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FISCAL LIBERALISATION

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Summary

Free-market principles are about more than commerce alone. Competition, accountability and choice, the major pillars of economic liberalism, can equally be applied to our political system. In this essay, we outline a radical vision of regional tax competition, based on the devolution of significant tax powers to sub-national bodies. By decentralising fiscal policy, regions and cities would be strengthened and governance improved. Competition between regions would create a marketplace in taxation, which would lead to efficiency gains and lower average tax rates. Most importantly, a radical policy of fiscal liberalisation would empower workers and jobseekers in underperforming regions. Through locally determined taxes, regions and cities would be able to develop their own competitive advantage, thereby attracting companies and talent. The arguments in this essay, which are supported by extensive empirical evidence, present the next transformative step in the history of ideas: a free-market revolution with no one left behind.

Introduction

We need a revolution. A radical vision of change; a paradigm shift in our political thinking. If the events of the past year have shown us anything, it is that the global integration of markets alone is not sufficient to increase prosperity for all. While reductions in trade barriers have transformed the fortunes of billions, bringing some of the world's poorest closer to Western standards of living, this positive effect has not been felt by the bottom third in advanced economies. Indeed, in countries such as the UK, the notion that liberalisation can result in greater material equality is widely seen as wishful thinking.

This essay will challenge the idea that free markets are the cause of inequality. The problem, we will argue, is that the liberalising spirit has not gone far enough: the principles underpinning the magic of markets – competition, accountability and choice – are equally applicable to areas that do not involve the trade in goods or services. These insights from economic theory, widely accepted in a traditional market context, should also inform the basic structure of our political system. In this essay, we will therefore make the case for fiscal liberalisation: the radical application of free-market ideas to one of the few remaining monopolies.

The remainder of this essay is structured as follows. In the first section, we outline the problems associated with the highly centralised tax system currently found in many advanced economies. Using the UK as an example, we demonstrate that regions and cities suffer from a one-size-fits-all approach that does not take varying needs and priorities into account. The following section contrasts that model with a tax regime based on regional competition and choice. We discuss the economic benefits associated with localised tax policy and describe the natural discovery process that allows the best fiscal strategies to prevail. In the third section, we focus on freedom: how does a system of regional tax competition promote non-economic interests, such as sovereignty and liberty? Finally, in the fourth section, we support our previous arguments with empirical data. As we will show, some of the most prosperous and economically free countries can be characterised by their effective use of fiscal federalism. This model, we will conclude, is the key to a new kind of economic progress: one that benefits everyone – and especially those that are yet to see the wonders of liberalisation.

The need for fiscal liberalisation

A policy initiative aimed at helping the bottom third of the income distribution must address the factors that prevent some segments of society from realising their economic potential. In the UK, as in many other developed countries, that requires an understanding of geographical differences. Inequality in Britain is, to a significant extent, *regional* inequality. According to data compiled by Eurostat, the gap between the richest and the poorest region in the UK is larger than in any other western European country.[1] As the Bank of England's Chief Economist, Andrew Haldane, recently acknowledged, regional inequality may be 'one of the most important issues that we face today as a country'.[2]

Britain is also a remarkably centralised country. Sharon White, a former senior Treasury official, has said that the UK 'jumps out in terms of the degree of centralisation'.[3] Indeed, an analysis by the Centre for Cities found that the concentration of political and economic power in London is virtually unique among OECD countries.[4] Nothing shows this geographic focus better than the way in which the UK raises its taxes. As the Institute for Fiscal Studies notes, taxes in the UK are 'exceptionally centralised, with only 5% of revenues raised locally'.[5] In England, all revenue streams except council tax are set in Whitehall.[6] These figures are in stark contrast to those from other advanced economies, such as Sweden or Finland, where local taxes account for approximately one-quarter of total revenue.[7]

The link between regional inequality and centralised taxation has been widely studied. It also makes intuitive sense. Fiscal policy devised in Westminster might be welcomed by City firms and large corporations: their metropolitan, international outlook is largely

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[1] Eurostat, Income of Households by NUTS 2 Regions, 28 March 2014, http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama_r_ehh2inc&lang=en (accessed 4 January 2017).
[2] BBC News, 2 December 2016, http://www.bbc.com/news/business-38186047 (accessed 4 January 2017).
[3] Global Government Forum, 27 January 2015, http://www.globalgovernmentforum.com/uk-most-centralised-developed-country-says-treasury-chief/ (accessed 4 January 2017).
[4] Centre for Cities, 15 December 2015, http://www.centreforcities.org/reader/beyond-business-rates/evidence-for-fiscal-devolution/ (accessed 4 January 2017).
[5] Adam, S. et al. (2006) 'Taxation in the UK', in *A Survey of the UK Tax System*, London: Institute for Fiscal Studies.
[6] Travers, T. (2015) 'Why the UK Must Embrace Tax Devolution', Fabian Society.
[7] Eurostat, 24 November 2016, http://ec.europa.eu/eurostat/statistics-explained/images/c/cd/Tax_revenue_tables_November_2016.xls (accessed 4 January 2017).

shared by the cabinet ministers in charge. For employers and workers in Sheffield or Plymouth, by contrast, the plans made at 11 Downing Street are often less helpful. Companies in other parts of the UK, working in a wide range of industries and environments, may well have priorities and requirements that differ considerably from their London counterparts. A single tax policy, imposed on a large and heterogenous country, inevitably benefits some regions over others. The capital's economic and political dominance thus leads to a self-perpetuating cycle, working at the expense of those who are already disadvantaged.

As well as neglecting varying regional needs, centrally determined taxation also runs counter to established economic principles. Fiscal policy is about finding the right balance: how much revenue can be raised to finance schools, hospitals and infrastructure while still attracting performance and investment? What combination of taxes – and at what rates – is the fairest or most efficient way of ensuring public needs are met? At present, the Chancellor of the Exchequer makes that judgement on the basis of fiercely disputed economic models, ideological beliefs – or his own gut instinct. In this respect, our current tax strategy suffers from the same flaws as centrally planned economies. If there is no room for experimentation, if we cannot trial competing tax policies in real life, then we are unlikely to find the best system of taxation.

A model for prosperity

In market economies, the answer to the balancing problem described above is competition and choice. No bureaucrat can know how much of a given good or service we need, but if thousands of entrepreneurs offer different products at varying prices, the most attractive options will quickly become apparent. Successful business models inspire competitors to adapt their own products to customers' needs, thus creating a constant drive to improve. These market forces have been widely praised for their efficiency and welfare gains, but until now, their scope has largely been restricted to the commercial context. In this section, we will outline a revolutionary vision for the future: what if the most defining feature of the state – the power to tax its citizens – were subjected to the same innovating pressures of competition and choice?

Imagine a Britain in which taxation is radically freed. Regions and cities are no longer almost exclusively dependent on transfers from the Treasury – they can now raise their own taxes, at their own rates. In doing so, they express their inhabitants' personal priorities: do they want to encourage investment by offering attractive tax cuts, or would they rather focus on generous public services? By taking into account local views on public spending and regional competitiveness, each city or county can tailor its fiscal policies to its unique circumstances. This flexibility translates into real choice for individuals and companies. If taxes vary significantly across different parts of the country, this factor will strongly influence relocation decisions.

A fiscally liberalised system would give regions that have seen a decline in jobs and productivity a powerful tool to raise their economic profile. Place-based taxation would thus be the easiest and most effective way to achieve what economists call 'spatial rebalancing': a move away from the cluster-building that we have seen in a small number of cities, mostly in London and the South East, at which current tax policies seem heavily targeted. At the same time, this radical reform would avoid picking winners and losers – rather than choosing a single 'Northern Powerhouse', this approach would set no limits to the regions' creativity in attracting talent and business. For the bottom third of the income distribution, this would mean that high-paying jobs are no longer limited to a small area of the UK: their own hometowns, far away from the M25, would see a revival in wealth and prosperity.

With dozens of counties and cities vying for local tax revenues and a satisfied public, getting the balance right would be more important than ever. Unlike in our current system, punitively high taxes or underfunded public services would provoke an almost immediate response: if companies and individuals move to other parts of the country, the feedback given to local authorities is unambiguous. In this way, politicians know exactly which tax policies encourage investment and are popular with their constituents, thus promoting good governance. This natural discovery process, spurred by competition and local accountability, mirrors the tried and tested market forces that bring us better and more affordable goods and services every day. Like successful entrepreneurs, prosperous regions would serve as a model for other areas of the country to follow. The result of this real-life experiment in regional taxation would be a process of continuous adjustment and improvement, leading to more efficient fiscal policies and a more balanced distribution of income.

Fiscal freedom causes economic freedom

As we have seen, the economic arguments for regional tax competition are compelling: decentralising our fiscal system would lead to more efficient and more targeted taxes that respond to local needs. Moreover, the proposed initiative would empower workers and jobseekers in currently disadvantaged areas, resulting in real income gains for the least well-off. But the benefits of fiscal liberalisation do not end there. Less quantifiable but just as significant, the decentralisation of tax powers promotes self-governance, reinforces communal identity and enhances individual liberty. We will now consider these aspects in turn.

2016 was a year in which marginalised voters across the world expressed their discontent at the polling stations. Rather than leaving elites in Westminster, Brussels or Washington in charge, millions of people, including large numbers from working-class backgrounds, sent a clear signal that they demand greater participation in the political process. Limiting central tax powers and handing them to regionally elected representatives would be a sign that these concerns are taken seriously. It would strengthen the democratic link between citizens and their governments by ensuring that locally raised money is spent on local priorities. Regional tax sovereignty would therefore amplify the voices of citizens and, in addition, offer them real exit opportunities should they feel dissatisfied with local politics. After all, if regions can determine their own public spending, the prospect of voting with one's feet is much more realistic.

Perhaps most importantly, the proposed reforms would contribute to our economic liberty. High tax rates and wasteful public spending prevent us from using our hard-earned money, and by extension our talents and resources, in accordance with our personal preferences. Tax competition minimises both. Because cities and counties would seek to attract firms and individuals, inefficiently high levels of taxation would soon be cut. Faced with competitive pressures, bloated public bodies would be forced to innovate, improve and streamline their services. Competition thus leads to lower average rates of taxation, which are particularly good news for those with little disposable income. Finally, for workers tired of hearing that tax cuts will eventually 'trickle down', the visibly positive impact of regional tax reductions on local jobs and investment will be a welcome change.

Evidence from fiscally liberalised countries

So much for the theory. But how has fiscal federalism worked out in practice? In the country most frequently associated with regional tax competition, the system has been a resounding success. With a population of about 8 million people, Switzerland is divided into 26 highly independent cantons, all vested with extensive tax-raising powers. It is regularly ranked as one of the wealthiest countries in the world in per-capita terms, and it has repeatedly been named the most economically free country in Europe.[8] Despite having some of the lowest average tax rates in Europe, Switzerland is known for its high-quality infrastructure, its world-class healthcare and its administrative efficiency. The Swiss experience shows that, far from triggering a race to the bottom, tax liberalisation promotes efficiency, democratic accountability and wealth creation.

The track record of fiscal federalism has been similarly positive in Canada, where tax powers are divided between the national government, the provinces and the territories. Canadian federalism is so pronounced that the country's 10 provinces together collect more revenue than the federal government.[9] Ranked in the global top 10 in terms of per-capita income as well as in the Human Development Index, Canada has benefited from geographically diverse developments across its different regions.[10] Moreover, the Canadian system of multi-level governance is renowned for its transparency and openness, suggesting that sub-national competition has a positive effect on administrative authorities.

The last example to consider here is Australia, whose federal structure is made up of six states and two territories. As in the Swiss and Canadian cases considered above, Australian taxes are highly decentralised and comparatively low: government spending relative to GDP is almost 10 percentage points below the UK's. Importantly, this fiscal efficiency has not come at the expense of public services or general welfare. In fact, several Australian cities are regularly included in the list of the world's most liveable cities, including Melbourne, Adelaide and Perth.[11] The fact that all these cities

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[8] Credit Suisse, *Global Wealth Report 2016*, https://www.credit-suisse.com/uk/en/about-us/research/research-institute/global-wealth-report.html (accessed 4 January 2017); Heritage Foundation, *Index of Economic Freedom 2016*, http://www.heritage.org/index/ranking (accessed 4 January 2017).

[9] Makarenko, J. (2008), 'Federalism in Canada', 11 January, http://www.mapleleafweb.com/features/federalism-canada-basic-framework-and-operation.html (accessed 4 January 2017).

[10] McLean, I. (2003) 'Fiscal Federalism in Canada', Nuffield College Politics Working Papers.

[11] The Economist (2016) 'The World's Most Liveable Cities', 18 August, http://www.economist.com/blogs/graphicdetail/2016/08/daily-chart-14 (accessed 4 January 2017).

are located in different states shows that regional competition can raise standards of living across the country.

The examples above demonstrate that countries of various sizes can flourish under systems of fiscal liberalisation, and this has been confirmed by a wide range of economic studies. In 1998, for example, two World Bank economists, Jeff Huther and Anwar Shah, created an index of 80 countries ranked by various measures of good governance. Using an extensive data set, Huther and Shah rigorously examined whether fiscal devolution between regions influenced a country's performance in areas such as social development, bureaucratic efficiency, lack of corruption and political stability. Their analysis produced a 'surprisingly strong positive correlation between fiscal decentralization and quality of governance', allowing them to reach 'unambiguous conclusions regarding the net positive effects of fiscal decentralization on public sector performance'.[12]

Conclusion

1989, the year the Berlin Wall came down, marked a shift in our political and economic thinking. The fall of socialism and central planning established a new international orthodoxy; the benefits of capitalism, privatisation and free trade were accepted by mainstream intellectuals, politicians and scholars. In short, the battle of ideas had been won.

Over the last two and a half decades, the policies informed by the new liberal consensus have had tremendous success, but the benefits of liberalism have not been distributed equally. While free trade has brought enormous improvements on a global scale, the bottom third in advanced economies have seen few improvements at a national level. One of the reasons for this disparity is the selective application of liberal principles. Politicians have shown commendable willingness to reduce trade barriers and to further global integration, but the ideas of competition and choice have only reluctantly been embraced at home.

In this essay, we have made the case for radical fiscal liberalisation. By decentralising the tax regime, developed countries can empower workers in currently underperforming regions. Through the devolution of tax powers to sub-national governments, cities and counties can actively create a competitive advantage and thereby attract talent and investment. The resulting spatial rebalancing particularly benefits those who might feel neglected by the political and economic system. In addition, the policy proposed in this essay would make governments leaner and more efficient, enhance economic freedom and strengthen political representation. Fiscal liberalisation can thus be the next transformative step in the history of ideas: a free-market revolution with no one left behind.

[12] Huther, J. and Shah, A. (1999) 'Applying a Simple Measure of Good Governance to the Debate on Fiscal Decentralization', Washington DC: World Bank Group.