Johnson, Paul

Working Paper

Tax without design: Recent developments in UK tax policy

IFS Working Papers, No. W14/09

Provided in Cooperation with:
Institute for Fiscal Studies (IFS), London


This Version is available at:
http://hdl.handle.net/10419/101332

Terms of use:
Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.
Tax Without Design: Recent Developments in UK Tax Policy

Paul Johnson

May 2014
Tax Without Design: 
Recent Developments in UK Tax Policy

ABSTRACT
This paper considers the development of tax policy in the UK over the last decade or so and assesses policy change against a low bar – consistency and coherence. While this government has followed some consistent policies – notably, in some aspects of corporation tax and in increasing the income tax personal allowance – there are few signs of a wider coherent strategy. The same has been true of other recent governments. Many aspects of the system have become more complex. There have been numerous policy reversals. And few of those aspects of the system in most need of reform have been tackled. The need for reform, and a clear strategy for reform, remain as pressing as ever.

I. INTRODUCTION
In the UK, as in most developed economies, the government takes about 40 per cent of national income in tax. Clearly, the way it does so matters. As we argued in the Mirrlees Review – a review to which we rather deliberately gave the title Tax by Design – there is considerable scope for improving the functioning of the tax system in ways that would enhance welfare. Too many aspects of it impose unnecessary costs and indeed create inequities. Part of the reason for that lies in a failure to treat the tax system as just that – a system.

In my preface to Mirrlees, I quoted my predecessor as director of the Institute for Fiscal Studies (IFS), Dick Taverne. In his own foreword to the Meade Review, published in 1978, he wrote

For too long, … tax reforms have been approached ad hoc, without regard to their effects on the evolution of the tax structure as a whole. As a result many parts of our system seem to lack a rational base. Conflicting objectives are pursued at random; and even particular objectives are pursued in contradictory ways.

I went on to say that this critique continued to hold true. The purpose of this paper is not to rehearse the arguments set out in the Mirrlees Review. Instead, the purpose is to assess the direction of travel in some of the main elements of the tax system in recent years rather than to review the structure of the whole system. I will offer some assessment against the principles set out in the Mirrlees Review, where we summarised the benchmark as a progressive, neutral system. But for the most part I will look to assess

1 The author would like to thank Robert Joyce, Soumaya Keynes and Barra Roantree for help with the analysis in the paper, Stuart Adam and Carl Emmerson for helpful comments, and Judith Payne for copy-editing.
progress against a rather less demanding set of criteria. Has policy been consistent over time and coherent against the objectives stated for it? Indeed, has it been coherent judged against any reasonable set of objectives? Does it look, in the words of William Simon, former US Treasury Secretary, ‘like someone designed it on purpose’?

Before plunging into the details of specific taxes, though, let us start by looking at the system as a whole at least in terms of where the revenue comes from. Figure 1 shows revenues as a percentage of total UK net taxes and National Insurance contributions (NICs) for selected years from 1989–90 through to 2018–19.

Revenues from income tax have been becoming more important over this period. Direct taxes on incomes and earnings (income tax and NICs) are due to have risen from 43 per cent of total revenue to very nearly 50 per cent, despite the many and much heralded reductions in income tax rates and more recent increases in allowances. Conversely, indirect taxes (VAT and excise duties) have been becoming less important as revenue raisers, especially since 1999–2000, although they are actually due to be slightly less important in 2018–19 than in 1989–90 despite two hikes in the main rate of VAT.
Recent Developments in UK Tax Policy

3

increase in the importance of VAT has been more than offset by lower revenues from ‘sin taxes’ and road fuel taxes. It may seem that our collective focus on environment and climate change has sharpened over the last decade but, relative to total revenues, we are due to be raising 40 per cent less from road fuel duties and vehicle excise duties – by far the main environmental taxes – in 2018–19 than we were at the turn of the century.

II. THE TAXATION OF INCOME

Taxes on personal income – specifically income tax and National Insurance contributions – make up nearly half of all tax revenues. Their design matters for work incentives and for equity.

The current government has had a very focused policy aimed at increasing the value of the tax-free personal allowance within income tax. The priority accorded to this policy can be seen clearly enough from the associated price tag – in an era of severe fiscal constraint, increases in the personal allowance introduced since 2010 will be costing more than £12 billion a year by 2015. Previous governments have focused particularly on reducing the basic rate of income tax, which has been gradually reduced from 33 per cent in 1978 to 20 per cent by 2008. So there have certainly been periods of clear direction and prioritisation in the design of income taxes. But the wider story shows rather less coherence.

One way of assessing the coherence of recent policy is to look at the marginal rate schedule faced by taxpayers. Figure 2a shows that schedule as it existed in 2009–10 for a married person with two children and a non-working spouse. Incomes (in 2014–15 prices) are shown along the horizontal axis; the combined marginal tax rate on earnings from income tax and employee NICs is shown on the vertical axis. The schedule is relatively straightforward. Income tax and NICs kick in at roughly the same point. The combined marginal tax rate starts at 31 per cent and rises to 41 per cent when income hits £50,000 or so.

Figure 2a. Marginal rate schedule, 2009–10 (for married person, non-working spouse, two children)

<table>
<thead>
<tr>
<th>Gross annual income (£000s)</th>
<th>Marginal rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>10</td>
<td>10%</td>
</tr>
<tr>
<td>20</td>
<td>20%</td>
</tr>
<tr>
<td>30</td>
<td>30%</td>
</tr>
<tr>
<td>40</td>
<td>40%</td>
</tr>
<tr>
<td>50</td>
<td>50%</td>
</tr>
<tr>
<td>60</td>
<td>60%</td>
</tr>
<tr>
<td>70</td>
<td>70%</td>
</tr>
</tbody>
</table>

Note: Marginal rate of income tax and employee National Insurance contributions. Thresholds have been uprated to 2014–15 prices using the consumer price index (CPI). This figure assumes employee contracted into State Second Pension.
For ease of exposition, and because I am focusing on the tax system specifically, I do not include the effect of the means-tested benefit system here. The benefit and tax credit system is, of course, extremely important – indeed, much more important than the tax system – in understanding the budget constraint of those on low incomes.

Figure 2b is the same picture for the system as it will be in 2015–16. A number of additional complications are evident. First, the point at which NICs become payable has diverged substantially from the point at which income tax becomes payable. This is a direct reflection of the current government’s policy of raising the income tax personal allowance whilst leaving the point at which NICs become payable unchanged in real terms.\(^4\) It is hard to think of a good reason for raising the one and not the other.

Second, there will be a sharp spike in the marginal rate facing this sort of individual at the point when higher-rate tax becomes payable. In fact, the marginal rate becomes infinite. This is because of the effect of the £1,050 transferable allowance for married couples, an allowance that will be withdrawn once higher-rate tax becomes payable. The effect is that the additional £1 of income that takes this person into higher-rate tax will result in an additional £210 tax bill. This amount may be relatively small, but it never makes sense to have this kind of thing in a tax schedule. Perhaps more importantly, it looks like an indication of a lack of direction. Introducing a transferable allowance for married couples is a substantive change to the tax system. The amount that can be transferred is set at just £1,050 – worth £210 a year or £4 a week to the 30 per cent or so of married couples set to gain. Introduction on such a modest scale may make sense to keep initial costs down. But introducing the transferable allowance in a way that will make it extremely hard to extend without making this cliff edge at the higher-rate threshold worryingly high smacks of a lack of long-term design.

\(^4\) Note that part of the gap also arises from the introduction of the new transferable allowance for married couples.
At incomes above £50,000, the marginal rate facing our example individual jumps to 60 per cent as child benefit is taxed away.\footnote{One could reasonably argue that the withdrawal of child benefit is actually part of the means-tested benefit system, which I am otherwise ignoring. But it is explicitly referred to as an income tax charge in official documents – for example, at \url{http://www.hmrc.gov.uk/budget2012/tiin-0620.pdf} – and it is collected through the income tax self-assessment system.} This withdrawal rate reaches over 70 per cent for those with four children, and is even higher for the most fecund. This is because child benefit is withdrawn as the income of the higher earner in a couple rises between £50,000 and £60,000. Since those limits are fixed as child benefit levels rise, so the marginal withdrawal rate rises.

Move further up the income scale and the marginal rate rises again once income hits £100,000. From here, the marginal income tax rate is 60 per cent as the personal allowance is ‘withdrawn’, resulting in a total marginal rate of 62 per cent until £121,000. Finally, the additional 45 per cent rate of income tax affects all those fortunate enough to have taxable income of £150,000 or more.

There is no plausible rationale for a rate structure that looks like this.

Two additional points are worth making in respect of where the different rates kick in and how the thresholds change. First, note that the point at which higher-rate tax becomes payable has fallen quite substantially. Since 2010, this has reflected a deliberate policy choice by a government aiming to keep down the (huge) costs of raising the personal allowance. One result is a big increase in the number of higher-rate taxpayers. We expect there to be 5.3 million higher- and additional-rate taxpayers in 2015–16, up from 3.3 million in 2010–11. Figure 3 plots the increase in numbers of these taxpayers since 1990. So far as I am aware, such an increase was never a deliberate policy choice and no government or political party ever set out to redesign the income tax system in this way.

A second, more general, aspect of the new schedule is that different components of it are subject to different annual uprating rules – and some are not set to rise with inflation at all.

**Figure 3.** Number of higher- and additional-rate taxpayers


© Institute for Fiscal Studies, 2014
The current government has chosen to raise the personal allowance much more than would be required to keep pace with inflation, whilst reducing the higher-rate threshold. By default, though, these parameters increase with inflation, as do the limits in the National Insurance (NI) system. Even here, a real curiosum has entered the system. At least for this parliament, parameters of the employer NIC system are by default rising with inflation measured by the retail price index (RPI). Parameters in the employee NIC system rise with the, generally lower, consumer price index (CPI). Who designed that?

But there are also now several elements of the system where there is no allowance for inflation built in. The band for the withdrawal of child benefit is fixed between £50,000 and £60,000. The point at which the personal allowance starts to be withdrawn is fixed at £100,000 – and as the level of the personal allowance has increased, the band of income to which a 60 per cent tax rate applies has therefore continued to grow. The £150,000 point at which additional-rate income tax starts to be paid is also fixed. The result is that, in real terms, the point at which these two higher marginal rates bite will, by 2015–16, have fallen by 12 per cent (relative to the CPI) since they were introduced in 2010–11.

There was a good reason for default indexation of allowances and thresholds. Chancellors looking to fill their coffers as a result of fiscal drag will no doubt enjoy the effects of the lack of indexation of these new thresholds, but this looks like a move away from rational design.

It is worth saying that while it is hard to believe the schedule in Figure 2b is in any sense optimal, it is more progressive than the schedule it replaced. Figure 4 shows how total income tax and NI payments rise with income under each system.

Remarkably, the opposition Labour Party would like to complicate the schedule further by (re)introducing a 10p starting rate of income tax. This policy has some history. The last Labour government introduced a 10p starting rate of income tax in 1999. Its demise was announced in 2007 alongside a cut in the basic rate of tax. Essentially, this redistributed from lower-income basic-rate income taxpayers to higher-income basic-rate income taxpayers. A set of compensatory policies centred on raising the personal allowance were announced in 2008 following the furore over the lower-income losers from this redistribution.

---

Figure 4. Income tax and NI payments under 2009–10 and 2015–16 systems by gross income level (for married person, two children, non-working spouse)

Source: Author’s calculations.

One might have thought that the lesson from this saga would be that introducing such complications into the tax system should be avoided. As was demonstrated rather clearly in 2008, undoing them can be messy, expensive and politically challenging. Not a bit of it. Despite the lack of any plausible coherent justification for such a policy, the Labour Party is committed to reintroducing it. I cannot put it more plainly than did my former colleagues Andrew Dilnot and Chris Giles back in 1997: 

Given the objectives outlined in the Labour manifesto (fair taxation and increasing work incentives for those on low incomes), increasing allowances or reforming means-tested benefits will always be more effective for the same cost than introducing a 10 per cent starting rate of tax. They will also avoid the unnecessary complication of the tax system.

... 

There must be a strong suspicion that adjustments to rates of income tax make better slogans than more sensible reforms to the direct tax system. At the other end of the income scale, Labour is committed to restoring the 50p rate of income tax on incomes over £150,000. This will not make the structure any more complicated, though it may result in more complex behavioural responses. And as a means to reduce the incomes and welfare of some of the very rich, thereby reducing inequality, this may be an effective policy. If that is the objective, the policy is defensible on those grounds.

But the evidence suggests that it is unlikely to be effective in raising revenue. The best currently-available evidence, accepted by the independent Office for Budget Responsibility (OBR), is that, while there is a great deal of uncertainty, a 50p rate is likely to raise very little additional revenue relative to the current 45p rate. Tax policy should be designed on the basis of the best available evidence – a point we stressed in the Mirrlees Review, where we described our approach as ‘determinedly empirical, drawing upon the best available evidence on the effects taxes have in practice’.

Of course, one could spend very much longer just on taxes on personal incomes, and perhaps they deserve more attention given how much revenue they raise. But for now we must content ourselves with a couple of observations about the other tax on income – National Insurance contributions. It is now a commonplace, accepted by virtually all tax experts outside of HMRC and HM Treasury, that NICs are no more than an additional tax on earnings. There is just the slightest relationship between whether they are paid and rights to some benefits. There is no relationship at all between how much is paid and rights to anything. They are a tax.

We have already seen how the focus on income tax has resulted in the income tax personal allowance rising recently while the point at which NICs become payable (the primary threshold) has not risen. The pious statements of politicians that they are raising the personal allowance in order to help ‘hard-working families’ look less credible in the face of the clear fact that raising the NI primary threshold would be more effective in doing so. Over a longer period, while rates of income tax have fallen, NI rates have risen. Figure 5 illustrates what has happened to the basic rate of income tax and the main employee and employer rates of NI since 1979–80.

---

One effect of this growing focus on NICs has been that the effective rate of direct tax on earned income has fallen by considerably less than that on ‘unearned’ income – or (almost) equivalently, the effective rate of direct tax on most people under state pension age has dropped by less than that for those over state pension age. It seems unlikely that this pattern is a result of conscious choice or design. It is most likely the unintended consequence of a series of decisions made because it is politically easier to raise NIC rates than the more salient income tax rates. A well-designed tax system would move towards integration. As we said in the Mirrlees Review:

Maintaining separate systems yields little benefit, but makes their combined effect less transparent and imposes extra burdens on employers ... There is therefore an obvious case for merging them... integration would underline the illogicality of most of the current differences between the two taxes ... It is patently absurd, for example, to have one tax assessed on earnings in each individual pay period and another assessed on income over the whole year.

Even more importantly, failure to account properly for NICs creates all sorts of difficulties in aligning the taxation of earned income, savings, income from self-employment and corporate income. These issues are beyond the scope of this paper but are at the heart of many of the design issues focused on in *Tax by Design*.

III. THE TAXATION OF SAVINGS AND CAPITAL

The failure to apply NICs to income from savings is one of the respects in which having more than one system of income taxation has the potential to create confusion and inefficiency. Over many years, the taxation of income from savings, and in particular capital gains, has been at the heart of
confusion over the design of the tax system. Indeed, it was partly frustration at the ill-thought-out way in which capital gains tax was introduced that led four financial professionals to set up IFS in the first place in the late 1960s. So I guess I should be grateful to the frustration caused by Harold Wilson’s administration. I am perhaps less grateful for the slowness of change in the nearly half-century since then.

**Capital gains tax**

Capital gains tax (CGT) is a tax perhaps more important for the role it plays in preventing avoidance than because of the revenue it brings in itself. It is expected to raise £5.4 billion in 2014–15 – rather less than 1 per cent of total revenue. If income can be converted into a capital gain and there is little or no tax on capital gains, then a way of avoiding income tax is created. Policy on CGT has swung to and fro since it was first introduced in 1965 at a flat rate of 30 per cent on increases in asset values. Geoffrey Howe introduced indexation allowances in 1982 to ensure that only gains in excess of inflation were taxed and in 1988 Nigel Lawson began taxing gains at the taxpayer’s marginal income tax rate. Gordon Brown comprehensively pulled this system apart in 1998, abolishing indexation allowances and introducing very generous ‘taper relief’ reducing tax rates dramatically on assets held for two years or more. Capital gains on any ‘business assets’ held for two years or more became subject to a tax rate of just 10 per cent. It was this provision that resulted directly in owners of private equity firms being able to boast about paying lower rates of tax than their cleaners.

It was partly because this system taxed some capital gains so lightly that Alistair Darling, in his 2007 Pre-Budget Report, presented a major simplification of CGT, abolishing taper relief and indexation allowances for periods before 1998 and announcing a single rate of tax of 18 per cent. He said that his goal was ‘to make the system more straightforward and sustainable; to ensure it sets consistent incentives for investment and enterprise; and to ensure it remains internationally competitive’ – all laudable aims, and something he would have begun to achieve with this reform. Unfortunately, the subsequent furore over the changes, which would have led to owners of existing business assets paying more tax than expected, led to a partial climbdown and re-complication of the tax regime with the introduction of ‘entrepreneurs’ relief’, which was available effectively to owner-managers of businesses. This is not the place to go over the details of the changes, though the process of change was a problem in itself. As Stuart Adam put it in an excellent review of what happened:11

The main lesson [of the reform] should be to avoid [problems] by providing certainty, stability and predictability, and to introduce carefully thought-out policies that will not need to be reformed or reversed in future. Yet the process of this reform has run exactly contrary to this lesson: an announcement was made without advance consultation; adverse reaction has prompted the announcement of a partial rethink, leading to instability and uncertainty; and the rethink is now being conducted under intense time pressure and lobbying, not the best environment for producing sensible policy proposals.

---

The coalition has increased the CGT rate for higher-rate taxpayers to 28 per cent, bringing the marginal rate at least somewhat more in line with that on earned income. On the other hand, the scope of entrepreneurs’ relief, under which CGT is charged at just 10 per cent on qualifying business assets, has been extended to cover £10 million of gains. This, of course, both creates new and important boundaries within the tax system and allows some people to be charged tax at just 10 per cent on what is effectively a return to their labour.

There are reasons for all this difficulty. There is a real challenge in designing CGT. On the one hand, there is a case for aligning rates with marginal rates on earned income so as to minimise avoidance opportunities. On the other hand, high rates of CGT may reduce investment incentives and increase ‘lock-in’ effects – if I don’t realise the gain I don’t pay tax, so a higher rate provides a tax-driven distortion towards longer holding of assets, a distortion magnified by the fact that all liability is forgiven at death.  

These competing pressures can perhaps in large part explain, if not excuse, 50 years of policy vacillation and the current uneasy compromise that involves rates still below income tax rates and very generous treatment of some business assets. There are ways around this conundrum: we proposed a ‘rate of return allowance’ in the Mirrlees Review, which would effectively involve taxing capital gains and other returns to saving in excess of a specified normal return at the taxpayer’s full (income tax and NI) marginal rate whilst leaving normal returns entirely untaxed. The key point, though, is the need for clarity and coherence. While the current system scores better on these fronts than the one in place before 2008, it remains less coherent than the system bequeathed by Nigel Lawson.

**Taxation of savings**

One way of illustrating the complexity associated with the current regime for taxing savings is to show the effect of taxes on returns to different assets. The figures in Table 1, based on the 2008–09 tax system, are estimates of how much taxpayers would need to invest in different assets to match the return they would make on £100 invested in an ISA, assuming identical pre-tax returns. ISA treatment is taken as a baseline because it is a tax-neutral treatment – an effective tax rate of zero. The differences in treatment between different assets are substantial. The concentration of household wealth in pensions, owner-occupied housing and, increasingly, ISAs is undoubtedly correlated with this pattern.

This government has enacted or proposed four major changes to the taxation of savings. One, in the 2014 Budget, was to increase the limits for tax-free savings in ISAs and liberalise them such that the entire sum can be held in cash. This can perhaps be seen as the latest step in a very long journey. The introduction first of Personal Equity Plans (PEPs) and Tax-Exempt Special Savings Accounts (TESSAs), and then of Individual Savings Accounts (ISAs), made tax-neutral saving available to large numbers of people such that about half of UK adults now have some money invested in

---

12 This forgiveness at death is a long-standing and significant distortion in the system which no Chancellor has attempted to tackle. See, for example, IFS Capital Taxes Group, *Death: The Unfinished Business*, Commentary 10, Institute for Fiscal Studies, London, 1988.

© Institute for Fiscal Studies, 2014
Table 1. Contribution to a range of assets required to match ISA return, 2008–09

<table>
<thead>
<tr>
<th>Asset</th>
<th>Required contribution for:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Basic-rate taxpayer</td>
</tr>
<tr>
<td>ISA</td>
<td>100</td>
</tr>
<tr>
<td>Interest-bearing account</td>
<td></td>
</tr>
<tr>
<td>– invested 1 year</td>
<td>101</td>
</tr>
<tr>
<td>– invested 10 years</td>
<td>110</td>
</tr>
<tr>
<td>– invested 25 years</td>
<td>127</td>
</tr>
<tr>
<td>Pension: employee contribution</td>
<td>94</td>
</tr>
<tr>
<td>Pension: employer contribution</td>
<td>72</td>
</tr>
<tr>
<td>Owner-occupied housing</td>
<td>100</td>
</tr>
<tr>
<td>Rental housing</td>
<td></td>
</tr>
<tr>
<td>– invested 10 years</td>
<td>109</td>
</tr>
<tr>
<td>– invested 25 years</td>
<td>122</td>
</tr>
<tr>
<td>Stocks and shares</td>
<td></td>
</tr>
<tr>
<td>– invested 10 years</td>
<td>103</td>
</tr>
<tr>
<td>– invested 25 years</td>
<td>105</td>
</tr>
</tbody>
</table>

\[\text{a We have assumed capital gains that match price inflation, and real returns that accrue as rent. We assume rental housing is owned outright, with no outstanding mortgage. We assume that a CGT liability is incurred. If no CGT were incurred, then the figures for the basic-rate (higher-rate) taxpayer would be 106 and 116 (112 and 134) for the respective horizons. With a CGT liability, if we were to incorporate mortgage interest that could be offset against half the rental income, then the figures for a basic-rate (higher-rate) taxpayer would be 106 and 113 (109 and 122), instead of 109 and 122 (116 and 142).}\]

\[\text{b We have assumed capital gains that match price inflation, and real returns that accrue as interest or dividends. We assume that a CGT liability is incurred. If no CGT were incurred, then the figures for the basic-rate (higher-rate) taxpayer would be 100 and 100 (108 and 120) for the respective horizons.}\]


an ISA.\[\text{13}\] The liberalisation of ISA rules to allow cash to be held up to the full (extended) limit will make even more tax-free saving in cash available. As was argued by the Mirrlees Review, there is a particularly strong case for this form of tax treatment to be applied to cash savings, and an intellectual debt to the Review is acknowledged in the Budget Red Book.\[\text{14}\]

A second step in the same direction was the introduction of a £5,000 zero-rate band for interest income.

### Taxing pensions

The other two recent reforms in this area apply to the taxation of pensions. The government has substantially reduced the annual and lifetime limits on which income tax relief is available for pension contributions. More recently, it has announced the abolition of tax penalties associated with taking out pension savings (from a defined contribution scheme) in a form other than an annuity.

The first of these changes has been part of a dramatic reversal in the direction of travel on the scale of tax relief on contributions, with little sense of where the end point will be. At the same time, there have been no

---


\[\text{14 Paragraph 1.172 of Budget 2014.}\]
Tax Without Design

attempts to deal with elements of the system that really do look very generous. In part, this relates to the problems caused by another failure to understand and account for NICs. More generally, there is a remarkable lack of agreement over what the tax treatment of pensions is actually trying to achieve.

On income tax relief, part of the major reforms in 2006 (so-called ‘A Day’), which allowed substantial annual payments into pensions, was undone very quickly. Annual and lifetime limits have been cut several times in the past four years. At the same time, there has been a growing chorus of support for reducing the rate of tax relief available at least to higher-rate taxpayers, a long-standing Liberal Democrat policy recently restated by the Pensions Minister himself.15

The constant changes, and the uncertainty that both the actual changes and the calls for further change create, are seriously problematic in themselves in the context of individuals and firms making long-term investment decisions. Indeed, the uncertainty is surely such that individuals’ decisions must now be influenced by fears over possible future changes. At root here is a problem over lack of clear strategy and design. What is the pension tax system intended to achieve? One view, which we at IFS have argued for over many years, is that a straightforward system allowing income tax relief upfront, with tax paid upon withdrawal, provides desirable neutrality.16

Most of the arguments for restricting the rate of tax relief seem to start from the different premise that providing tax relief on contributions is a generous incentive which creates a large cost. But if an appropriate, neutral system is considered to be one that avoids the double taxation of savings by levying income tax only once – in this case, at the point at which income is drawn – then, relative to this benchmark, tax relief on contributions should not be counted as a cost.

Curiously, where there are clear deviations from a neutral system, rather fewer voices have been heard to favour change. The existence of the tax-free lump sum is one such deviation. Perhaps especially now that there is to be no enforced annuitisation of defined contribution pensions, it is hard to understand the justification for allowing those who have managed to accumulate a pension pot worth £1.25 million to take free of income tax £312,500 of income that has never previously been taxed.

Again, though, it is the failure to consider NICs that creates perhaps the greatest divergence from a neutral system. Employers and employees pay National Insurance contributions on salaries. But no NICs are paid on money that employers contribute to a pension scheme on an employee’s behalf. And no NICs are paid when the pension is received. Not surprisingly, the large majority of pension contributions are made by employers rather than employees. The treatment is astonishingly generous and almost impossible to defend either on efficiency grounds or on grounds of equity. Yet the apparently hidden nature of NICs seems to ensure that this relief is barely discussed, while the much more rational system of income tax relief is continually revised and attacked.


© Institute for Fiscal Studies, 2014
Inheritance tax

Inheritance tax (IHT) can be thought of rather separately from other aspects of the tax system and is an area where international practice is most variable. The current government has frozen the threshold for payment of inheritance tax, and currently plans to keep it frozen right through to 2017–18. Partly as a result of this, receipts are due to rise from £2.7 billion in 2010–11 to £5.8 billion in 2018–19. At the same time, the Prime Minister has proclaimed an aspiration to dramatically increase the threshold to £1 million. Those represent, to say the least, conflicting messages. Were the threshold to be raised so substantially, revenues could fall by as much as 70 per cent, leaving the very basis for the continuance of this tax open to question. Part of the problem would seem to be that, in common with previous governments, there appears to have been no effort made to make IHT more effective in achieving what it is presumably there for – to tax large transfers from the wealthy. No tax is levied on transfers made more than seven years from death, various kinds of assets (including agricultural land) are free of IHT, and other opportunities for avoidance exist for the very wealthy that are not open to the majority, whose major asset is the house they occupy. This rather undermines support for the tax.

There is clearly disagreement between those who believe that there is a strong equality-of-opportunity case for taxing transfers of wealth heavily and those who believe in the right of people to transfer their own wealth free of additional tax. Where we are in policy terms seems to reflect an unfortunate and ineffective compromise, and a determination not to provide any clear sense of direction.

IV. INDIRECT AND ENVIRONMENTAL TAXATION

VAT was introduced in 1973, replacing the old purchase tax. But in the decades since the abolition of the separate rate of VAT on ‘luxury goods’ in 1979, the overall structure of indirect taxation has not changed dramatically. The main rate of VAT has gradually climbed in steps to 15, 17.5 and now 20 per cent. But little progress has been made towards broadening the tax base, which remains among the narrowest in the OECD in the sense that a smaller proportion of consumer spending is subject to VAT in the UK than elsewhere. Attempts to make big changes (the extension of VAT to domestic energy in 1993) and small changes (the extension to more warm food proposed in the ‘omnishambles’ Budget of 2012) have met with concerted opposition. The rather more damaging system of VAT exemptions, which prevent recovery of VAT paid on inputs, has also remained essentially untouched, although the UK government can perhaps escape much of the blame for this particular failure since exemptions are largely mandated by the EU. Overall, the prospects for a well-designed VAT system look as distant as ever.

The idea that the ‘pasty tax’ was somehow introducing new areas of complexity by making it difficult to distinguish between particular types of good for VAT purposes is rendered more than a little absurd by the examples in Table 2. That said, the policy would not have moved the boundary between the zero and standard rates to a significantly more coherent place. Most disturbingly, it has probably set back the cause of more serious VAT reform.

Table 2. VAT rates on different foods

<table>
<thead>
<tr>
<th>Products currently facing 20% VAT</th>
<th>Products currently facing 0% VAT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cereal, muesli and similar sweet-tasting bars</td>
<td>Flapjacks</td>
</tr>
<tr>
<td>Potato crisps</td>
<td>Other roasted vegetable chips, tortilla chips</td>
</tr>
<tr>
<td>Marshmallow snowballs with no biscuit base</td>
<td>Marshmallow teacakes with a biscuit base</td>
</tr>
<tr>
<td>Chocolate bars that are ‘eaten with fingers’</td>
<td>Chocolate body paint</td>
</tr>
<tr>
<td>Sweet-tasting dried fruit for snacking</td>
<td>Sweet-tasting dried fruit for home baking</td>
</tr>
<tr>
<td>Chocolate buttons not for use in baking</td>
<td>Chocolate mini-buttons for use in baking</td>
</tr>
<tr>
<td>Frozen yoghurt and ice cream</td>
<td>Baked Alaska</td>
</tr>
<tr>
<td>Gingerbread men decorated with chocolate</td>
<td>Gingerbread men on which the chocolate amounts to no more than two dots for eyes</td>
</tr>
</tbody>
</table>


As we argued in *Tax by Design*, a more sensible and simpler tax system would charge VAT at a standard rate on most consumption. Within the overall tax and benefit system, it would be possible to compensate poorer households for such a change on average and leave the overall system more efficient than and at least as redistributive as the current system. The failure to achieve this, or even to move in this general direction, seems to reflect a combination of a failure to consider the tax and benefit system as a whole, a failure to set out a long-term direction for change and the difficulty associated with changes that leave certain groups worse off – although, in this context, the contrast with the apparently minimal political cost associated with raising the main rate of VAT to 20 per cent is remarkable.

If the lack of change to the VAT base indicates a failure to tackle some fundamental issues in tax design, the toing and froing on the second-biggest indirect tax – road fuel duties – would appear to indicate even less of a sense of direction. Road fuel duties raise around a quarter of the amount VAT raises and roughly the same as each of council tax and business rates. They are an important part of the tax system. Unlike VAT, though, fuel duties have been falling in real terms over the past few years, as illustrated in Figure 6. The current government is receiving more than £5 billion less in fuel duties than it would have done had it stuck to its predecessor’s announced policy.

Figure 6. Duty on a litre of petrol

© Institute for Fiscal Studies, 2014
Table 3. Actual and announced fuel duties since 2011

<table>
<thead>
<tr>
<th>Dates uprating originally due</th>
<th>Dates uprating due following policy announcement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Budget 2011</td>
<td>Autumn Statement 2011</td>
</tr>
<tr>
<td>Apr 2011</td>
<td>Jan 2012</td>
</tr>
<tr>
<td>Apr 2012</td>
<td>Aug 2012</td>
</tr>
<tr>
<td>Apr 2013</td>
<td>Apr 2013</td>
</tr>
<tr>
<td>Apr 2014</td>
<td>Apr 2014</td>
</tr>
<tr>
<td>Apr 2015</td>
<td>Apr 2015</td>
</tr>
<tr>
<td>Apr 2016</td>
<td>Apr 2016</td>
</tr>
</tbody>
</table>

These cuts do not appear to be part of a clear plan to reduce fuel duties in the face of evidence that they are too high to reflect the externalities imposed by driving. Indeed, Table 3 illustrates how they do not seem to have been part of any plan. Increases in line with inflation have been announced time and again. Time and again they have been withdrawn. While the table looks only at the period since Budget 2011, one could construct a similar table displaying similar vacillation over much of the preceding decade.

For the longer term, the difficulty associated with keeping fuel duties constant even in real terms will pose additional problems. Cars are becoming more fuel efficient. The OBR suggests that even if duties rise with inflation, real revenues will fall.18 The effective tax rate on congestion – the main externality associated with driving – will also fall. Further down the road, the wholesale shift to electric vehicles, upon which our legally binding climate change targets are predicated, will see road fuel duties, and the tax on congestion, all but disappear. The need to design motoring taxation robust to future change is becoming increasingly urgent. The natural, and efficient, option would be to move towards a system of congestion charging. No strategy for dealing with this issue is apparent.

If design of these old taxes – income taxes, VAT, fuel duties – leaves something to be desired, so too does the design of the newer environmental taxes, and especially carbon taxes. Over the last decade or so, a range of new taxes and charges have been levied on energy use by households and businesses. In the face of climate change and targets for reducing emissions, there is a clear case for putting a price on carbon emissions. Yet policy has not been designed to impose anything approaching a constant carbon price. This is illustrated in Figure 7, which shows the effective price per tonne of CO₂ according to type of fuel and consumer. Rates are lower for households than for businesses and much lower for gas than for electricity. Indeed, there is no tax on gas consumption by households – just a subsidy (relative to other forms of consumption) in the form of reduced VAT. If anything, this disparity is set to grow over time.

Another illustration of the lack of long-term design in this important aspect of tax policy comes from the 2014 Budget. The carbon price under the EU Emissions Trading Scheme (ETS) has been very low – lower than intended partly as a result of the recession. So in 2013 the government introduced a top-up charge (the Carbon Price Support rate applying to large emitters under the EU ETS) and set out an intended trajectory for the total carbon price through to 2020 – in part, it said, to introduce certainty for investors in low-carbon technology. Just one year later, that trajectory was

abandoned. If the original policy had any merit, it was the introduction of a clear path for taxes and prices. As the Committee on Climate Change put it, ‘introducing a policy and then fundamentally changing it a short time later is not conducive to providing the clear and consistent signals that investors require’.19

V. THE TAXATION OF HOUSING

Housing appeared as an asset in Table 1 where we looked at different assets in the context of the tax treatment of savings. But it is worth considering the tax treatment of housing separately for two reasons. First, it is important to consider it in the context of both savings and consumption taxes, for housing is both an asset and a consumption good. Second, not only is the tax treatment of housing currently a mess, but also it seems rapidly to have been moving in the wrong direction.

Before going on to bemoan what has been going wrong, though, it is only right to mention one triumph of tax policy – the abolition of mortgage interest tax relief. The gradual abolition, particularly through the 1990s, was a welcome and consistent move towards a more rational tax system. The existence of the relief provided a substantial tax advantage to owner-occupation. The fact that it proved possible, albeit over a protracted period, gradually to phase it out is good evidence that reform really is possible even when the tax break being abolished is popular and many losers are created.

At present, there are two main taxes on housing.20 One is stamp duty land tax (SDLT), which is a transaction tax paid by the purchaser and charged as a proportion of the property value. The other is council tax, charged annually and, in England and Scotland, related to the estimated value of the property as at April 1991.

20 Of course, landlords also pay income tax and CGT. I refer here to taxes specific to housing.
Stamp duty land tax

Both the current coalition government and its Labour predecessor have repeatedly turned to increasing SDLT to raise revenue. Charged at a flat rate of 1 per cent on property sales above £60,000 (half of all sales) when Labour came to power in 1997, it is now charged on sales above £125,000 (around two-thirds of sales in 2013–14) at rates rising from 1 per cent on sales up to £250,000 to 7 per cent on sales above £2 million. This transformation of stamp duty is illustrated in Figure 8.

Figure 8. Stamp duty land tax rates in the UK

While still providing only a small share of revenue, that share has grown, pushed by rapid property price rises as well as rate increases. Stamp duty revenue from residential property stood at only £0.8 billion (0.26 per cent of total government revenue) in 1997–98 but is forecast to reach £14.9 billion (1.9 per cent of revenue) by 2018–19.

Stamp duty was introduced in 1694 and stems from a time when few other potential taxes were straightforward to implement, whereas the transactions on which stamp duty was levied were easy to identify and to measure and the duty was cheap to collect. But in the modern era of broadly-based taxation, the case for maintaining stamp duty is very weak indeed. To quote Stuart Adam once more:

SDLT is a strong contender for the UK’s worst-designed tax. Its structure is especially perverse because (unlike, say, income tax) the relevant rate applies to the full sale price, not just the part above the relevant threshold. So a house selling for £2,000,000 would attract tax of £100,000 (5 per cent of £2,000,000), whilst a house selling for £2,000,001 would attract tax of £140,000 (7 per cent of £2,000,001) – a £1 increase in price triggering a £40,000 increase in tax liability. That is, of course, an absurd


structure for any tax. Transactions of very similar value are discouraged to completely different degrees and there are enormous incentives to keep prices just below the relevant thresholds. At a bare minimum, the UK government should move away from this ‘slab’ structure for SDLT, as the Scottish government is proposing to do with its newly acquired autonomy over the SDLT system for Scotland.

But there is a more fundamental flaw with SDLT. One of the most basic tenets of the economics of taxation is that transactions taxes should be avoided. There is no reason to impose a heavier tax on those properties that change hands more often. Assets should be held by the people who value them most: the effect of a transactions tax such as SDLT is to discourage mutually beneficial transactions. If a family in a small house want to move to a larger one (because they are having children, for example) while a neighbouring family in a large house want to move to a smaller one (perhaps because their children have grown up and left home), SDLT might discourage them from buying each other’s houses, leaving both families worse off. At a macroeconomic level, one manifestation of this is to reduce labour mobility, as people are discouraged from moving to where suitable jobs are available. The introduction of a 7 per cent SDLT rate on transactions above £2 million has taken the discouragement of mutually beneficial transactions to new heights of absurdity: the average SDLT bill for sales subject to this rate was expected to be around £270,00023 – more than the UK average house price. In other words, if the two parties to the transaction decided not to go ahead, the tax they saved would be enough to buy an entirely new house and still have money left over.

Yet, as we have seen, SDLT is a tax that governments of both persuasions have seen fit to increase time and time again and whose structure has got worse over time, not better.

Council tax

The other major tax on housing – council tax – is, in principle at least, less objectionable than SDLT, though it is certainly one of the least popular taxes. It is in principle less objectionable because there is a good economic case for charging tax on the consumption of housing, just as we charge VAT on the consumption of fridges, cars and most other purchases. Were council tax to be charged as a flat proportion of the current value of properties, it would serve this role in the tax system rather well.

Of course, that is not how it works. The amount paid is, for properties in England and Scotland, based on the value of the property in April 1991. These values will very soon be a quarter of a century out of date. After such a long time, and especially given the divergence in house price growth in different localities over that period, the current base for the tax is patently inequitable. Yet there is no sign of any political interest in updating values – the political cost of creating losers is judged too great. The seemingly interminable review of local government conducted for the last government

23 Budget 2012 estimated that the introduction of the 7 per cent rate would raise £235 million in the absence of behavioural response (page 23 of http://cdn.hm-treasury.gov.uk/budget2012_policy_costings.pdf) and that ‘...there are currently around 3,000 residential property transactions per annum at over £2 million’ (http://www.hmrc.gov.uk/budget2012/tiin-2138.pdf). That would imply an average tax increase of around £78,000 per property. If a tax rise of 2 percentage points (from 5 per cent to 7 per cent) corresponds to an average tax rise of £78,000, that implies that the full 7 per cent tax bill would be (7/2) × £78,000 = £274,000 – though the degree of rounding involved (particularly in the 3,000 figure) means that this figure should only be considered approximate.
by Michael Lyons\textsuperscript{24} resulted in the end in this whole issue being kicked into touch. The idea of a revaluation was ruled out immediately the current government entered office. It seems more than likely that we will enter the 2020s and beyond with our main property tax, and indeed our only local tax, based on property values from the latter part of the last century.

The failure to update property values is by no means the only failing of council tax. It differs from other taxes on consumption, and indeed from any other current tax I can think of, in being \textit{deliberately} regressive in its design.\textsuperscript{25} The amount of tax due falls as a proportion of the (1991) property value as the value increases. And it is capped. So this is a tax that deliberately sets out to impose a heavier burden on people with the lowest levels of housing consumption and wealth than on those with the highest levels.

And beyond all that, there seems to be little certainty as to its future role, and certainly its scale, in the UK tax system. While real levels of council tax rose quite significantly over the first part of the 2000s, council tax levels have been frozen in nominal terms in Scotland since 2007–08, and in England most local authorities have responded to government incentives by freezing levels since 2010–11. In 2013, the incentives for local authorities to keep council tax frozen were extended through to 2015–16. Council tax revenues are likely to be £3–4 billion lower in 2015–16 than they would have been had they simply kept pace with (CPI) inflation from 2010. The longer freezes continue, the harder it may become to start raising rates in line with inflation.

Is council tax, and thus both our main tax on housing and our main local source of revenue, facing a long drawn-out death? Or will it be resurrected? I don’t know. It looks unlikely, though, that it will be even properly updated, let alone coherently reformed, in the near future.

\textbf{VI. BUSINESS TAXATION}

Since 2010, the government has been very clear about its aspiration to create a corporate tax regime that is the most competitive in the G20. This aspiration appeared in the coalition agreement, was repeated in the 2010 Corporate Tax Road Map\textsuperscript{26} and has been stuck to ever since. The road map presented a welcome degree of clarity over the direction of change, which went well beyond plans to reduce the headline rate of corporation tax (now due to reach 20 per cent by 2015–16, which in fact constitutes a much more substantial reduction in the headline rate than that originally envisaged). It also contained plans to reform the controlled foreign company (CFC) regime, reduce capital allowances and introduce a ‘Patent Box’.

Much of the direction of policy set out, and indeed followed since then, was broadly consistent with the direction followed by the previous government. While the Labour government implemented rather more modest reductions in the headline rate of tax, and actually saw the effective tax rate in the UK rise above the OECD average for the first time in many years,\textsuperscript{27} it had set in train the Patent Box policy and reforms to the CFC regime. In

\textsuperscript{24} http://www.lyonsinquiry.org.uk/.
\textsuperscript{25} The effect of some other taxes – notably, tobacco tax – is to be regressive. The distinction is that regressivity is built into the design of council tax.
addition, it moved, perhaps rather belatedly in 2009, to a territorial principle for the taxation of foreign corporate profits.

This move to territoriality brought the UK into line with the large majority of major economies – the US is the big exception – and means that dividends received from foreign subsidiaries are now exempt from UK corporate income tax. The UK also weakened the scope of the CFC regime – the rules that attempt to counter avoidance opportunities by taxing income that is artificially held in a low-tax jurisdiction – and added a focus on not attempting to tax active investment income, or passive income that was actively managed offshore. Between them, these moves help ensure that domestic multinational firms are not put at a disadvantage when making offshore investments. In some cases, UK firms may gain a competitive advantage.

Combined with the substantial reductions in the headline rate, these changes have no doubt moved the UK system in the direction envisaged – towards being more competitive and internationally attractive. The Patent Box is intended to have a similar effect by charging a lower rate of tax on income associated with patents. Such regimes are increasingly popular across Europe and have been introduced in 13 other European countries. This largely reflects the fact that income associated with intellectual capital can be highly internationally mobile. Policies of this sort may therefore raise revenue more efficiently by charging a differential (lower) rate of tax on more mobile income streams.

But all of this activity aimed at making the UK more attractive to investment from multinationals has been accompanied by growing concerns over tax avoidance. With more integrated markets, an increasing proportion of international trade occurring within firms, and recent growth in digital services and transactions occurring over the internet, it is increasingly difficult to determine exactly where profits are ‘really’ being earned. It is also difficult to stop companies manipulating their real or reported activities such that profits are reported in low-tax jurisdictions. Transfer pricing rules – which are supposed to ensure that when trades occur across borders but within a multinational, prices are set as if the trade were occurring between two unrelated parties – are extremely hard to set and enforce. In these circumstances, international cooperation is crucial. Governments from most developed countries have engaged in initiatives aimed at preventing the most aggressive forms of tax competition and, through the OECD base erosion and profit shifting (BEPS) project, are looking to change rules to prevent double non-taxation. The UK has been fully engaged in this process.

If that is a necessarily brief overview of recent developments in corporate tax policy, it is also presented as a rather coherent one. The full story is, of course, a little more complex. Part of the problem is that many of the difficulties that arise in taxing multinational companies are inherent to the underlying system, which relies on a source-based profits tax – the aim of the system is to tax profits where they are made. There often is just no single correct answer to the question ‘Where were the profits earned?’ As a result, manipulation of where profits are reported, and incentives to earn or report profits in low-tax jurisdictions, are inherent to the system. Even the BEPS process, involving as it must international agreement, seems likely at best to provide a sticking-plaster solution. This has led some commentators to suggest that, in the end, the source-based system of tax will have to be

abandoned in favour of a destination base, in which tax would be levied not
where the profits are made but where the sale to a final consumer is made.29
There is no immediate prospect, though, of any serious move in that
direction. And for now we do, for better or worse, actually collect quite a lot
of corporation tax revenue.

So within the confines of a source-based world, and acknowledging the
difficulties that perhaps doom it to eventual failure, is the current strategy
genuinely coherent? There are at least three reasons for thinking it might not
be – and they are in addition to potential conflicts, at least in appearance,
between a desire to make the UK system as attractive to business as possible
whilst at the same time looking to minimise the opportunities for
‘avoidance’ that the international system creates.

First, as rates have been cut, so the base for corporation tax has been
widened through reductions in investment allowances.

The scale of these cuts in allowances has been substantial; indeed, the
allowance for industrial buildings has been scrapped altogether. This policy,
pursued by all recent governments, seems to arise from an inappropriate
focus on looking at revenues from corporation tax in isolation from the tax
system as a whole. As we stressed in the Mirrlees Review, it is a central
aspect of tax design that the system be seen as a whole. If it is appropriate to
cut rates of corporation tax, that should not imply that the base needs to be
broadened to make up the revenue loss. One particular problem with
reducing allowances is that doing so moves the corporate tax system further
away from a neutral or efficient system in which only economic ‘rents’ are
taxed.

Second, over the last few years, there has been an absurd degree of
inconsistency in the setting of annual investment allowances.

The annual investment allowance (AIA) allows the immediate deduction
of expenditure on most plant and machinery from taxable profits. The limit
was set at £50,000 between 2008 and 2010, when it increased to £100,000. It
was cut to just £25,000 in 2012 but increased to £250,000, supposedly
temporarily, in 2013. In the 2014 Budget it was raised again to £500,000,
but on current plans it will return to £25,000 in 2016. These changes and
instability create costs and uncertainty and distort behaviour. More
fundamentally, restricting the AIA to investment in plant and machinery
only creates distortions through differential treatment of assets.

Third, the Patent Box is not well designed.

As we have seen, there may be good reasons for imposing a lower rate of
tax on income derived from intellectual property. But there are substantial
potential problems with the current policy and it is unlikely that its effects
will be the same as its stated objectives.

The Patent Box is almost certainly poorly targeted at the types of activities
that generate spillovers (relative to an R&D tax credit, for example), making
it hard to justify as an innovation policy. It subsidises the return to research
rather than the research itself and is bound to involve a large element of
deadweight cost. It is unlikely to be effective at incentivising additional
R&D.

Whilst it might affect the decision over where patents are held and where
the associated income is declared, it is less clear what effect it will have on
the location of real activity. Any positive effect is being weakened as more
countries introduce the policy. In the early 2000s, the OECD took steps to

Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles and J.
Poterba (eds), Dimensions of Tax Design: The Mirrlees Review, Oxford University Press for
encourage governments to remove or substantially reform preferential regimes for mobile activities, because of concern that they reduced revenues for many governments, with little offsetting benefit. The EU Commission has now taken a stance against the UK Patent Box, arguing that it meets two of the criteria used to identify harmful tax measures and most notably saying that ‘real economic activities and a substantial economic presence in the UK’ are not necessarily required for the Patent Box to apply.  

In an ideal world, it might have been better if European countries had coordinated and not operated Patent Boxes, rather than competed with ever more. The UK might face some specific issues because of the way that the policy is designed. Companies can effectively include most of the income from the sale of a product that includes a patented item (i.e. not just the arm’s length value of the patent). This makes the scope quite broad. It may reduce the incentive to undertake new innovations (and thereby also weaken the link to spillovers).

The design challenges for corporate taxation are serious. I have concentrated here on policy towards larger and multinational companies, not least because that is where the large majority of revenue comes from. But aligning the corporate system, and in particular the way that small businesses are taxed, with the structure of individual taxation is also important. This was amply demonstrated by the absurd decision to reduce the starting rate of corporation tax from 10 per cent to 0 per cent in April 2002. Both this and further tax changes drove large increases in the number of incorporations – for example, from 5,000 in April 2002 to 8,000 in the same month a year later. Choice over legal form was clearly distorted by poorly-designed tax policy. The policy was reversed three years after it was introduced.

**Business rates**

There is another tax on business – business rates – which raises more than £26 billion a year. Business rates raise more in the UK than do taxes on business property in most other OECD countries.

From an economic point of view, business rates combine one of the worst taxes – a tax on the value of business property – with one of the best – a tax on land values. Until recently, they have, unlike council tax, at least been based on reasonably up-to-date property values, with revaluations occurring every five years, and this has been one element of the tax system that has enjoyed a long period of stability. Not anymore. The next revaluation has been delayed by two years – a move that is likely to lead to sharper changes in bills than would otherwise have been the case. A system of ‘temporary’ reliefs was introduced in 2010 and has been extended every year since, leaving little sense of where we will end up in the long term. Most recently, additional reliefs for retail properties have been introduced, again adding complexity, uncertainty and potentially arbitrary boundaries into the tax system.

These recent changes essentially reflect responses to pressures from businesses, which have not seen business rates fall as the economy has contracted. The problem lies in the fact that they look like short-term fixes,

---

32 This is a modified quote from William Vickrey; see W. Vickrey, ‘Simplification, progression, and a level playing field’, in K. Wenzer (ed.), *Land Value Taxation: The Equitable and Efficient Source of Public Finance*, M. E. Sharpe, Armonk, NY, 1999.
which may prove difficult to undo and which provide no sense of direction for the system as a whole.

VII. CONCLUSIONS

This has, of course, been a very partial survey of tax changes and their coherence. It may not even be entirely fair in places. It no doubt misses examples of sensible and coherent reform. And while it has focused on problems with the current tax system and reforms made by this government and its immediate predecessor, it should certainly not be taken as implying that all was well with policy before that. But there are perhaps two more fundamental challenges to this analysis.

The first is that none of this matters ever so much. Economists and others can complain about the fact that structures don’t look optimal, that budget constraints look a bit complicated, that policy is uncertain, but in the end it doesn’t make all that much difference. We have to raise tax revenue. Doing so is costly. And the cost of doing it the way we do is not appreciably greater than the cost of a system that meets all the desiderata that an economist might come up with.

The second, related, point is that, in the end, the thing that really matters is the capacity to raise tax revenue, and the current system, for all its faults, raises a lot of revenue with, by and large, the acquiescence of the taxed. In the words of Jean-Baptiste Colbert, Finance Minister to Louis XIV of France, ‘the art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing’. We all know, so the argument goes, that ideally council tax should be updated and reformed, that National Insurance is a tax and should be treated as such, that environmental taxes should be more coherent, but taxation is all about the art of the possible. If government were more explicitly coherent in what it did, it would risk (to use another goosey metaphor) killing the goose of taxpayer acceptance which lays the golden egg of £600 billion a year in tax revenues.

The first criticism is just wrong. There are very substantial economic and social welfare costs associated with a poorly-designed tax system and, conversely, big benefits to be had from a well-designed one. Taxes take around £4 in every £10 earned in the economy. It is inconceivable in principle that the way they are designed might not matter. And in practice there is irrefutable evidence that poorly-designed taxes can result in lower employment, lower wages, lower investment and lower welfare. The effects will often be opaque to individual taxpayers, but they are there.

The second criticism is more worrying, and is certainly harder to refute. But it is important not to confuse different elements here. Much of what this paper has focused on have been changes that have made the system less coherent. It is hard to argue that many of those changes – increases in stamp duty, the complication of the personal tax schedule or successive changes to CGT, for example – have been necessary for taxpayer acceptance.

It is also perhaps too easy to use fear of taxpayer revolt as an excuse for political timidity. Coherent reform of council tax, for example, might be difficult, but revaluations have occurred in Scotland and Wales without a huge taxpayer revolt. Fear of revolt can also be used as an excuse for governments actually actively conspiring to ensure that certain taxes are not well understood and can be manipulated accordingly. That seems to be the only way of rationalising much policy towards National Insurance.
contributions. It has worked well for them for a long time, but hardly seems the most robust basis on which to conduct policy.

And there are problems created by lack of coherence. The last Labour government introduced the 10p starting rate of income tax and a badly-designed CGT system, and suffered when it came to putting them right. The current government did not have a clear narrative or strategy when it came to trying to introduce its ‘pasty tax’. Badly-designed taxes can also become unpopular because they are not seen as equitable – inheritance tax is surely an example of that. It is not just radical reform that can undermine the system. So can failure to explain and introduce necessary and coherent reform.

But there is no denying that there are huge political pressures militating against sensible design. The candour of Norman Lamont reflecting on his Budgets of 1992 and 1993 is both refreshing and deeply depressing. In his 1992 pre-election Budget, he cut taxes when the public finances did not warrant such a move and also introduced a lower starting rate of income tax. In 1993, he responded to the real fiscal pressures by proposing tax increases, including an extension of VAT to domestic energy. Here is his reflection on these two Budgets:\(^\text{33}\)

[The 1992 Budget] was the most political of all my budgets, and it completely wrong-footed Labour, who were not sure whether to oppose or support a low rate band, because of its appearance of help for the lower paid. Looking back on it, it was not a very good budget. But it did help us to win the 1992 election. My next budget, my third budget, helped to lose the 1997 election for the Conservatives, but it was definitely my best budget.

As we concluded the Mirrlees Review:\(^\text{34}\)

Government in a media-driven democracy is difficult and there is a need to work within the bounds of the politically feasible. But there is a better way to make tax policy. There are taxes that are fairer, less damaging, and simpler than those we have now. To implement them will take a government willing to be honest with the electorate, willing to understand and explain the arguments, willing to listen to and to consult experts and public alike, and willing to put long-term strategy ahead of short-term tactics.

And the costs of not doing so, while opaque, are very large. Our best estimates suggest that economic welfare could be improved by many billions of pounds annually if the taxation of income, expenditure, profits, environmental externalities, and savings were reformed in the ways we have suggested.


IFS residential conference:
“Taxing remuneration: principles and practice”

09:00 Friday 5 Sept 2014 – 13:00 Saturday 6 Sept 2014
Murray Edwards College, Cambridge

Every two years, IFS holds a residential conference, aiming to facilitate high-level knowledge exchange between practitioners, policymakers and academics on key areas of policy and practice. We always provide delegates with a mix of plenary and breakout sessions and we invite a wide range of engaging and knowledgeable speakers to inform and encourage discussion and debate. Our next conference will take place in Cambridge and will focus on taxing remuneration.

Taxing individuals’ earnings is by far the largest source of government revenue. Over the course of two days, we will consider the different ways in which individual earnings are taxed, according to whether they are derived from employment, self-employment or partnership or as small firm entrepreneurs, and depending upon whether they are taken as cash or benefits or deferred in pensions, share schemes or employee benefit trusts. We will ask how tax policy and administration can and should respond to changing patterns of work and pay, including increasing mobility between different taxing jurisdictions in Europe or further afield. We will also discuss topical issues such as recent reforms to the taxation of limited liability partnerships and the Office of Tax Simplification’s review of benefits and expenses, and we will consider what issues ought to attract more debate than they currently do.

Breakout sessions will allow greater depth of exploration of key areas of interest to delegates. Overnight accommodation will be provided and a conference dinner and drinks reception will take place on Friday evening.

**Booking**
IFS members: £320 + VAT (academic/charity) and £545 + VAT
Non-members: £370 + VAT (academic/charity) and £595 + VAT
Delegate fees include en-suite accommodation and meals on Thursday 4 and Friday 5 September.

Though the main conference will take place on Friday 5 and Saturday 6 September, delegates are encouraged to arrive on Thursday 4 September to register, check in to accommodation and meet other attendees (check-in on Friday 5 is not possible until after 12 noon). A limited number of non-residential places are available: please contact us at events@ifs.org.uk if you want this option. The conference programme will commence at 09:00 on Friday 5 September and the event will conclude with a light lunch at 13:00 on Saturday 6.

For further information and to download a booking form, please visit www.ifs.org.uk/events/1025

This event has been organised by the ESRC Centre for the Microeconomic Analysis of Public Policy at IFS. Our events team will be happy to answer any questions: events@ifs.org.uk / 020 7291 4800

**Confirmed participants include:**
Mary Aiston (Director of Specialist Personal Tax, HMRC)
Paul Aplin (Tax Partner, A C Mole & Sons and Chair, Tax Faculty Technical Committee, ICAEW)
Philip Baker QC (Gray’s Inn Tax Chambers)
Colin Ben-Nathan (Partner, KPMG and Chair, CIOT Employment Taxes Sub-Committee)
Judith Freedman (Professor of Taxation Law, University of Oxford)
Malcolm Gammie QC (One Essex Court and Chairman, IFS Tax Law Review Committee)
David Gauke MP (Exchequer Secretary to the Treasury)
Mark Groom (Partner, Deloitte’s Employer Services practice)
Paul Johnson (Director, IFS)
Daniel Lyons (Partner, Deloitte’s Indirect Tax practice)
Cerys Morgan (Deputy Director Personal Tax, HM Treasury)
Edward Troup (Tax Assurance Commissioner, HMRC)
Mike Truman (Editor, Taxation Magazine)
John Whiting (Tax Director, Office of Tax Simplification)

“IFS residential conferences should appeal to anyone interested in tax policy and practice. Rarely do senior figures from policy, business and academia have such a good opportunity to share knowledge and engage in discussion and debate over two days.”

Sam Mitha
Former Deputy Director of Central Policy at HM Revenue & Customs