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The Case for Different Income Tax Rates in Different Regions

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Our income tax system should be shut down. No more money should go to Gordon Brown at the Treasury. Put up your hand if you agree. Cut to tumultuous cheering. From the wings, cries of 'Oswald for Prime Minister'. Newspaper headlines: 'Warwick Prof hero of the hour'. Front-page photographs of the economist being carried through Trafalgar Square.

Well, back to reality. Although my suggestion might produce a forest of waving arms, I do not mean it in the extreme libertarian sense that would find favour among, for instance, some right-wing American economists. Probably like most people, when they think it over, I feel there is plenty to be said for income tax – or more precisely for the services that the tax revenue can buy. Income tax is like a bank standing order: it regularly hurts but it gets the bills paid.

Where I part company from conventional wisdom, however, is on the design of the tax system.

At the moment it makes no difference which part of the country you live in. A taxpayer in Cumbria faces the same thresholds and tax schedule as folk who live in Croydon.

But that is inappropriate and unfair. Because the cost of living varies so much, we ought to have different income tax systems in different regions of the country. Most especially, it does not make economic sense to have the tax bands (such as the income level at which people start paying 40% as a marginal tax rate) cutting in at identical earnings levels everywhere. Recently the Liberal Democratic party suggested that there should be a small local income tax – as a way to reduce our reliance on property taxes such as council tax. My suggestion, though, is more radical and about the whole system.

The point is that 30,000 pounds is a good salary in the North and a pretty ordinary one in Central London. Yet currently the Treasury's tax designers ignore this.

My colleague David Blanchflower and I have been using statistical surveys to examine the regional patterns in Britons' remuneration packages. Remarkably, the government has just decided that researchers can no longer have access to data sets like these in a way that allows regional analysis (no comment on that decision). So it is necessary to extrapolate from figures from the surveys up to about 2001.

The average hourly rate of pay in Central London is approximately 15 pounds. By contrast (or should it be Buy Contrast), the average hourly rate in the area called 'Rest of the South East' is 9 pounds. Average pay in the Rest of England and Wales is 8 pounds an hour. Even more strikingly, the majority of workers in Central London are in Britain's highest one-percent of earners, while less than a quarter of employees in the Rest of England and Wales make it into this one percentile group.

Depending on your chosen definitions, the spread of pay among identical workers from the highest-paying part of Britain to the lowest-paying part is somewhere between 50% and 100%.

Yet this makes the whole concept of a national tax system look muddle-headed. South-Easterners, and particularly Londoners, effectively start paying the 40% tax rate far too soon.

Of course there would be administrative issues. Would the revenue go to the regions directly? How would we cope with tax avoidance, like people registering at workplaces with favourable tax treatments? But even so.

We ought to press for a new tax system. It should bear in mind that identically bulging pay packets buy very different real amounts in different areas. Britain needs regional income-taxes to replace our national tax system. Most especially, tax thresholds should vary across the regions.