxes on development gains. A similar argument applies to natural resources, such as oil, and has been used to justify specific taxes and leasing arrangements to tap the difference between the low-cost producer and the high-cost one. In areas like the North Sea this difference is worth billions of pounds. The levy on ITV licence holders is another example of a tax on rent.[64]

In the late 20th century rents have moved not only to property in towns and to natural resources, but also to the monopolies built up in the economies of knowledge and information. For example the holder of a patent for an effective Aids drug, a computer operating system like MS-DOS, or the owner of a hit film or record are all beneficiaries of a form of rent. Government gives each a time-limited monopoly; in the case of copyright, one that seems like a hangover from a very different era – a 50 year copyright fits oddly in the age of instantaneous post-modern culture.

These are the purest examples of the new forms of rent. But there is also a sense in which much of modern industry now works through the creation, and rapid exploitation, of temporary monopolies. The designer of a new car, running shoe or microprocessor seeks to maximise the profit that accrues from their monopoly before competitors imitate them and the market becomes more traditionally competitive.

We may now be on the brink of a new appreciation of the importance of information and knowledge, parallel in significance for tax thinking to the physiocrats' identification of agriculture as the source of all wealth in the 18th century. The full consequence of this shift has yet to be worked out, and as yet tax policy has barely acknowledged the scale of the shift towards a more information-driven economy. But some of the outlines of a new tax regime constructed around the new rents, are already apparent.

In the field of culture, for example, recent work by John Kay has shown the potential for national authorities to tax the rent in blockbuster films[65] without either increasing the price to customers or discouraging investment. By the time they reach the European market most Hollywood films have already covered their costs in the US markets. Each year the top 10 films gross over £900 million per year from theatrical, video and television exhibition in Europe, as much as half of which is repatriated as profit to the US. Most of this is rent, which is then shared between US distributors and producers. A considerable amount is paid to stars. A tax on that rent could raise significant revenue at little or no cost to the public. It could then either be paid into central funds or hypothecated to support new film production.

Patents are another starting point, since they represent a monopoly granted by the state as a means of encouraging innovation. It would clearly be possible to use patents as a tax-raising tool, with the state extending patent periods and taking an increasing proportion of the proceeds in the latter part of a patent's life. Since private companies value income flows in the early years more highly than the state (in economic terms they have a higher discount rate) it makes sense for the state to leave the great bulk of the early proceeds of a patent to the patentee, and take the bulk of its share in later years. As in the case of films, receipts could either go to general funds or be hypothecated into public research and development.

A third new area of rent is the electromagnetic spectrum. This serves to support everything from television and radio to microwave communication, mobile phones and satellites. Its potential uses are multiplying yet it is still generally provided by governments at a nominal charge even though, like land, it is a classic source of rent which is open to taxation through user fees and auctions.[66]

A fourth area to explore is the promotion of brand names through mass advertising. These are now treated as assets, like landed property, and are entered in company balance sheets as such. They provide a rent for the owner of the brand name, well in excess of the costs of production of the commodities concerned. It is this rent which is available for tax through the indirect proxy of advertising.

These are four examples from a broad field. None of these taxes are direct taxes on rent, but it is the existence of the economic rent that provides their rationale. Each needs to be carefully designed, to ensure that they do not discourage innovation, and to limit complexity. But they indicate an important new direction of enquiry and are prime candidates for fiscal reform in the twenty-first century.

## Linking corporate tax to economic benefits

The last option builds on our other arguments for connection. Most large companies recognise that an effective social and economic infrastructure is essential to the success of modern production. They consistently lobby for higher spending on railways or education. In some cases they partially fund provision themselves, but in others they have to rely on the public sector. The trouble is that at the moment there is little connection between the tax they pay and the benefits they receive.

An imaginative government could link some of the proceeds of business taxes to the infrastructures necessary for modern production. One familiar example is the levy on payroll costs which could be earmarked for training as it is in France.

In the same way government could establish a direct connection between tranches of corporation tax and the costs of investing in railway electrification or technology transfer, business schools or language training, a preventative health programme targeted at the workplace, or provision of childcare facilities which would release women into the workforce.

In each case the connection would establish an informal contract between government and business. It would increase government's obligation to make a clear argument justifying spending.

Just as Japanese industry pays some of the world's highest corporation tax rates because of its sense that government is serving its interests, so corporate tax connection elsewhere could encourage a permanent dialogue about priorities and reduce the incentives for multinational business to avoid taxation.

# Conclusions

The modern nation-state, like the dynasties and empires that preceded it, rests on a system of tax. Unlike them, its governments have to cope with a world where money has become almost infinitely flexible, and where there is the constant need to be seen as legitimate by the citizens who pay the bills.

Over the last two decades governments have found themselves perpetually buffeted by their failure to solve either problem. They have placed a rising tax burden on an ever more resentful group of relatively immobile citizens whose patience has worn thin. And they have failed to devise a more international system of tax to fit the age of instantaneous transactions and global markets.

The new right reforms of the 1980s were a radical attempt to solve the problem by going backwards to the taxing and spending regimes of the 19th century. For the reasons we have outlined they failed, and left governments less confident and less legitimate. If governments are not simply to stumble from crisis to crisis, a new period of reform is now needed which more clearly addresses the prime sources of the crisis, above all the problem of legitimacy.

In this pamphlet we have suggested some of the ways forward. We have emphasised the crucial importance of connections, both as means of legitimating taxes and as a means of disciplining governments. We have proposed a range of new connections between the citizen and the multiple levels of government, running in a continuum from new budgetary arrangements to direct democratic choices. We have shown that these imply a radical reshaping of local governance, treasuries, and, indeed, of representative institutions, and a move away from budgets determined by departmental wrangling towards funding that is more clearly linked to outcomes. We have also drawn the outlines of a better balance between the need to integrate systems and the democratic case for greater autonomy and decentralisation.

The implementation of this programme will be neither easy nor fast. There are powerful vested interests locked into every clause of the tax system. Many have been brought up within the old model and have internalised its assumptions. But the pressures towards reform are inescapable. They derive from deep shifts in the foundations of modern societies and economies. They can be postponed or hidden but not avoided.

Many in politics will understand this. Governments will recognise that new models of choice can insulate them from the full costs of tough political choices. Oppositions will find it easier to justify their preferred new initiatives if they can guarantee voters that taxes will not disappear into a governmental black hole.

But there is also a global context. During previous eras of transition those nations that reformed first gained a significant advantage over those that did not. In the 1990s too, those nations that move first will be the ones with efficient and legitimate government and high quality provision, while those that follow will struggle with discontent and decline.

This is why although the ideas we have set out apply with particular force to the archaic and centralised structures of the UK, they are also relevant elsewhere. Most other countries devolve much greater power to towns, cities, districts and regions. But they too are facing profound crises of legitimacy. They too are in need of new ways to cope with globalisation.

Our arguments are also pertinent to an evolving European Community. The Community has an important role to play as a harbinger of a new global corporate tax regime. But any invention of new European-wide taxes without a concomitant concern for their legitimacy, and the connections of which they are a part, will surely lead to disaster.

Schumpeter was right when he wrote that the thunder of world history can be heard best in the realm of public finance, stripped of all phrases. Today, after two decades of revolt and reform there is still thunder in the air, and a strong sense that we are at the beginning, not the end, of a period of transition.

The first great period of tax reform took place in the 1790s. The next one reached its high point in the 1890s.

This hundred year rhythm may now be set to be repeated, in the 1990s, with the beginning of a new period of reform. If our argument is correct, then once again tax is on the move. And once again the ways in which it changes will be part of a new and much wider settlement around the state, political parties and representative institutions.

# Summary of analysis and recommendations

Tax has moved to the centre of the political stage. In the 1970s and 1980s the irresistible upward pressures of public spending set off a succession of tax revolts, from proposition 13 in California and the Progress Parties in Denmark and Norway, to the rebellions against value-added tax in Japan and the poll tax in Britain. Ever since, tax-raising governments have lost elections and oppositions that promised new taxes have failed to win them.

As in previous periods of transition the prime cause is the upward pressure on public spending. In the late 18th century this was caused by the costs of war and in the late 19th century by the costs of maintaining social peace. Today it is caused by the rising relative costs of maintaining labour intensive public services, and the expanded number of people dependent on the state.

As in the past, the crisis has exposed fundamental shifts in the nature of society and the economy that are rendering the old system unsustainable.

The first great shift we term **disconnection**: the separation of the tax bill from the benefits it finances. The great majority of tax is paid into a general pool, and is divided up according to ministerial horse-trading. This model, which was consolidated at the end of the last century, has become increasingly inefficient and unresponsive. People are less willing to pay blank cheques and to accept the state's right to decide how much is spent on what. The system has become too opaque and too centralised for a sophisticated, consumerist culture.

The second shift is the **globalisation** of economic life which has eroded national governments' power to tax. Where once governments taxed predominantly national and local companies, today the main producers and repositories of wealth are multinational companies which can declare their profits in low tax countries, while continuing to operate in high tax ones. Both firms and individuals can now take advantage of the huge flexibility of global electronic transactions and a proliferation of tax havens.

The combined effect of these two shifts is that governments need to raise more money from the immobile middle and working classes at a time when their systems of taxing and spending render them less legitimate.

During the 1980s **the new right** tried to solve the crisis of taxing and spending through tax cuts and a radical deconstruction of the welfare state. Their next steps would be to further simplify taxes, to cut pensions and benefits, and to raise vat on necessities. But by most criteria their policies have not succeeded. In spite of a decade of restrictive policies, all but three OECD countries saw the share of public spending in GDP rise during the 1980s. Cuts in top marginal rates did not feed through in any simple way into higher growth. Cuts in public spending undermined the social infrastructures on which modern production depends and a simpler tax system simply made spending even more opaque.

We propose an alternative agenda. It has two main components. The first is to **reconnect** taxes and services, and to share sovereignty between elected representatives and citizens. Its goal is to bring tax raising closer into line with service provision by **hypothecating** funds wherever possible, for example through new forms of insurance and funding models which encourage a systemic view of sectors such as transport. It proposes expanding **citizen choice** over how much services should be funded, for example through giving voters a choice over the real level of the NHS budget, or new investment in London's Underground. It argues for greater **subsidiarity** and the devolution of tax raising power to the local and regional level. It proposes local choices over specialised taxes targeted at such things as the provision of nursery places, a regional infrastructure programme or an Olympic bid, and a new mix of compulsory and voluntary payments. In each case the goal is to introduce a new discipline into government. Services would have to be argued for and justified rather than being determined by top-down decision-making.

The second area of reform is to tackle globalisation. Three complementary options are proposed for nations which do not want to be drawn into tax competition. The first is to follow the California model, preferably through international cooperation to create a common framework of **unitary taxation** according to which firms' share of economic activity in each country is estimated and taxed accordingly. The EC now needs to take a lead in this area. The second is to develop taxes focused on the modern forms of economic **rent** such as culture, patents, electromagnetic spectrum and brands where national authorities can tax without either impeding investment or raising prices. The third is to **link corporate taxes to uses** which are of benefit to business, such as preventative health, technology transfer or training, so as to discourage avoidance.

All contribute to a new agenda that encourages a more modern balance between decentralisation and the integration of systems. All help to solve the profound crisis of legitimacy which is undermining governments in much of the world. All are about reconnecting the means of taxation to its ends, reversing a 200 year history of centralisation and pooling. Together these suggest a radical programme of reform for the 1990s potentially as profound in its impact as the reforms of the late 18th and late 19th centuries.

# Notes

1. For a discussion of the current UK situation see H. Glennerster, *Paying for Welfare: Issues for the Nineties*, LSE Welfare State Working Programme, Discussion paper no. 82, December 1992.
2. Attitudes are summarised in 'What do citizens think about taxes' in B. Guy Peters, *The Politics of Taxation*, Blackwells: Oxford 1991, which gathers together and critically assesses a very wide range of surveys and studies.
3. On the history of tax see Gabriel Ardant, *Histoire de l'Impot*, Fayard 1971. The second volume covers the period from the 18th century to the present. Published on the eve of the oil price rise and the first major postwar slump, Ardant had no sense of the profound fiscal changes which were to come, save for being an early exponent of environmental taxes. See also Carolyn Webber and Aaron Wildavsky, *A History of Taxation and Expenditure in the Western World*, Touchstone, 1986.
4. For Britain see B. E. V. Sabine, *A History of Income Tax*, Allen and Unwin, London, 1966.
5. This attitude was embodied in successive pieces of legislation and has only begun to be tackled in the 1990s. The 1842 Finance Act stated that 'the profits of any married woman living with her husband shall be deemed the profits of her husband.' The 1918 Act introduced the 'married man's allowance' and the 1970 Income and Corporation Taxes Act 1970 stated that 'a woman's income shall be deemed for income tax purposes to be his income and not to be her income.' *Income Tax and Sex Discrimination*, Equal Opportunities Commission: Manchester, 1979.
6. All sides of the political spectrum have been guilty in this respect. The same tax scare technique which was used by the Conservatives to defeat the UK Labour Party in the 1992 election was used by the Australian Labour Party to win reelection in 1993. In neither case did the electoral argument bear much relation to the real choices facing each nation.
7. One exception was the poll tax or community charge, an ill-conceived

attempt to make transparent the link between local tax and local services. The Government deliberately tried to change the language of payment away from the word 'tax', with its deeply-buried meaning of an externally-imposed burden, towards the more neutral concept of a charge for collective provision. The general public successfully resisted this verbal sleight of hand. But despite the ignominious demise of the poll tax the years ahead are likely to see a succession of new words to describe compulsory payment.

8. 62% of redistribution is what the LSE group call 'William Beveridge' redistribution through the life-cycle, compared to 38% for 'Robin Hood' redistribution between social classes. In our view it is remarkable how little attempt has been made by government to package and legitimise this connection. Jane Falkingham, John Hills, Carli Lessof, "William Beveridge versus Robin Hood: Social security and redistribution over the life-cycle, *Welfare State Programme* 88, London School of Economics: London, March 1993.
9. William Beveridge deliberately made this a founding principle, so that although the effects of insurance were redistributive between classes, the form of payments and entitlements appeared as a redistribution within the life-cycle between periods of work and periods of unemployment. In some countries, such funds are wholly self-financing, as with Singapore's Central Provident Fund for pensions.
10. The term was coined by Andre Levi-Gourhan in *Le Geste et le Parole*, Albin-Michel: Paris 1964. It has been used by Pierre Dupuy, 'Myths of the Informational Society' in *Myths of Information: Technology and Post-Industrial Society* ed. Kathleen Woodward, Routledge, London, 1980.
11. Changes to tax could be an even more important cause of disconnection in the future. Much of the logic of recent reforms has been towards a simpler system, perhaps with a single rate for all income whether personal or corporate. In New Zealand, the Labour Finance Minister Roger Douglas introduced a 10% goods and services tax with a very wide base, and a widened scope for income tax, as a deliberate, and radical step in this direction. At first glance this seems attractive. But its great danger is that it would simply make the whole system of spending even more opaque and incomprehensible and would further the loss of connection between taxes and services.
12. Colbert, Louis XIV's finance minister, said that the art of taxation consisted in 'so plucking the goose as to obtain the largest amount of feathers with the smallest possible amount of hissing.'
13. The practices of transfer pricing and the problems inherent in its public control are discussed in R. Murray, Ed., *Multinationals Beyond the Market*, Harvester: 1981. Areas with high concentrations of research and development believe themselves to be particularly hard done by, as profits are declared where manufacturing takes place, unless an

adequate price is paid for the technology.

14. W. D. Vinyard Jr, 'Higher taxes, stricter audits lie in wait *Financial Times*, 22nd August 1990, quoted in Stuart Holland, *Economic and Social Cohesion in the 1990s*, A Study for the European Commission, November 1992, part 2, which also contains a useful discussion of transfer pricing and action at the European level to control it.
15. Zav Rustomjee, 'Capital flight from South Africa, 1970–1988' Transformation, no. 15, 1991. Morgan Guaranty did a similar study and found average losses through the exchanges of $1.5–2 bn per annum.
16. This estimate comes from Karl Ziegler of the Centre for Accountability and Debt Relief, formerly of Banker's Trust International. The Cayman Islands figures were released at the 1992 Plaza Hotel conference of international fund managers.
17. This point is made by Charles Adams in his chapter on tax havens in *For Good and Evil, The Impact of Taxes on the Course of Civilisation*, Madison Books, 1993. Adams is a specialist in international tax and tax law, and was one of those who helped build up the Cayman Islands as a tax haven.
18. Although Britain too would benefit from a tougher approach to transfer pricing. One study of the United States Internal Revenue Service (USIRS) showed returns for its transfer price control department of S650 million per annum. Robin Murray, *Transfer Pricing and Control*, Institute of Development Studies, University of Sussex: 1981.
19. The states in the USA have long suffered from such competition, which is why it is often said that income tax should be a federal tax. The last 20 years have seen this type of fiscal rivalry extend itself onto a world scale, both for corporations and individuals.
20. See Rudiger Dornbusch, 'Credibility, Debt and Unemployment: Ireland's failed stabilisation, *Economic Policy*, 8, 1989.
21. There has been a vigorous debate about the impact of taxes on labour. Most North American economists see labour taxes (direct or indirect) as cutting real wages. In this case it would be immobile labour not mobile capital which would pay the tax. But there is an alternative 'distributional' theoretical tradition which sees the issue as less clear cut. If wages are at a subsistence level, then a tax on labour is likely to drive wages up, and profits down, and therefore finish up as a tax on capital. Similar results would come from unions bargaining to maintain their level of real wages. The form of the tax would also play some part in the outcome, as in the case of social security payments. Ireland's recent history supports the distributional approach.
22. A good recent survey of the Irish economy can be found in Lars Mjoset. *The Irish Economy in a Comparative Institutional Perspective*, National Economic and Social Council, December 1992.
23. Note Leona Helmsley's remark during her trial for tax fraud that 'taxes are for little people.' One of the

reasons for this is the access of the wealthy to the best tax advisers. There are an estimated 325,000 tax advisers worldwide, and the best sources on avoidance and evasion are books and articles written by them. A recent example is Charles Adams' book, cited above. He points out that the failure of the billionaire Howard Hughes to pay any income tax exemplifies a general rule that 'the more wealth a taxpayer possesses, the easier it is to avoid taxable income. A person's wealth and ability to pay do not necessarily bear any relation to taxable income.' He regards income tax as much less effective in taxing the rich than a wealth tax for this reason. See his book (cited note no. 18) p. 453, and more generally Chapters 33 and 34.

24. The major exception is Japan where the top rate remains at 65%.
25. 50% of corporation tax yield in 1991 was accounted for by the top 3,000 payers, and 10% by the largest seven. But we do not know the breakdown of these payers between multinationals and large, predominantly national firms like supermarkets.
26. In the US, one study found that one-fifth of the 250 largest US corporations paid no tax from 1981–1985.
27. So-called 'tax exhaustion,' when companies have insufficient profits against which to offset past losses, rose from 2% in 1970 to 40% in 1980 in the Devereux sample. This resulted in part from the combination of recession and an array of allowances. But this was also a period of increased internationalisation, and the sustaining of tax exhaustion into the mid-eighties suggests that recession was not the only explanation. See Kay and King, *The British Tax System*, OUP, Oxford, 1980, and Michael Devereux, 'Taxation and the Cost of Capital: the UK Experience,' *Oxford Review of Economic Policy*, vol. 3 no. 4.
28. Sir Douglas Hague, *A Target for Public Expenditure*, unpublished mimeo, 1992.
29. In California, which has often led the world in this area, some authorities estimate that the ratio of tax-payers to tax-beneficiaries has fallen from eight to three since the 1950s.
30. This remains a contested topic. For a detailed econometric survey which suggests the importance of lower average tax rates to productivity growth, and which also shows that the UK failed to reverse economic decline in part because of the Thatcher government's failure to lower average rates, see A. Newell and J. Symons, 'Macroeconomic consequences of taxation in the 1980s,' Working Paper 113, *Centre for Economic Performance*, LSE: 1991.
31. The concept of representative democracy was developed by the utilitarians as a way of preserving this top-down model while extending the franchise, and was later accepted by the Left who saw the resultant state as an instrument which, once captured, could be used progressively.
32. A full list is provided in Barry Bracewell-Milnes, 'Earmarking in Britain: Theory and Practice,' in *The Case for Earmarked Taxes*,

Institute of Economic Affairs: London, 1991, p. 57 ff.

33. The case for hypothecation never wholly disappeared. James Buchanan argued in the early 1960s that tax decisions and expenditure decisions should be relinked so as to better reflect individual preferences. See J. Buchanan, 'The economics of earmarked taxes', *Journal of Political Economy*, October 1963: 457–69. There have also been studies showing that hypothecation can improve compliance, since voters will have more confidence that their money is spent on useful outcomes. See for example Elizabeth Deran, 'Earmarking and expenditures: a survey and a new test,' *National Tax Journal*, December 1965. However ideas of this kind never made much headway against the prevailing conventional wisdom.
34. Hypothecation of this kind seems to fit better with public attitudes than pooled taxation. Contrary to the assumptions of the majority of economists who have influenced tax theory, most people see different goods and services such as transport, land, water, justice or schooling as different in kind, and consequently believe that it is quite appropriate to reflect these differences in tax policy. This is one reason why there is far stronger support for a more equal distribution of healthcare, justice and education than there is for an egalitarian distribution of money. In this respect Michael Walzer's approach is considerably more useful than those of more abstract political philosophers and economists. See *Spheres of Justice*, Harvard: Cambridge MA, 1983.
35. The Swiss motorway charge is also an interesting example of a tax that is precisely designed to fall more heavily on foreigners who use Swiss roads.
36. See for example the excellent survey of insurance systems, markets and informational failures in Nicholas Barr, 'Economic Theory and the Welfare State,' *Journal of Economic Literature*, XXX June 1992.
37. The insurance system could dovetail with a reformed education system. There is a lively debate beginning about whether everyone should be given the right to a number of years of tertiary education at some point in their life: like a modified insurance system it would encourage a more efficient and equitable use of time.
41. Interestingly, a more direct involvement by electorates in tax policy would tend to reinsert morality. This is both a question of desert and need for people and a question of how different goods are taxed. Most people recognise that goods bring with them very different levels of risk and danger, both external and personal. This is not well-represented by tax neutrality. A strong public sense of good and bad (and not just price inelasticity) lies behind the long history of 'sin' taxes on products such as alcohol and tobacco, or gambling, and, conversely, the tax exemption of books and newspapers. A public that is becoming rapidly more attuned to risk in fields such as food, cars and cosmetics may well seek a more differentiated tax system to reflect this.

42. For the first time government would have to show the local and regional impacts of decisions, and whether, for example, subsidies to depressed industrial areas are of the same order of magnitude as indirect subsides through the defence budget, or mortgage tax relief to the South-East.
43. There is conflicting evidence about how electorates would react, whether to packages offering specific action on poverty or to a broader programme of redistribution. David Miller suggests that a democratically determined distribution of incomes, to the extent that it is conceivable, would be 'substantially inegalitarian, but at the same time a good deal less inegalitarian than that which currently obtain.' It would reflect a widely shared belief that different abilities and work should be differentially rewarded and an equally widely shared belief that the existing system often rewards the wrong people. Miller's survey also demonstrates the weakness of popular support for familiar notions of social justice. David Miller, 'Distributive Justice: What the People Think,' *Ethics* 102, April 1992: 566.
44. Increasing direct voter choice would not have easily predictable results. The public attitudes tracked in *British Social Attitudes* (SCPR) do little to illuminate how voters would choose. The more detailed investigative work of small group analysis may be more suggestive. See for example the excellent survey and analysis in David Miller's essay, cited above, 555–593.
45. The most recent UK government forecast is of a 0% real increase for NHS funding in both 1993/4 and 1994/5. A 2% increase in funding for the NHS, roughly what is needed to maintain the existing quality of service, would cost an average £34 on income tax.
46. See for example the assessment in Joanna Mack and Stewart Lansley, *Poor Britain*, Allen & Unwin: London, 1985, of the 'price sensitivities' of altruism which would be relevant to such a package.
47. A very different example of direct democracy would be a public referendum on the gradual elimination of income tax. There has been a long debate about the virtues of shifting the whole balance of taxation away from income and towards resource use and expenditure. Nicholas Kaldor proposed this in the mid-1950s, James Meade in the 1970s and John Kay and Mervyn King in the 1980s, but governments have proved unable and unwilling to push through radical change of this kind. A wider public debate and public decision making power could succeed, and legitimate the results, where governments have failed, bringing together the various interests which would benefit. One group is the environmental movement which has long argued for shifting the burden of tax away from labour and onto resources so as reduce the use of energy and materials and slow down global warming. A second group is efficient, high technology business which would benefit from a shift away from profits taxes towards

taxes on resources, since the existing system penalises the efficient and successful over the inefficient and wasteful. These would be joined by many others if they devised their package carefully, with a gradual phasing out of taxes on income in all their forms (apart from a residual higher level income tax to maintain some proportionality across the income range), and a package of related measures such as incentives for renewable energy or recyclable materials. But the key point is that whereas the existing budget process is relatively insulated from public debate, the need to secure majority support for an initiative would ensure the best kind of politics: open and intensive negotiation between all the different interests involved.

48. The UK Liberal Democrats' election pledge in 1992 to direct a 1% rise in income tax to education was a step in this direction. A more novel innovation would be to consult on the introduction of a 'tax on time,' whereby those receiving state-funded higher education would be required to pay it back in the form of work for public or not-for-profit organisations. A policy of this kind has been proposed by President Clinton.
49. This would restore in a new form the linkage which existed between London rates and London Transport investment. Two-thirds of investment was paid out of a levy on the rates until 1990 when the link was cut to soften the introduction of the poll tax.
50. This is the great advantage over asking users of the underground to pay directly. Higher fares would simply drive more people onto the roads, where there is already the prospect of a 50% rise in car ownership in London by the year 2010.
51. In Italy a referendum on amending legislation requires 500,000 signatures and the approval of the Constitutional Court. In Switzerland laws passed by parliament can be changed if 50,000 signatories call for a referendum. Constitutional initiatives can be launched by 100,000 signatories: they then need to be approved both by a majority of voters and a majority of cantons. In California, an initiative needs the backing of 8% of those who voted in the most recent gubernatorial election.
52. It is sometimes assumed that direct democracy always leads to votes against public spending. In the USA, in the wake of Proposition 13, many states did indeed have taxes cut because of such ballots. However, generalisations are misleading. By 1988 eight out of ten propositions on state ballots allowed governments to increase revenues or expenditures.
53. California is sometimes cited as an example of 'initiative politics' gone mad. The combination of federal requirements and citizen initiatives (such as the requirement that education spending should not fall below 40% of the total) means that 85% of the states budget is outside the governor's control ('Government in California,' *The Economist*, 13 February 1993, p. 23). It is significant, however, that almost no one is contemplating abolition of

the initiative process. Despite the irrationality of some of its results there is no sign yet that citizens wish to hand their power back to politicians.

54. We would recommend a minimum of 5% of the electorate, both at local and national level.
55. Tower Hamlets in London has held two referenda, the first in February 1992 on the 1992–3 community charge, and the second in February 1993 on the 1993–4 council tax. Tower Hamlets was not bound to take the results of either referendum into account when setting local taxes. Although the referendum on the council tax was legal because residents had to be notified of their band in any case, there is a dispute over whether Tower Hamlets was empowered to finance the referendum on the level of poll tax.
56. For this very reason it is opposed by the Treasury which views local autonomy as a threat to national public spending controls. There is a long-standing argument about the extent to which local autonomy undermines national macroeconomic management. The jury is still out, although interestingly there is a strong correlation between substantial devolved taxes and high Gnp per head. See for example David King, 'Local Government Taxation,' in Frank Vibert, Ed. *Britain's Constitutional Future*, Institute of Economic Affairs: London, 1991, p. 107.
57. Bondholders could also be given usage rights, such as cheap access to a swimming pool or childcare facilities, in the same way that Channel Tunnel shares gave discounts on future use of the tunnel.
58. In Germany taxpayers can choose to opt out of making a direct contribution from their tax bill to the churches.
59. A version of this idea was proposed by Nicholas Albery, in *The Encyclopedia of Social Innovations*, Virgin Books: London, 1992, p. 68, and before him by Norman Strauss of Templeton College.
60. For the current dispute see George Graham, 'In a squeeze over tax,' *Financial Times*, 14th May 1993.
61. These complexities have been hugely increased by the growing importance of intangibles in multinational production. It has been estimated that payments of royalties and licence fees between related parts of US multinationals were more than $13 bn in 1990, more than three times as much as payments to unrelated firms. See Gary Hufbauer, *US Taxation of International Income*, Institute for International Economics: Washington DC, 1992 and 'Taxing Question', *The Economist*, 22 May 1993, p. 83.
62. If international tax authorities do come into existence they may begin to investigate an obvious but hitherto untapped source of revenue: electronic transactions in 1992 was $225 trillion. Martin Walker has pointed out that a 0.001% tax on these transactions, collected by the major financial centres, would be sufficient to finance the UN's peace-keeping bill, while a 0.003% tax would finance the whole of the UN's operation.

Neither would having an noticeable effect on the efficiency of markets or on the relative competitive positions of London, New York, Frankfurt and Tokyo, although such a tax would raise substantial problems of collection.

A rather different approach would be to use the UN's planning powers over geostationary orbits to levy a tax on satellite transponder use; in this way too global economic activity could be used to finance global ends, turning to a new use the technologies which have hitherto served to evade the reach of governments.

63. As with the effects of a tax on labour, there has been a long debate about the impact of property taxes. One approach, originating with Adam Smith, sees property prices as the result of adding together the cost of land, capital and labour that has gone into making land productive. A land tax would then be a further cost and increase the land price.

A second tradition that stems from David Ricardo says that land itself is not a cost. The market determines the total outlay property users are willing to pay, for rent and property taxes combined. If property taxes go up, the pure rental element of the property price will fall. Property taxes would therefore not affect the profits of mobile capital as property users, but only that part of it which was dependent on property rents. The modern debate on local rates turns on this long running economic argument.

64. There is a long exposition of the principles of taxes on rents in John Kay and Mervyn King, *The British Tax System*, OUP: Oxford, 1990, pp. 178–88.
65. See the British Film Institute's forthcoming monograph *The Hollywood of Europe* which draws on work by John Kay and London Economics and PACT on new tax options for the audiovisual industries. Taxing audiovisual rents could raise substantial revenues. Estimates based on the current size of the cinema market suggest that taxing 40% of gross box office receipts above £4 million would yield £36 million. A similar calculation for the video rental market, using an appropriate threshold, would raise an estimated £10 million, while a similar tax on video sales market, using a threshold of £2 million and a tax rate of 40%, would yield £17 million. In total, the tax on rents using these formulæ would have raised £63 million in 1991, equivalent to the total invested annually in film production in Britain at the end of the 1980s.
66. Spectrum charges have been an increasingly important area of debate not only in the USA and UK but also in New Zealand and Australia. As well as being a useful source of revenue they also have the virtue of encouraging more efficient spectrum use. For a full analysis of issues relating to electromagnetic spectrum see G. Mulgan, *Communication and control: networks and the new economies of communication*, Polity: Cambridge, 1991.

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Naturally all responsibility for its contents lies with the authors alone.