



Institute for
Fiscal Studies

Tax By Design: The Mirrlees Review

Indirect and environmental taxation

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Outline

- Two guidelines for indirect taxation
- Broadening the VAT base
- Financial services
- Housing
- Environmental taxation

We arrive at two guidelines for indirect taxation

1. Tax final consumption only

- VAT generally achieves this
- But stamp duties, business rates and VAT exemptions do not

2. Tax goods at the same rate

- Complexity creates strong presumption against differentiation
- There are sound economic efficiency arguments for differentiation
- But case sufficiently strong in only a few cases
 - ‘Green taxes’, ‘sin taxes’, childcare
- Distributional arguments for differentiation are weaker

VAT in the UK

- UK zero-rates most food, water, books, children's clothes,...
 - Clearly for distributional, not efficiency, reasons → should be ended
 - Other countries show that it is not inevitable
- Reduced rate on domestic fuel looks particularly bad given environmental concerns
- Exemptions violate *both* of our principles

Broadening the VAT base (1)

- We simulate removing almost all zero and reduced rates
- Raises £24bn (with a 17.5% VAT rate) if no behavioural response
- Reduces distortion of spending patterns
 - If uniformity were optimal, could (in principle) compensate every household and have about £3bn left over
- But on its own, would be regressive and weaken work incentives
- Can a practical package avoid this?

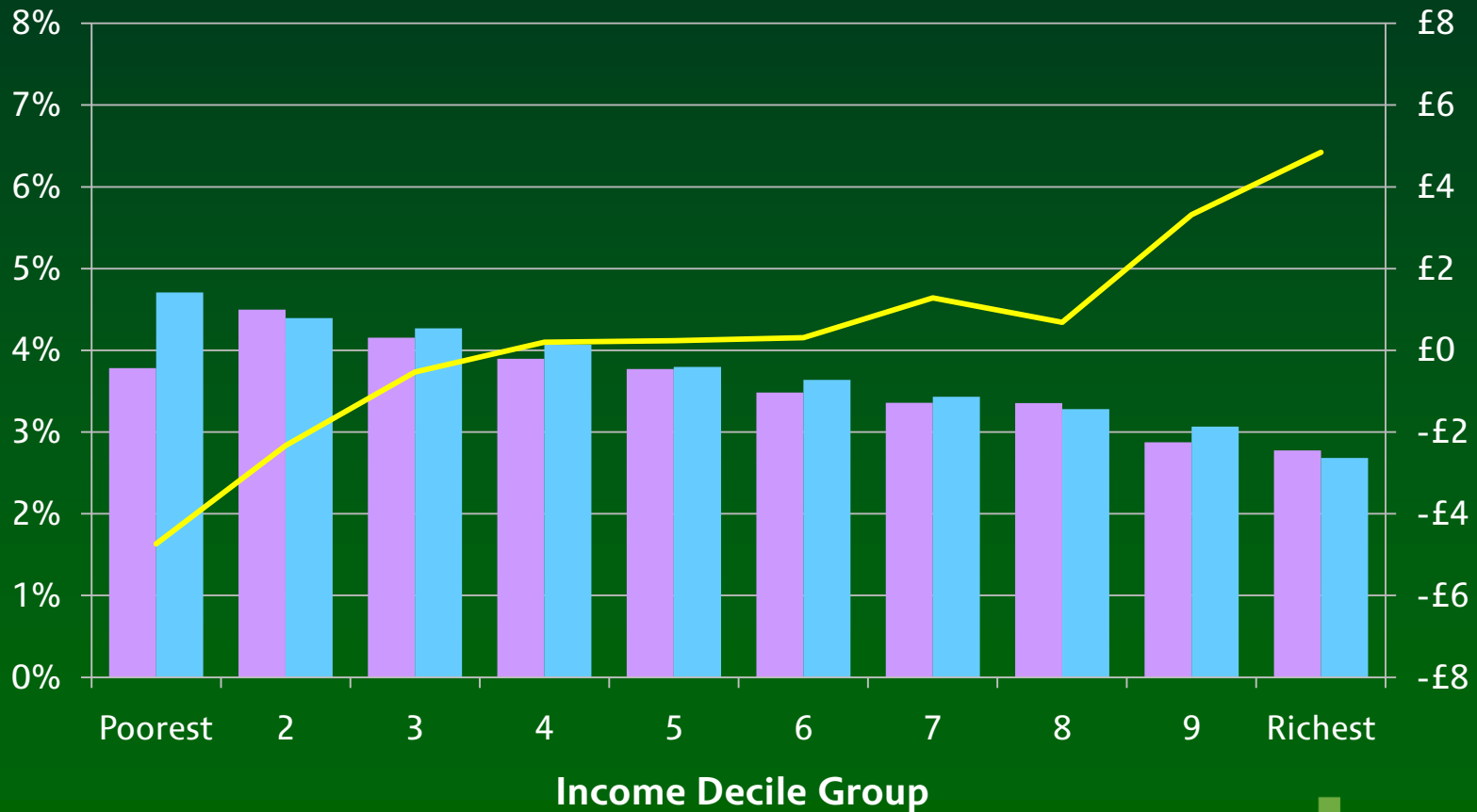
Broadening the VAT base (2)

We illustrate one way of using the money:

- Automatic 3.4% indexation of all tax thresholds and benefit rates. Plus...
- Extra 3.4% means-tested benefits, 2% state pension, 10% child benefit
- £1,000 increase in income tax allowances
- £4,530 cut in income tax basic rate limit and NIC upper earnings limit
- 2p cut in basic rate, 1½p cut in higher rate, of income tax

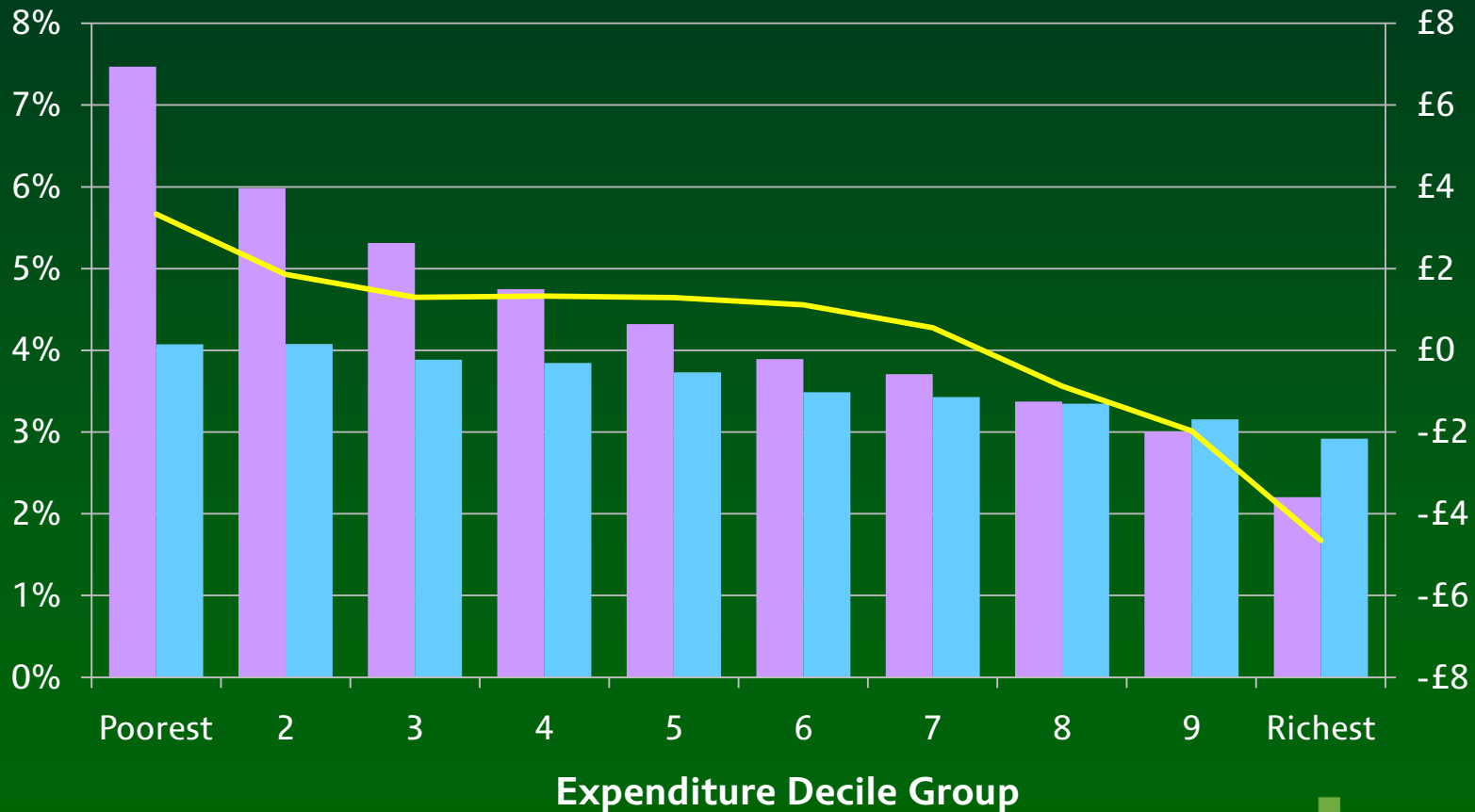
VAT reform: effects by income

■ % rise in non-housing expenditure ■ % rise in income
— cash gain/loss (£/week, RH axis)



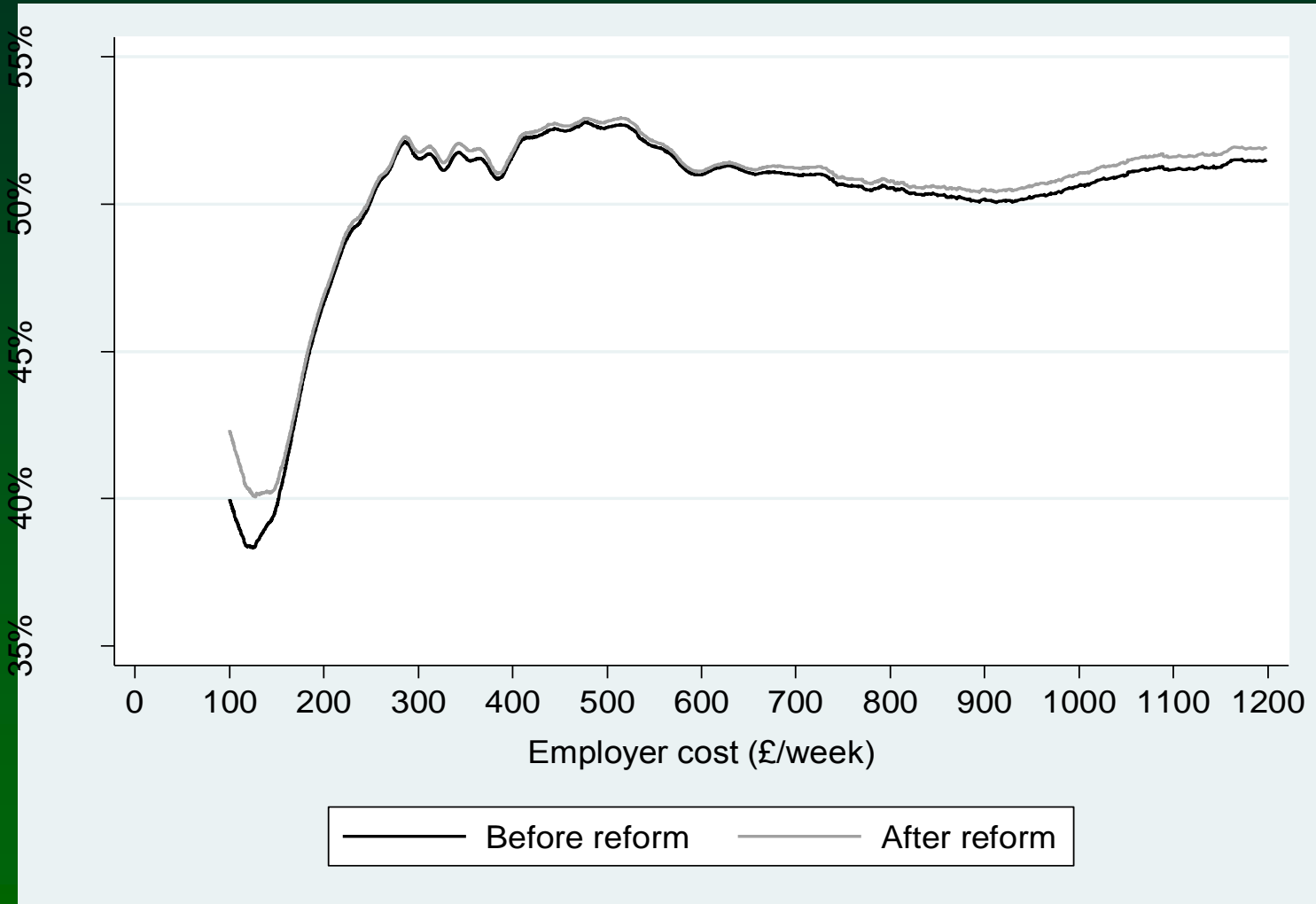
VAT reform: effects by expenditure

■ % rise in non-housing expenditure ■ % rise in income
— cash gain/loss (£/week, RH axis)



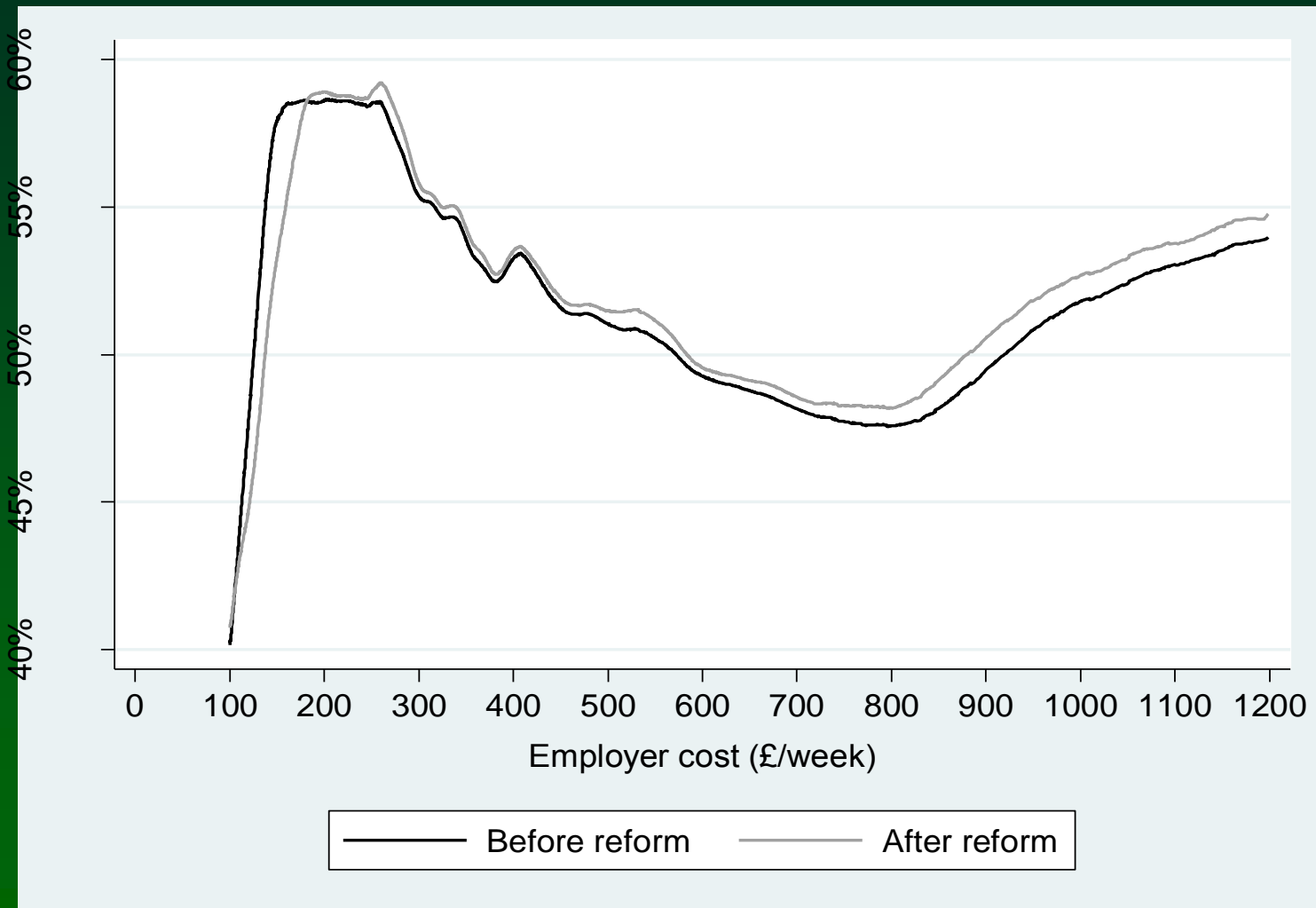
VAT reform: incentive to work at all

Participation tax rates



VAT reform: incentive to increase earnings

Effective marginal tax rates



VAT and financial services

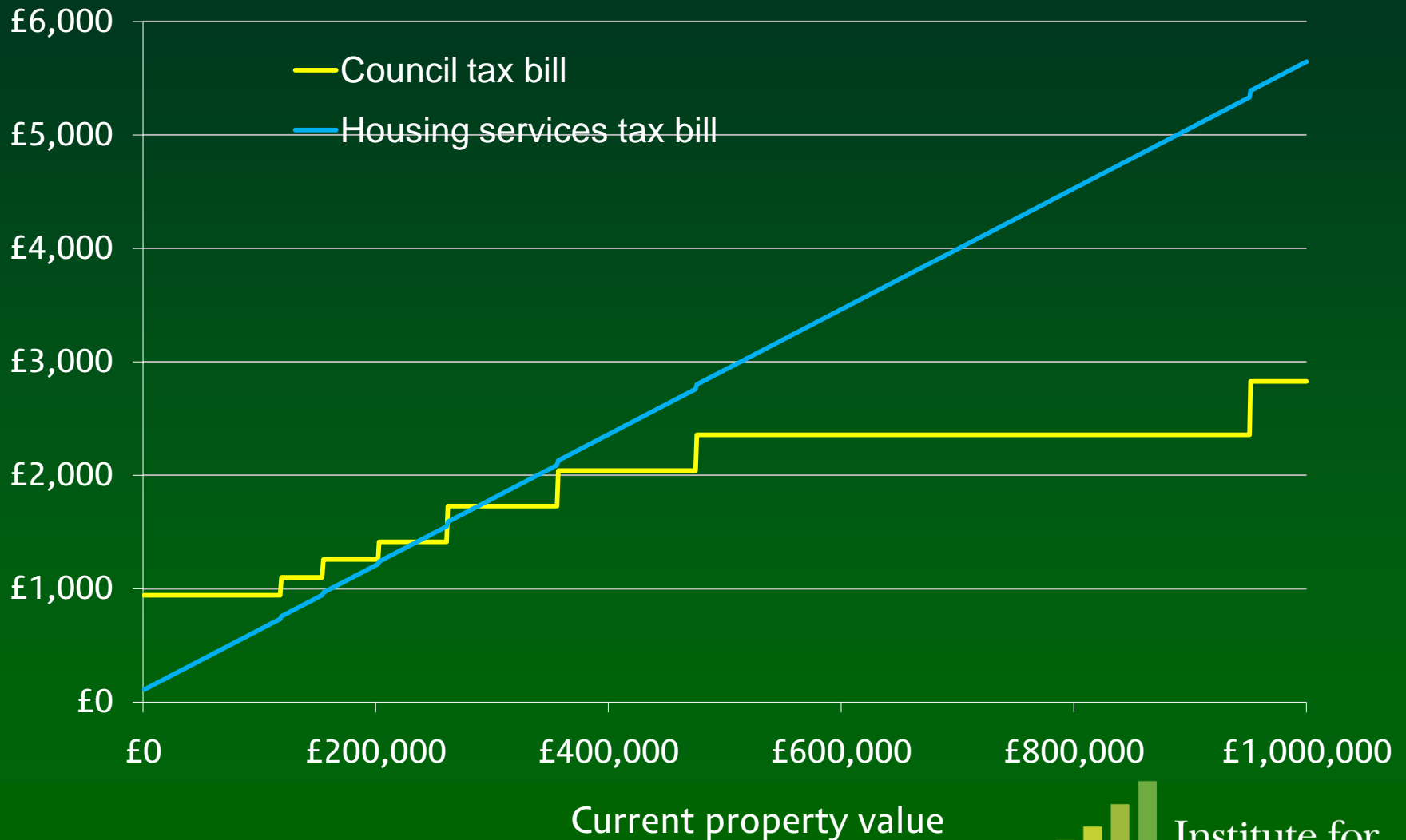
- Consumption of financial services should be taxed
- Exemption causes serious problems
 - Financial services too cheap for households, too expensive for firms
 - Costs around £7bn (though insurance premium tax recoups £2bn)
- Can't be taxed through standard VAT mechanism
- But there are equivalent alternatives
 - Cash-flow tax, Tax Calculation Accounts, Financial Activities Tax,...
- Need detailed study to find the most practical option

Taxing consumption of housing services

- Housing should be taxed like other consumption
 - But not currently subject to VAT
- Could either tax new build, or stream of consumption
- From where the UK starts, the latter makes more sense
- Tax the annual consumption value of housing: substitute for VAT
- Looks like a sensibly reformed council tax
 - Based on up-to-date valuations (rather than 1991 values)
 - Proportional to values (rather than pointlessly regressive and banded)
 - No discounts for single occupancy (rather than 25% discount)
- And replace stamp duty on housing in the process
 - Initially on a revenue-neutral basis

A 'housing services tax'

Note: rough guide only – see Chapter 16 for details



Implicit carbon taxes, 2009-10

Excluding VAT subsidy of domestic energy



Congestion charging

- Congestion charging could have big benefits
 - Eddington Review: potential welfare gains maybe 1% of national income
- In contrast, fuel duty and vehicle excise duty not well targeted
 - But far too high to justify by carbon emissions alone
- And will get even worse
 - Increased fuel efficiency; shift to electric cars?
- National road pricing should replace much of fuel duty
- A premium on acting quickly
 - Before lose what little we have
 - And while still a quid pro quo to offer

Summary of main recommendations

- End almost all zero rates, reduced rates and exemptions in VAT
 - Use revenue to compensate poor and maintain work incentives
- Apply equivalent taxes to financial services and housing
 - The former would remove the need for insurance premium tax
 - The latter would replace council tax and stamp duty on housing
- Move towards consistent pricing of greenhouse gas emissions
- Replace most of fuel duty with a national system of road pricing