THE ZERO-RATE FRAMEWORK

A Transformative Strategy for UK Economic Rebalancing

Cornerstone Global Associates, Blue Paper, March 2025

EXECUTIVE SUMMARY

The United Kingdom faces interconnected challenges: regional inequality, productivity stagnation, defense underfunding, and overreliance on financial services. This paper presents the Zero-Rate Framework—a comprehensive approach that evolves from enhancing central bank effectiveness toward a more automated, rules-based monetary-fiscal system over time. This system would:

- Fund defense spending increases (2.5% of GDP by 2027, with potential for 3-5% as strategic needs dictate)
- Enable investment in other strategic national priorities as needed (infrastructure, R&D, healthcare)
- Substantially reduce both income and capital gains taxes
- Revitalize manufacturing across UK regions
- Strengthen fiscal sustainability without austerity
- Preserve London's position as a global financial center

The framework's innovative approach resolves what has been seen as an impossible fiscal trilemma: increased public investment, lower taxes on productive activity, and fiscal sustainability. By taxing passive wealth holding while exempting productive investment, it enables a more vibrant economy while funding essential sovereign functions, with defense being the immediate priority in the current security environment.

Unlike previous wealth tax proposals, this framework is not primarily redistributive but creates a system-balancing mechanism that funds sovereign functions while enabling tax reductions on productive activity, with a practical implementation path that respects market realities.

EVOLUTIONARY APPROACH TO ZERO-RATE TARGETING

The framework employs a wealth tax with strategic exemptions to create natural downward pressure on government borrowing costs while enhancing fiscal sustainability. This approach evolves through distinct phases:

Phase 1: Enhanced Central Bank Effectiveness (Years 1-3)

Mechanism Design

- Initial wealth tax rate of 0.3-0.4% with full gilt exemption
- Central bank maintains discretionary authority with wealth tax creating natural support for policy objectives
- Downward pressure on gilt yields through arbitrage between taxed and exempt assets
- Learning infrastructure established to study market responses

Policy Benefits

- Natural downward pressure on government borrowing costs (estimated 0.2-0.4% reduction)
- Improved monetary policy transmission throughout the economy
- Enhanced fiscal space for defense investment and tax reduction
- Beginning of manufacturing revival through defense industrial strategy

Learning and Development

- Comprehensive market monitoring system established
- Data collection on arbitrage patterns and market responses
- Valuation technologies tested and refined for major asset classes
- International coordination mechanisms developed

Phase 2: Advancing Toward Automation (Years 4-6)

Mechanism Refinement

- Wealth tax adjustment to 0.5-0.7% based on observed market response
- Central bank role gradually shifts toward monitoring and exceptional intervention
- Introduction of initial rules-based adjustment parameters

- Progressive improvement in valuation systems and compliance infrastructure

Infrastructure Development

- Advanced digital asset tracking for major wealth categories
- API integration with financial institutions for valuation reporting
- Regional economic development centers aligned with defense industrial strategy
- Enhanced international reporting standards and coordination

Policy Evolution

- Further reduction in government borrowing costs
- Progressive shift from discretionary to rules-influenced monetary policy
- Increased predictability of financial market conditions
- Expanded defense industrial capacity across regions

Phase 3: Rules-Based System (Years 7+)

Advanced Mechanism Implementation

- Wealth tax rate of 0.8-1.0% with mature exemption framework
- Algorithmic adjustments with transparent formulas replacing discretionary decisions
- Central bank role evolves toward system oversight and exceptional intervention
- Potential for blockchain-based implementation of core mechanisms

Policy Transformation

- Implementation of principles similar to Friedman's rule on minimizing the opportunity cost of money
- Market-driven interest rates with minimal discretionary intervention
- Potential for substantial reduction or elimination of income tax for most citizens
- Self-regulating capital allocation across productive sectors

Institutional Adaptation

- Bank of England mandate potentially revised to reflect new framework
- Economic Transformation Authority with cross-partisan governance
- Integration with global financial architecture
- Continuous technological enhancement of wealth assessment systems

REALISTIC IMPLEMENTATION CONSIDERATIONS

THEORETICAL FOUNDATIONS

Adam Smith's Taxation Principles

The framework directly implements Adam Smith's first maxim of taxation from "The Wealth of Nations" (1776):

"The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state."

This principle establishes that wealth taxation is philosophically aligned with classical liberal thought:

- Core government functions (defense, rule of law, property rights) disproportionately benefit wealth holders by providing security and stability for their assets
- The wealth tax therefore creates a direct connection between benefits received and contributions made
- The exemption for productive financial claims ensures that only passive wealth holding is taxed, preserving economic dynamism
- This creates a more coherent system than taxing productive activity (income, capital gains) to fund wealth-protecting services

The framework thus represents not a departure from market principles but their more consistent application, ensuring that those who benefit most from the state's protective functions contribute proportionately to their funding.

Friedman-Fisher Synthesis

The Zero-Rate Framework also builds upon Milton Friedman's monetary insights and Irving Fisher's work on velocity:

- Friedman emphasized that monetary stability is best achieved through predictable rules rather than discretionary intervention
- The framework creates a natural, rules-based mechanism for interest rate stability through the wealth tax exemption for financial claims

- Irving Fisher demonstrated the crucial relationship between debt cycles, monetary velocity, and economic stability through his equation of exchange (MV = PT)
- The wealth tax mechanism helps stabilize monetary velocity by creating predictable effects on the holding of money and financial assets
- This addresses a key weakness in Friedman's k-percent rule—velocity instability—while maintaining his preference for rules over discretion

As modern monetary economist John Cochrane notes, "M=PY/V is right. We live in the passive money world." The Zero-Rate Framework works within this reality, accepting that central banks primarily influence interest rates rather than directly controlling money supply. By creating natural downward pressure on interest rates through the wealth tax exemption, it implements a version of Friedman's rule on minimizing the opportunity cost of holding money.

Swiss Wealth Tax Experience: Proven Viability

Switzerland provides a valuable real-world example of wealth tax implementation that has functioned effectively for decades:

- Swiss cantons have successfully maintained wealth taxes ranging from 0.3% to 1.0%
- The system has demonstrated administrative feasibility without causing capital flight or economic harm
- Swiss approaches to valuing illiquid assets offer practical starting points:
  - **Private Business Valuation**: A standardized "Swiss formula" blends earning value (weighted 2x) and asset value (weighted 1x)
  - **Real Estate**: Standardized methodologies that deliberately value properties at 70-80% of market value to account for illiquidity
  - **Artwork and Collectibles**: Self-declaration with specialized audit protocols for high-value items
  - **Self-Declaration System**: Strong audit provisions and significant penalties for undervaluation maintain compliance
  - **Standardized Federal Guidelines**: Ensure consistency across cantonal implementation

The Swiss experience demonstrates that wealth taxation is administratively feasible even without advanced digital infrastructure. The Zero-Rate Framework can build on these proven approaches while enhancing them with modern technology.

Embracing Empirical Learning

The framework acknowledges the need for continuous learning and adaptation:

- Initial implementation based on theoretical models that will be refined through real-world data
- Transparent monitoring of market responses to the wealth tax and exemption mechanisms
- Regular assessment and calibration of tax rates based on observed dynamics
- Recognition that perfect theoretical models must be adjusted based on market realities

Technological Development Path

Implementation relies on progressive development of necessary technologies:

- Initial phase leverages existing financial reporting and valuation systems
- Middle phase introduces API integration and improved digital asset tracking
- Advanced phase potentially incorporates distributed ledger technologies
- Development of improved wealth assessment mechanisms occurs in parallel with implementation

Wealth Valuation Pragmatism

Building on Switzerland's proven approaches while leveraging modern technology:

Liquid Financial Assets

- Market prices with standard methodologies for publicly traded securities
- Established valuation services for common financial instruments
- Integration with existing financial reporting systems

Private Business Interests

- Enhanced version of the Swiss formula balancing earnings and assets
- API integration with accounting systems to streamline reporting
- Self-assessment with audit provisions and undervaluation penalties
- Sectoral indices for interim valuation adjustments

Real Estate

- Automated valuation models enhanced with AI for residential properties
- Combined rental yield and comparable sales approaches for commercial properties
- Regional price indices for interim valuation adjustments
- Option to use the Swiss approach of conservative standardized valuations (70-80% of market value) during initial implementation phases

Capital Flight Mitigation

- Comprehensive tax treaties with major financial centers
- Phased implementation coordinated with international reporting standards
- Anti-avoidance provisions with effective enforcement mechanisms
- Competitive overall tax environment to maintain UK attractiveness

FISCAL VIABILITY ANALYSIS

The wealth tax component creates a robust fiscal foundation that makes both increased defense spending and reduced taxes on productive activity simultaneously viable:

Wealth Tax Revenue Estimation

- UK household wealth above £1 million threshold is estimated at approximately £5-6 trillion
- A 0.4% tax rate would theoretically yield £20-24 billion annually at full compliance
- A 0.7% tax rate would theoretically yield £35-42 billion annually at full compliance
- A 1.0% tax rate would theoretically yield £50-60 billion annually at full compliance
- Behavioral responses would reduce these figures as wealth shifts toward exempt assets:
    - Assuming approximately 10% of taxable wealth moves to exempt gilts, loans, and productive investments
    - Resulting in actual revenue approximately 90% of theoretical maximum
- International experience suggests wealth tax avoidance is less severe when:
    - The tax is implemented with adequate preparation time
    - Valuation methods are clear and consistent
    - Anti-avoidance provisions are robust
    - There are viable exempt alternatives (as in this framework)

Defense Spending Viability

- Increasing UK defense spending from 2.2% to 2.5% of GDP represents approximately £7-8 billion in additional annual funding
- A further increase to 3.0% of GDP would require approximately £15-17 billion in additional annual funding
- Even at conservative estimates, the wealth tax revenue would be sufficient to fund these defense spending increases
- The wealth tax exemption for gilts may also reduce government borrowing costs, creating additional fiscal space for defense commitments

Tax Reduction Viability

- Income tax reductions of 2p in the basic rate would cost approximately £12 billion annually
- Capital gains tax reductions to promote productive investment would cost approximately £3-4 billion annually
- With defense spending increases funded, remaining wealth tax revenue (even at the 0.4% rate) would be sufficient to support meaningful tax reductions while maintaining fiscal balance
- As the wealth tax rate increases in later phases, more substantial tax reductions would become viable
- The resulting economic stimulus from reduced taxation on productive activity may generate additional tax revenue through conventional channels

Combined Economic Impact

- Economic theory suggests this combination of policies could positively impact GDP growth through several mechanisms:
    - Shifting tax burden from income/capital gains to passive wealth may increase incentives for productive activity
    - Defense industrial investment could generate positive spillover effects in manufacturing regions
    - Reduced taxation on enterprise formation and investment may stimulate business growth
    - Further economic modeling would be required to quantify these effects with precision
- This additional growth further enhances fiscal sustainability through conventional tax channels

- The wealth tax itself becomes more productive as total wealth increases through economic growth

The framework's innovative approach thus resolves what has been seen as an impossible fiscal trilemma: increased fiscal spending, lower taxes on productive activity, and fiscal sustainability. By taxing passive wealth holding while exempting productive investment, it enables a more vibrant economy while funding essential sovereign functions.

BENEFITS ACROSS ECONOMIC DIMENSIONS

Financial Sector Evolution

- The City of London evolves toward higher-value activities supporting the real economy
- Reduced volatility in government funding markets
- New financial products emerge (productive enterprise funds, regional development bonds)
- Geographic integration of finance with regional manufacturing centers

Regional Manufacturing Revival

- Defense-led regeneration in traditional industrial regions
- Technology transfer between defense and civilian manufacturing
- Supply chain development creating regional industrial ecosystems
- Technical education and skills pipeline development

Enhanced Business Investment

- Reduced capital gains taxation improves returns on successful ventures
- Wealth tax exemptions direct capital toward productive enterprise
- Long-term investment horizons extended by favorable tax treatment
- Regional opportunity zones attract investment to manufacturing regions

POLITICAL FEASIBILITY

Conservative Appeal

- Sustainable defense funding for national security
- Reduced income and capital gains taxation

- Market-based capital allocation mechanisms
- Limited government through potential future rules-based system
- Support for traditional Conservative-voting regions

Labour Appeal

- Regional manufacturing revival
- High-skill employment outside London
- More progressive overall tax system
- Sustainable funding for public services
- Strategic industrial policy

CONCLUSION

The Zero-Rate Framework offers a pragmatic yet transformative approach to the UK's economic challenges. By creating natural downward pressure on government borrowing costs while improving fiscal sustainability, it establishes the foundation for a more automated, rules-based system over time.

The framework's innovative approach resolves what has been seen as an impossible fiscal trilemma: increased public investment (particularly defense in the current security environment), lower taxes on productive activity, and fiscal sustainability. By taxing passive wealth holding while exempting productive investment, it enables a more vibrant economy while funding essential sovereign functions.

This evolutionary approach acknowledges the need for learning and technological development while maintaining ambition for fundamental improvement. It provides immediate benefits in terms of defense funding, regional rebalancing, and productive tax reduction, while establishing the foundation for potentially more profound economic governance reforms in the future.

Rather than attempting to implement a theoretical ideal immediately, the framework embraces a process of continuous improvement through empirical learning and technological advancement. Each phase builds on insights gained from previous implementation, creating a robust path toward a more effective monetary-fiscal system.

We recommend the Treasury and Ministry of Defence conduct a comprehensive feasibility study on implementing the Phase 1 components, with particular focus on establishing the market monitoring infrastructure that will guide subsequent evolution of the framework.