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Fiscal Studies

UK tax policy

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Aims

- Describe the current UK tax system
- Historical and international context
- Recent policy developments and debates
- Strengths and weaknesses

Outline

- Revenues
- Tax policy
 - Direct personal taxes
 - Corporate income taxes
 - Indirect taxes
 - Property and local taxes
 - Cross-cutting issues
- The tax policy-making process
- ❖ Not going to talk (much) about welfare benefits

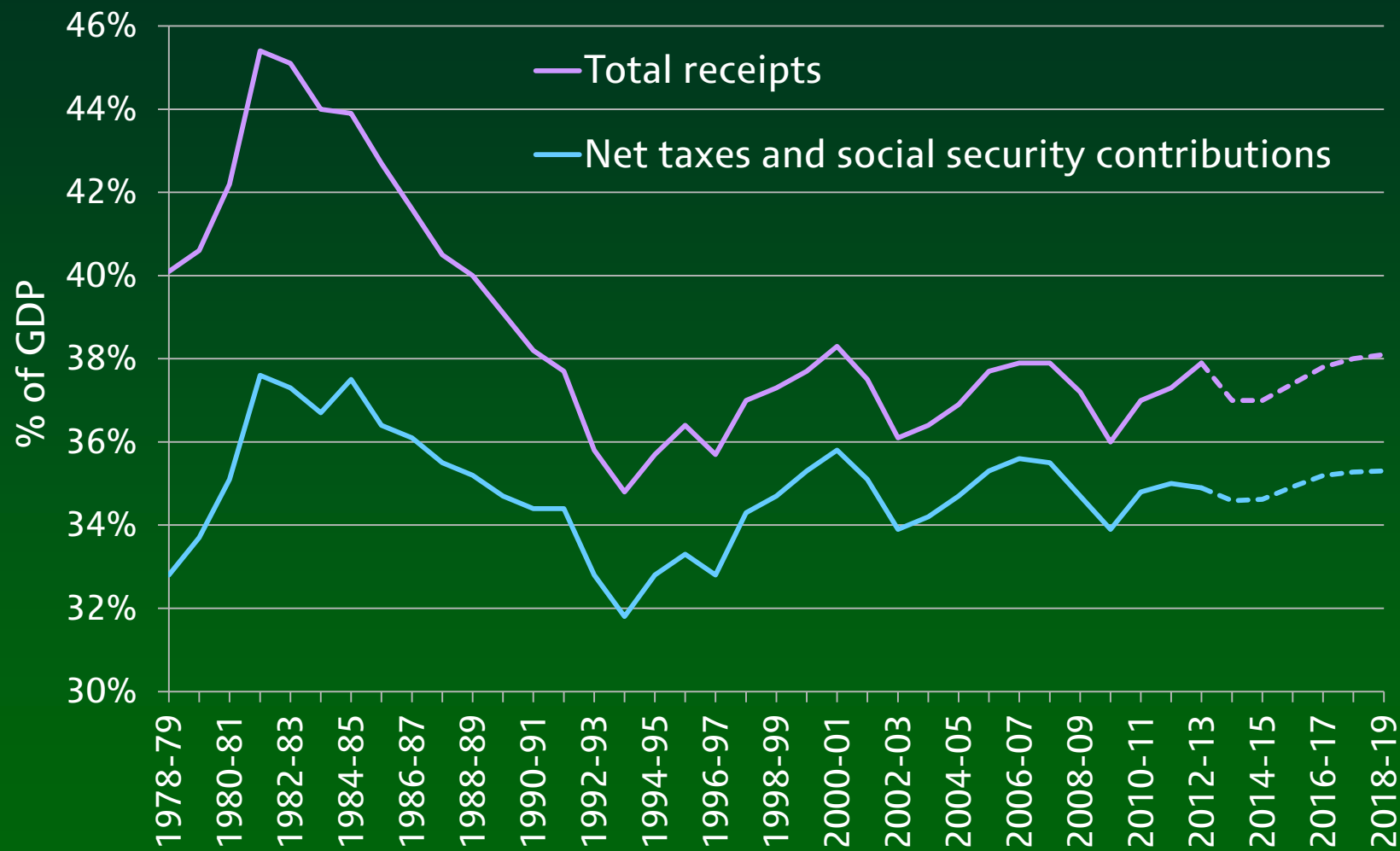
Useful links

- This presentation
 - <http://www.ifs.org.uk/publications/7378>
- HM Revenue and Customs (HMRC) Statistics
 - <https://www.gov.uk/government/organisations/hm-revenue-customs/about/statistics>
- HM Treasury
 - <https://www.gov.uk/government/organisations/hm-treasury>
- Office for Budget Responsibility: official public finances monitor
 - <http://budgetresponsibility.org.uk/>
- User-friendly facts and figures, Budget analysis, etc
 - http://www.ifs.org.uk/tools_and_resources
- The Mirrlees Review of tax policy
 - <http://www.ifs.org.uk/publications/mirrleesreview>

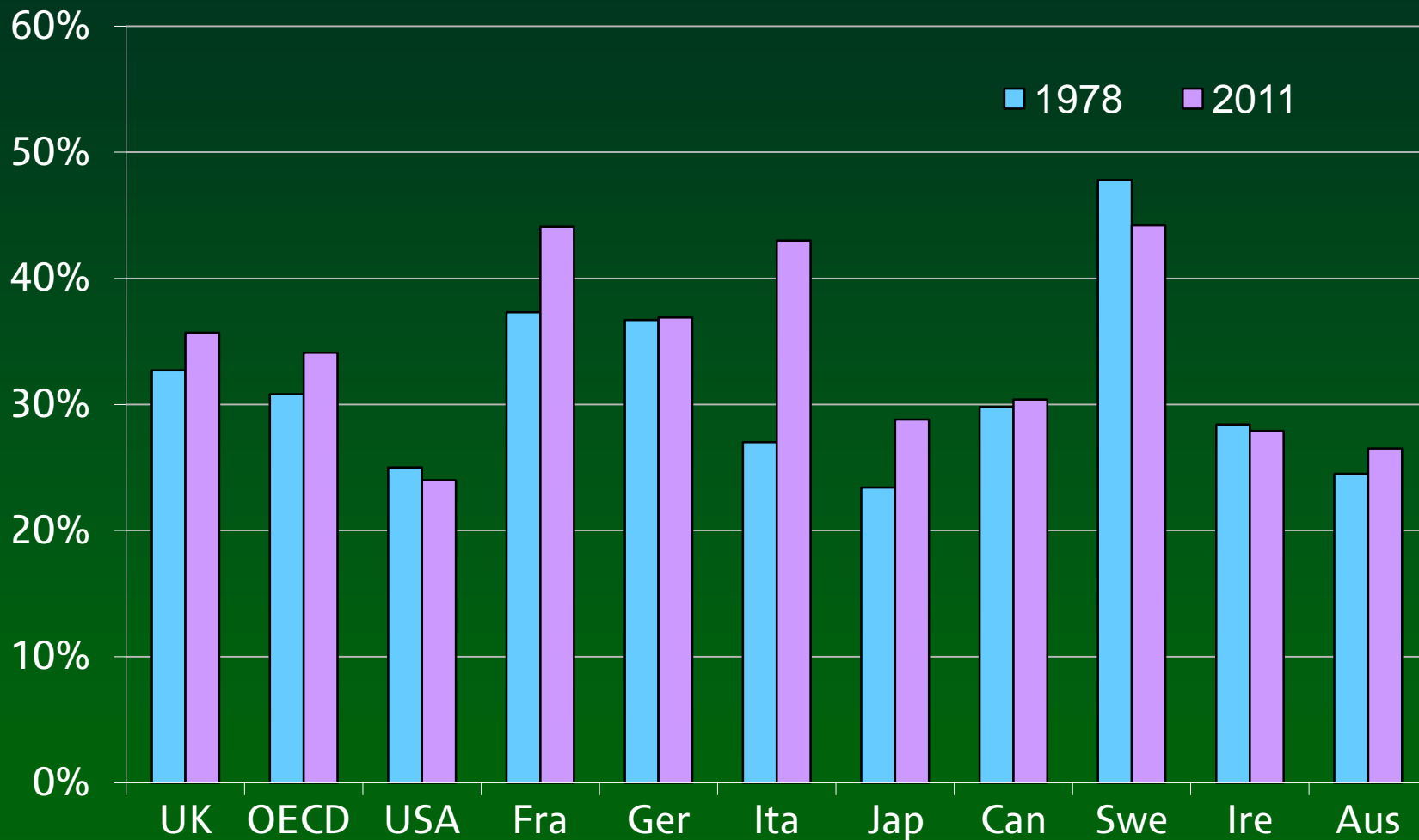
Some background

- Tax year runs from 6 April to 5 April
- Budgets usually in March (and Autumn Statements in Nov/Dec)
- Coalition government in office from May 2010 to May 2015
- Big government budget deficit following the 2008 crisis
 - But mostly being closed by spending cuts, not tax increases
- Scotland's independence referendum

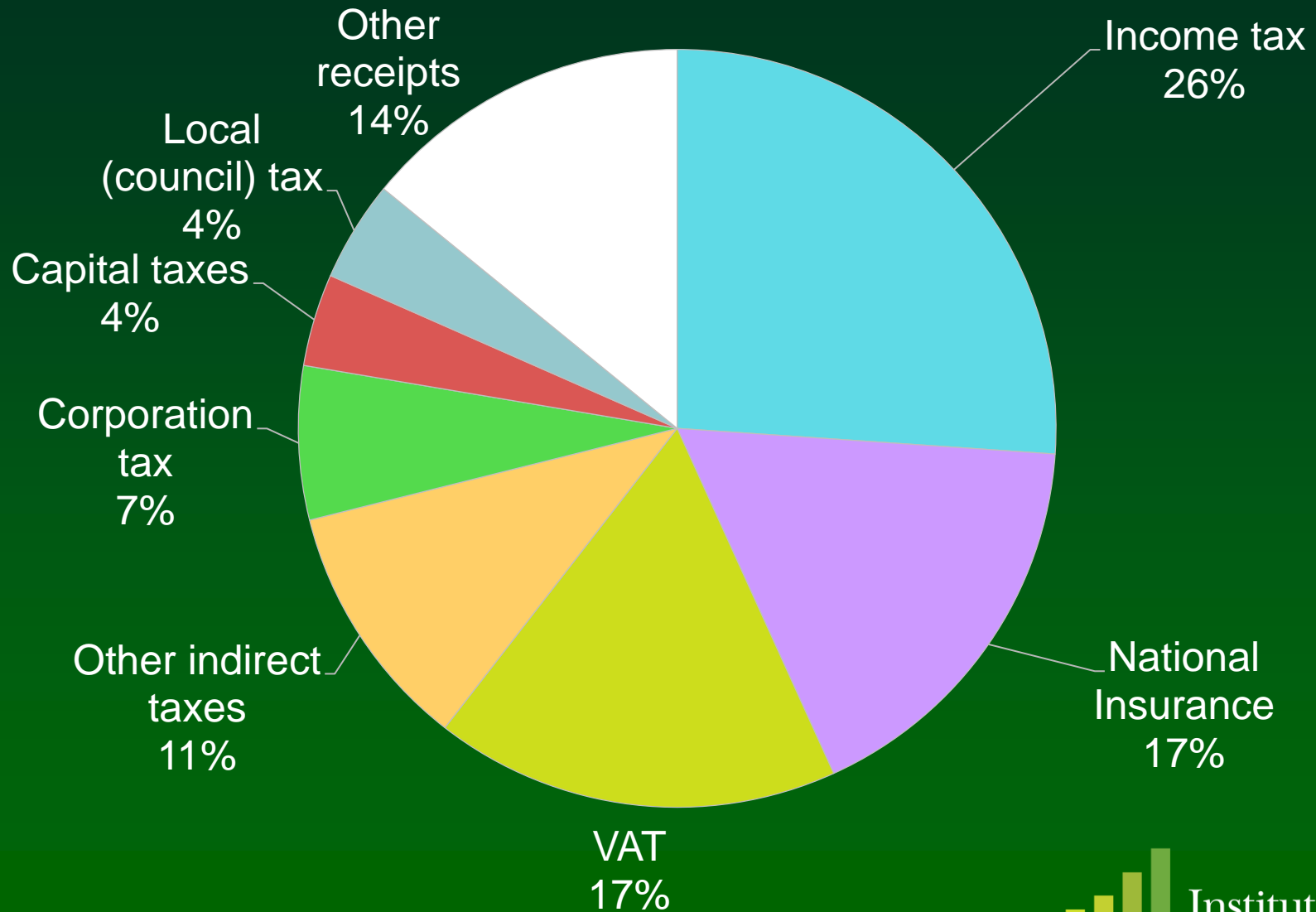
UK government revenue



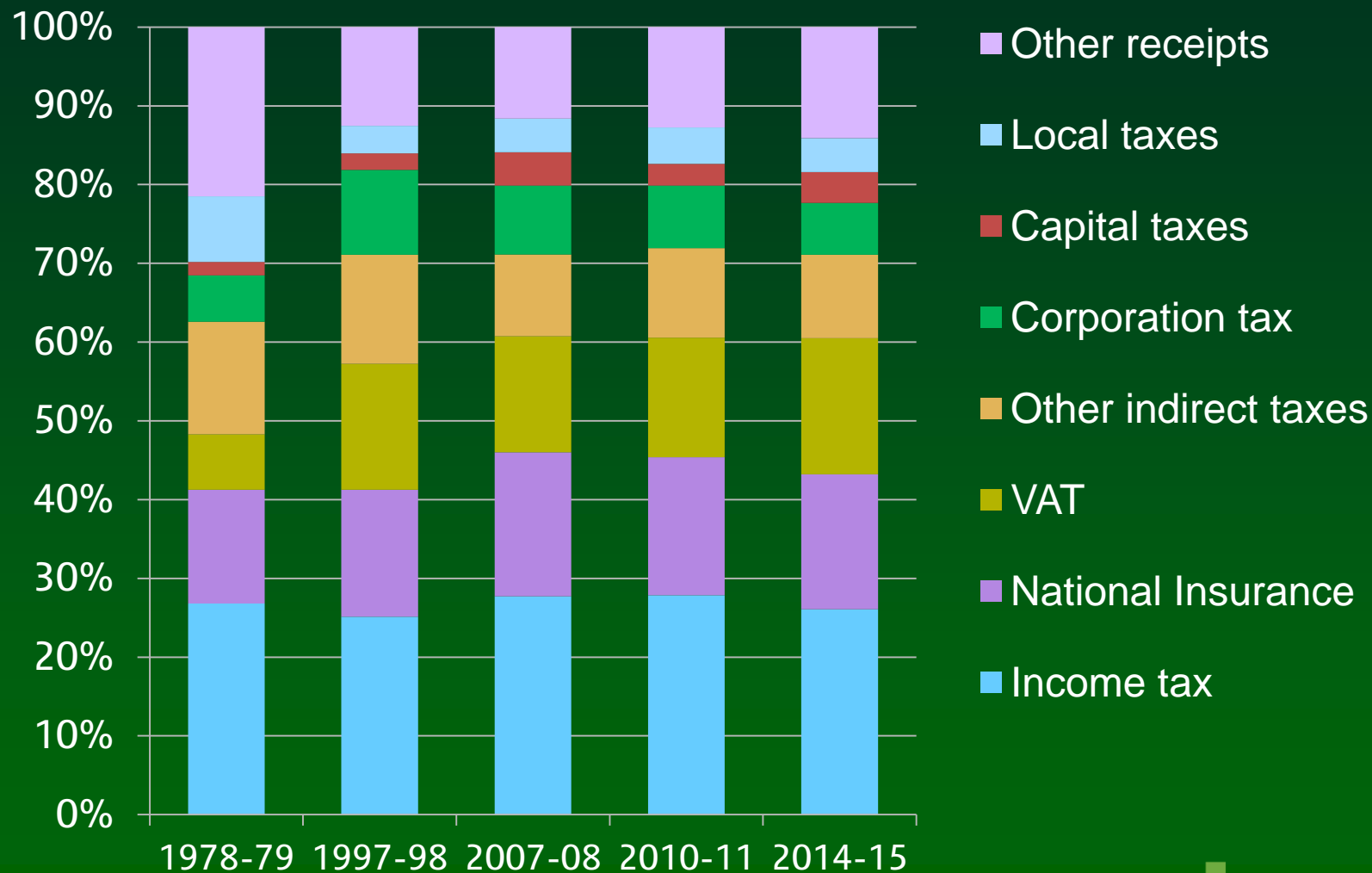
Tax revenue as a share of GDP



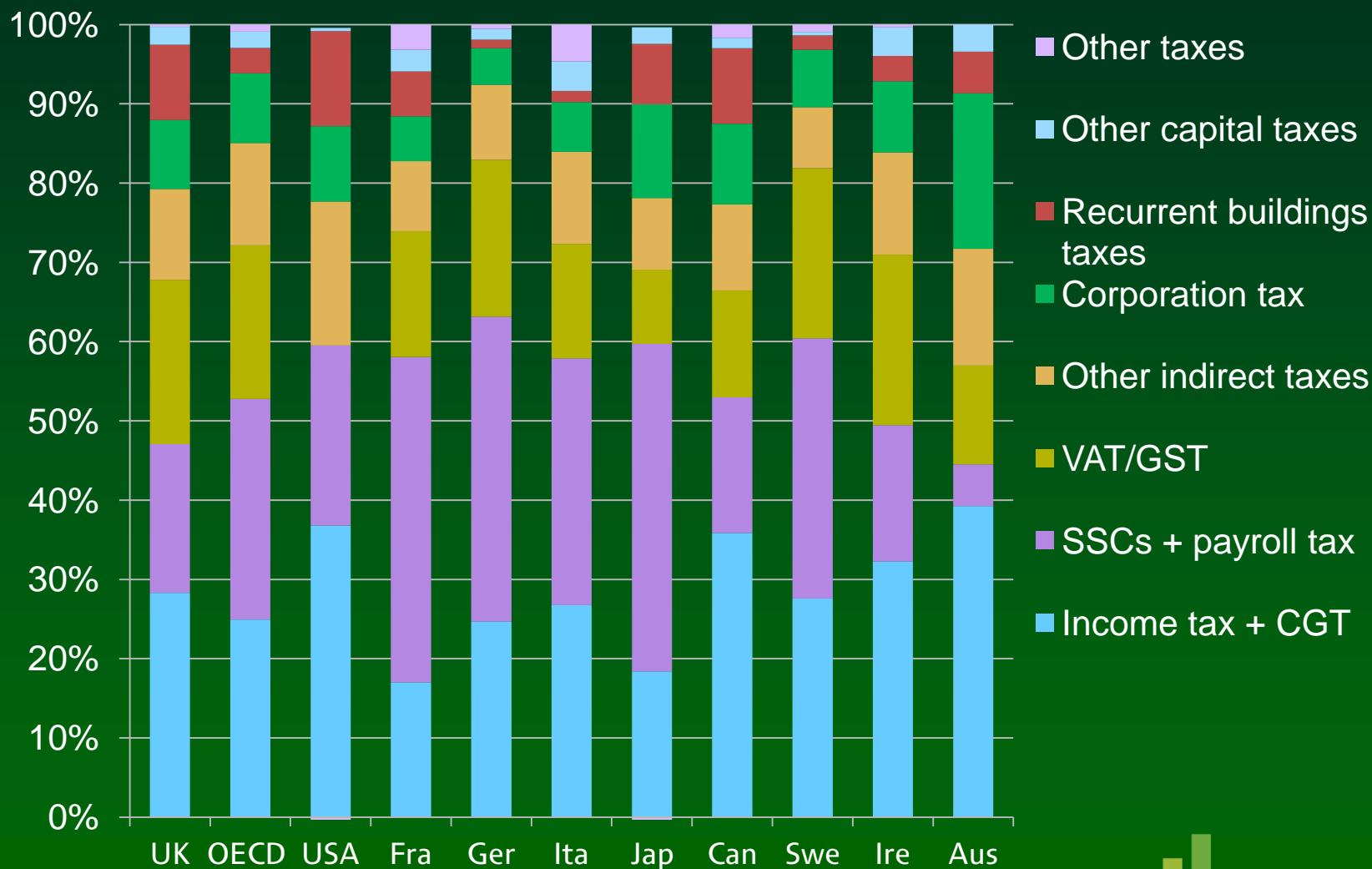
Composition of revenue, 2014-15 forecast



Composition of revenue

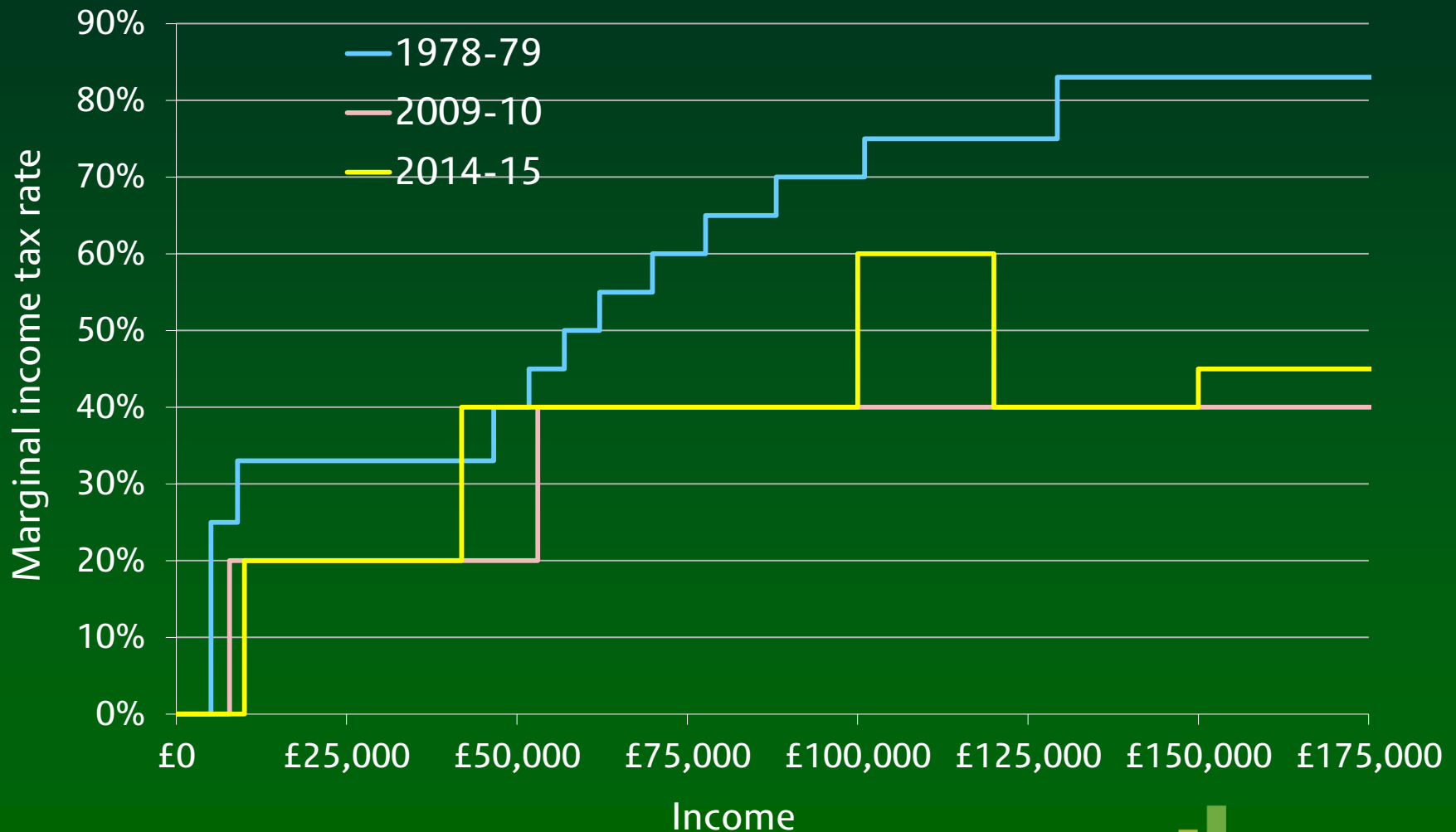


Composition of tax revenue, 2011



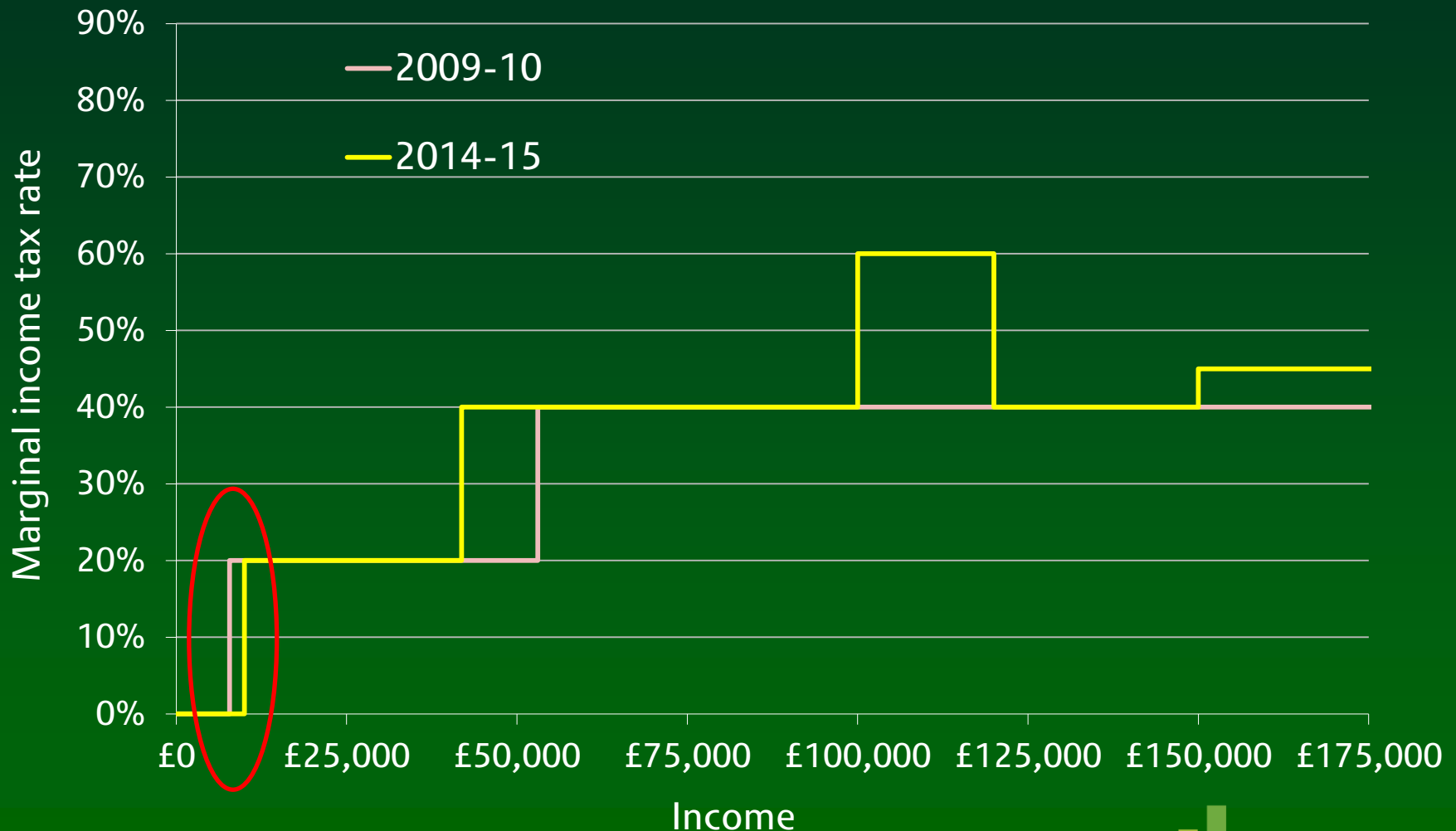
Income tax schedule

For earned income, April 2014 prices



Income tax schedule

For earned income, April 2014 prices

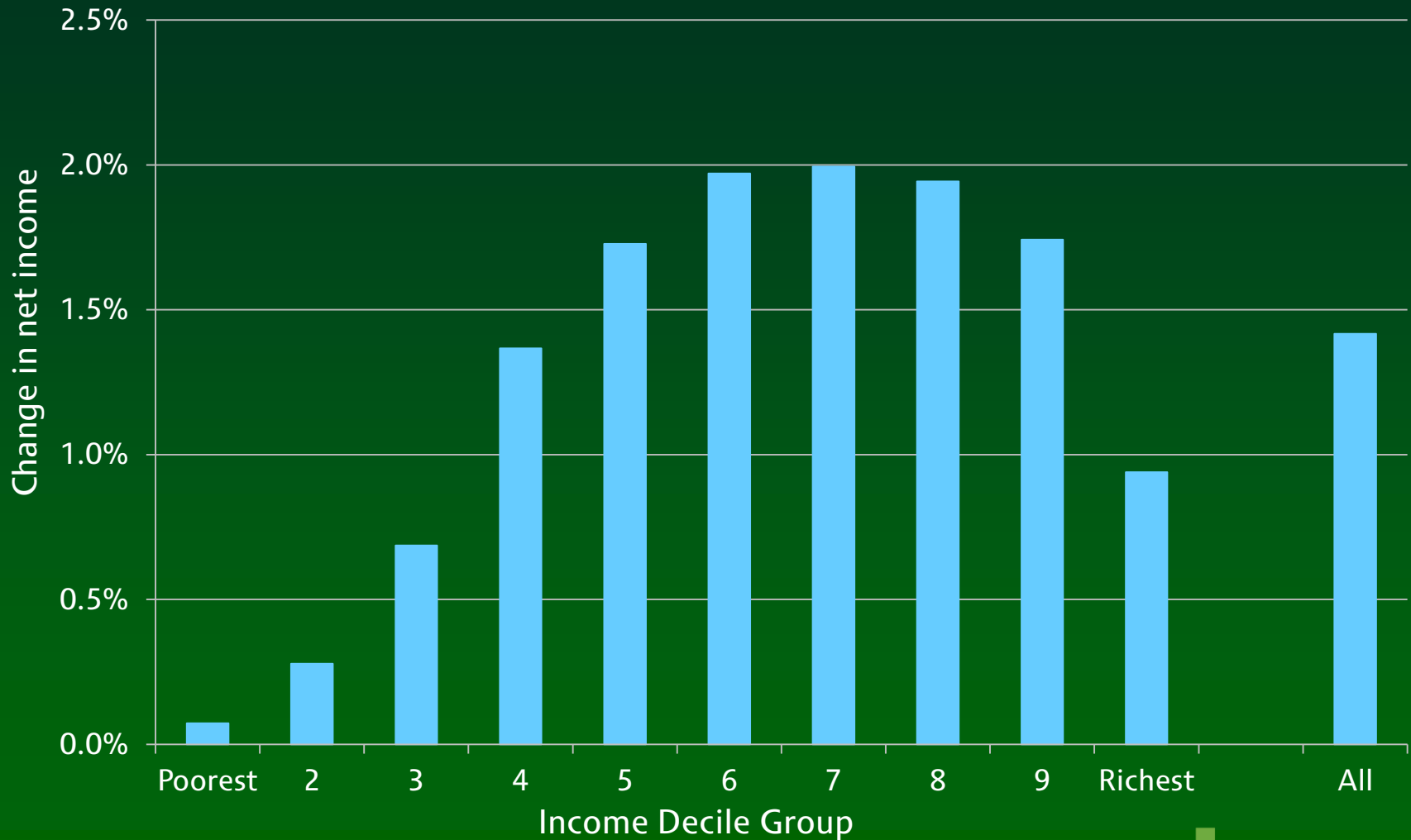


Recent reforms to the income tax schedule

- Personal allowance to reach £10,500 in 2015-16
 - £2,855 higher than plans govt inherited – costs over £12 billion per year
 - Basic-rate taxpayers gain £571 a year; 2.4 million taken out of income tax

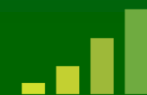
Increasing the personal allowance

Distributional impact of an increase from £10,000 to £12,500



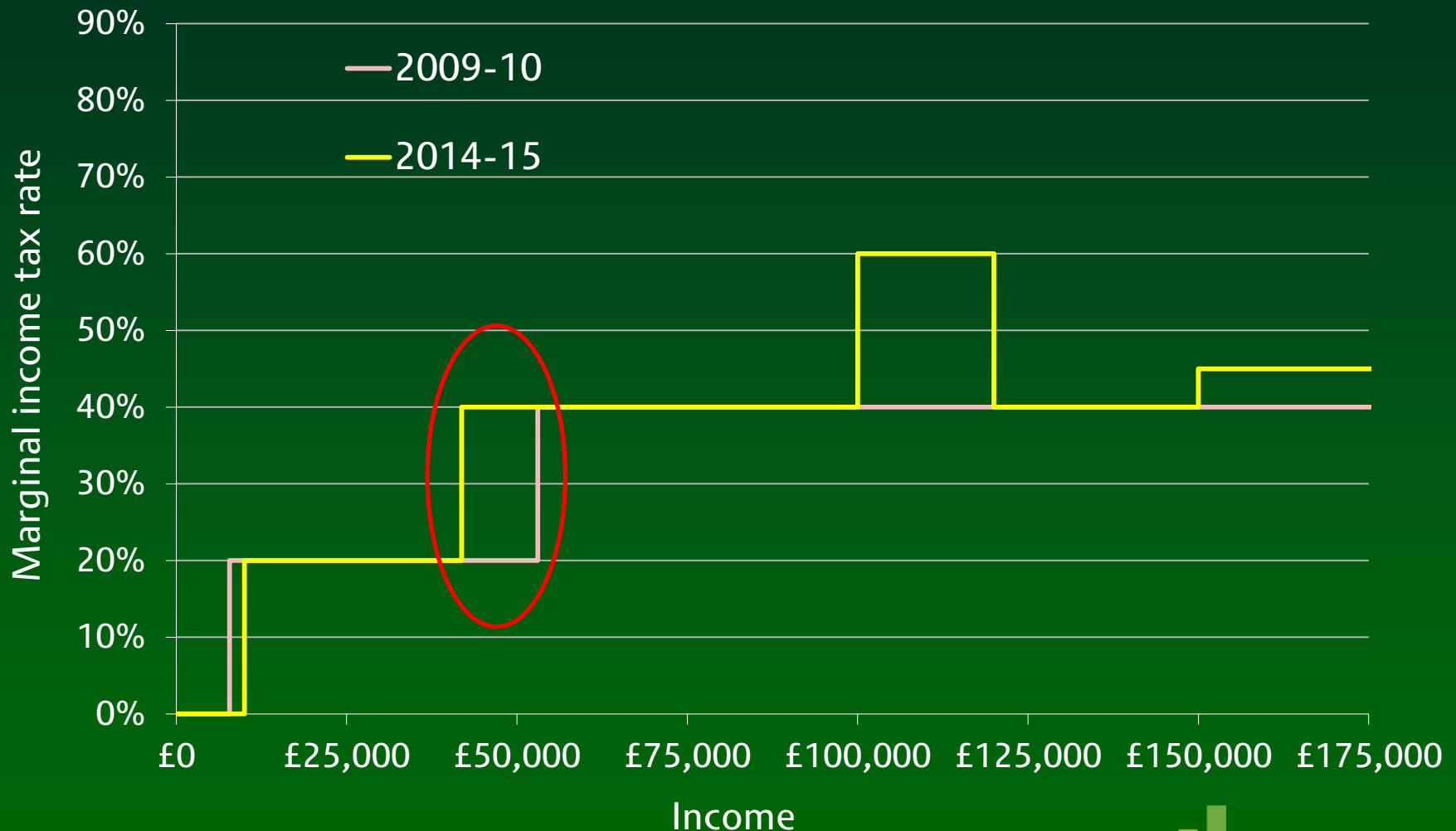
Assumes higher-rate threshold held constant.

Source: Figure 7.4 of *The IFS Green Budget: February 2014*



Income tax schedule

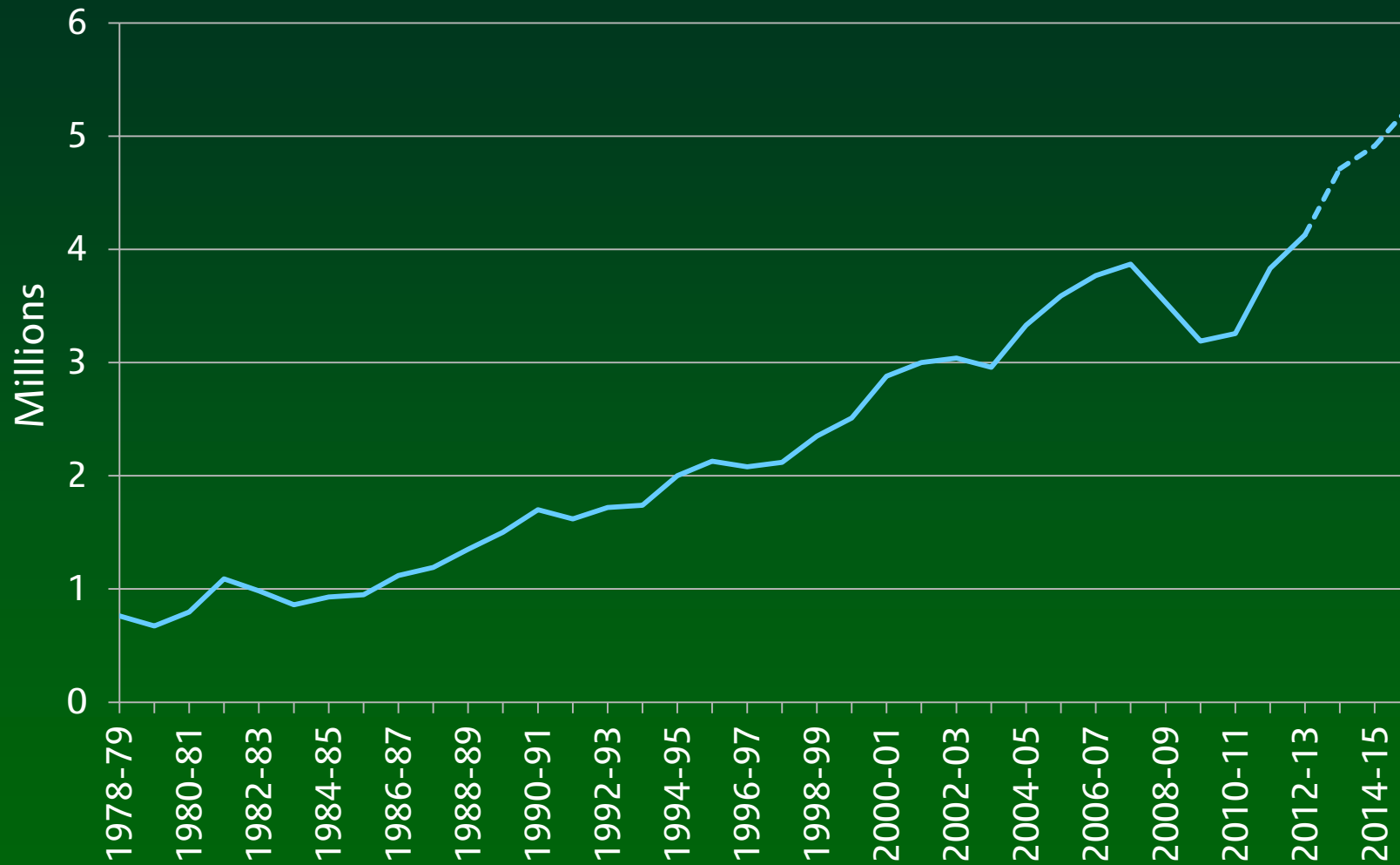
For earned income, April 2014 prices



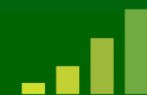
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Number of higher-rate taxpayers

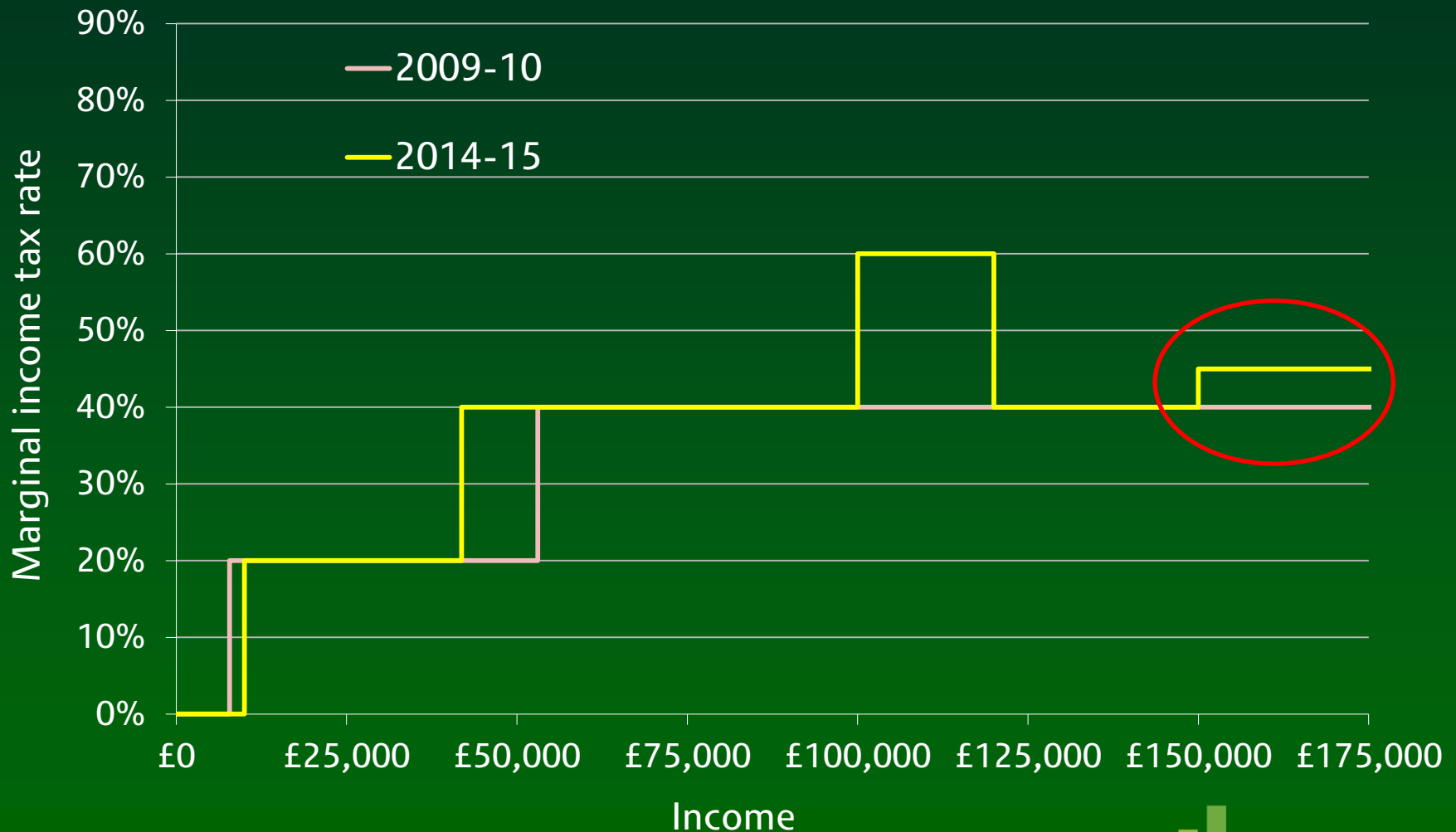


Note: includes additional rate taxpayers.
Source: HMRC Statistics and IFS projections



Income tax schedule

For earned income, April 2014 prices

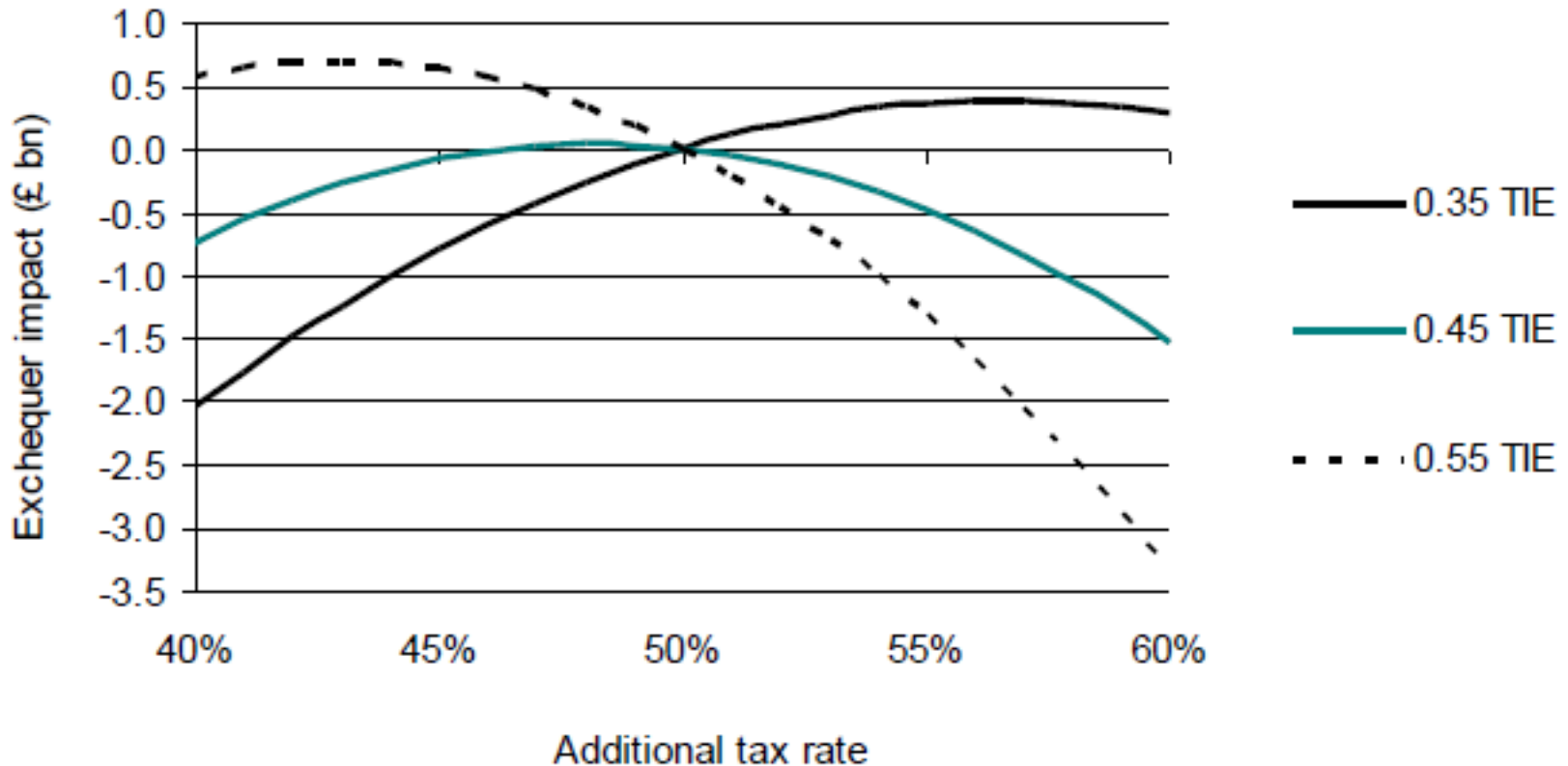


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- 50% rate introduced above £150,000, then reduced to 45%
 - The 1% of taxpayers affected provide 30% of income tax revenue
 - Best guess is little revenue effect, but no-one really knows

Top tax rate and revenue: the government's view

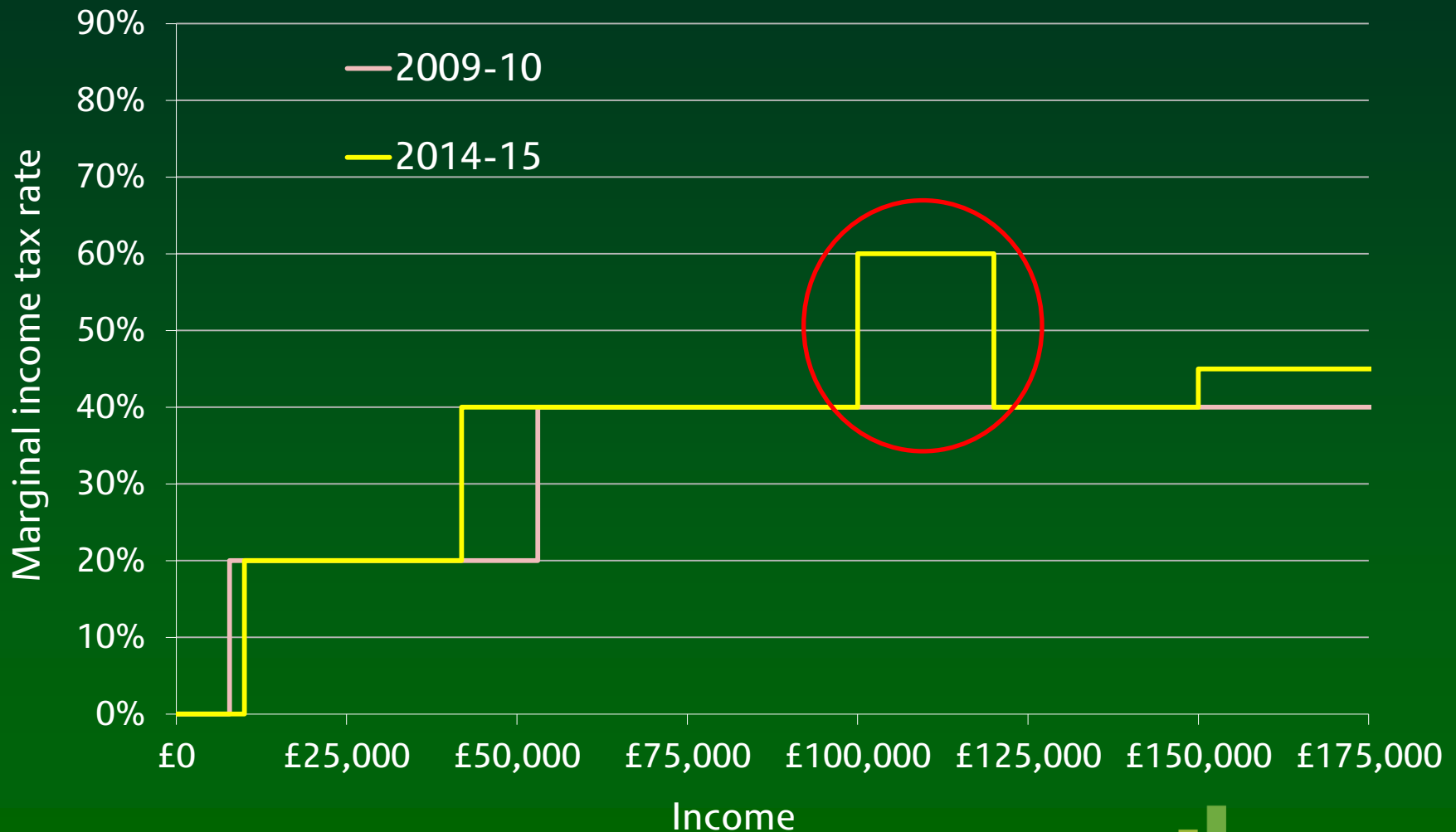
Chart A1: The additional rate Laffer curves



Source: HMRC (2012), *The Exchequer effect of the 50 per cent additional rate of income tax*

Income tax schedule

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 - The 1% of taxpayers affected provide 30% of income tax revenue
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- Personal allowance gradually withdrawn once income exceeds £100k
 - Equivalent to a 60% tax band – why not call it that?
 - Bizarre shape for the rate schedule!

Income tax treatment of the family

- Shift from (largely) joint to individual taxation in 1990
 - Part of an international trend
- Abolition of additional allowances for marriage and children
- Shift towards providing support for low-income families via tax credits
 - 2003 tax credit reforms created big practical problems
- Tax credits now starting to be merged with several means-tested working-age benefits into a single ‘universal credit’
 - But implementation problems → running far behind schedule
- Income tax now starting to depend on family circumstances again
 - Used to withdraw child benefit from those with high incomes
 - 10% of tax allowance transferable to basic-rate spouse from April 2015

Collecting income tax

- 90% collected via Pay-As-You-Earn (PAYE)
 - Exact cumulative deduction of tax by employers
 - So two-thirds of taxpayers don't fill in a tax return
 - Unusual internationally
 - Works well for most, but goes badly wrong for a sizeable minority
 - Similar system withholds basic-rate tax from bank interest
- Self-assessment (tax returns) for those with more complex affairs
- Real-Time Information (RTI) reporting introduced in April 2013
 - Employers must report salaries when paid, not at end of year
 - Partly so government can use information to adjust benefit awards
 - 'Temporary' easing of requirements for many small firms

National Insurance contributions (NICs)

- Simple rate schedule, applied to earnings only:
 - Employers: 13.8% of earnings above £153 per week
 - Employees: 12% between £153 and £805 per week; 2% above that
 - Self-employed pay much less
- Since April 2014, each employer gets £2,000 deduction
- Just another income tax – not really social insurance
 - Link between ‘contributions’ and benefits small and shrinking
 - Could be transformed into a true social insurance scheme. Otherwise...
- Should be merged with income tax: a major simplification
- Not *perceived* as just another income tax – leads to bad policymaking
 - Why increase income tax allowance but not NICs threshold?
 - 2001 election: promised not to increase income tax, then increased NICs



Income tax and NICs treatment of saving

- By default, savings income subject to normal income tax, but not NICs
 - Lower income tax on dividends, reflecting corporation tax already paid
- However...
- Individual Savings Accounts (ISAs) are tax-free
 - Can put up to £15,000 per year into these, in cash or shares
- No tax on imputed income from owner-occupied housing
- Pensions:
 - Income tax relief on contributions, up to a limit which has been reduced in recent years (NICs relief on employer contributions only)
 - No tax on income within the fund
 - Income tax (but not NICs) on money withdrawn except a 25% lump sum
- So in practice most savings are tax-free
 - And pensions are subsidised in ill-designed ways

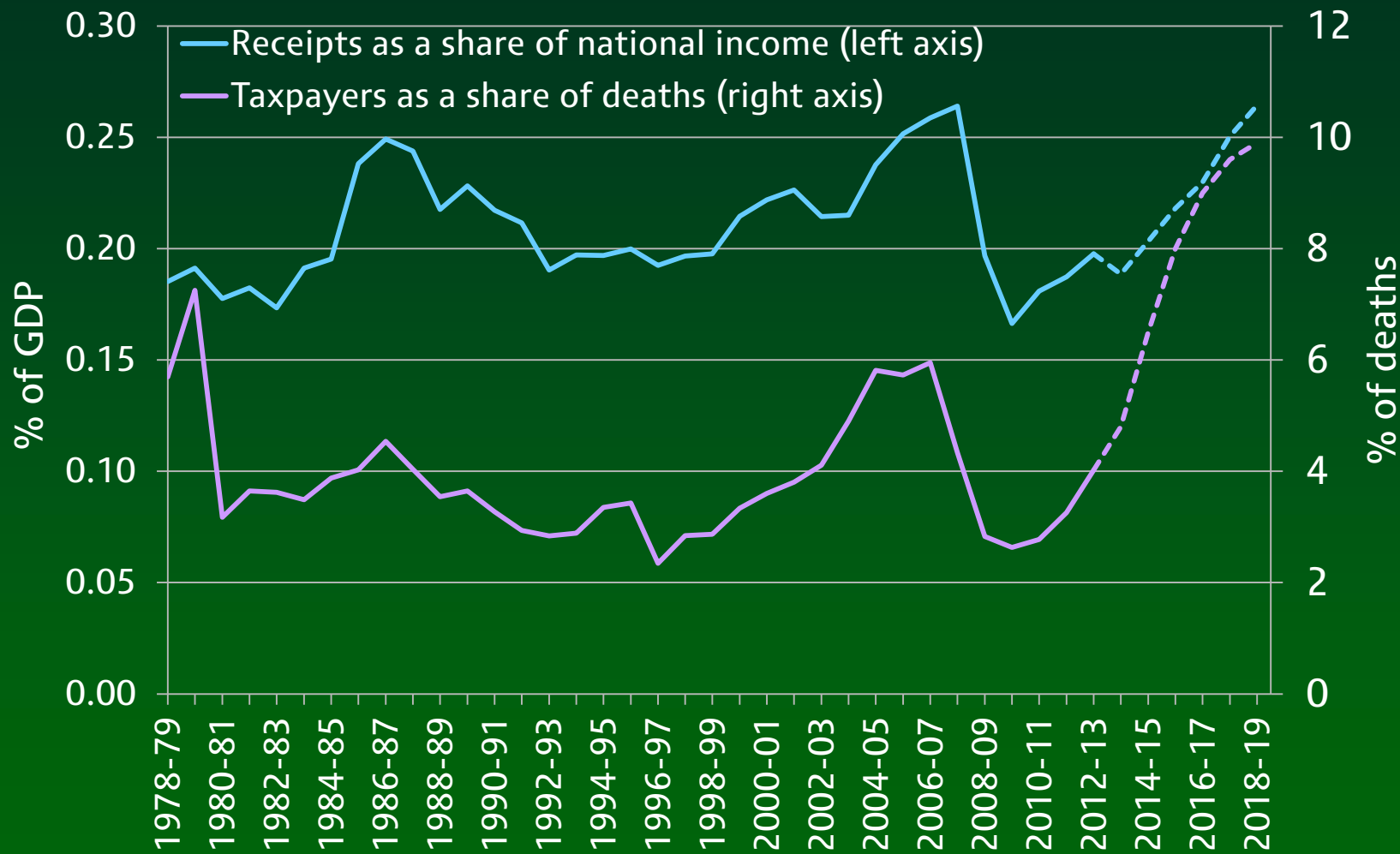
Capital gains tax

- Levied on gains above £11,000 realised in a particular year
- 18% for basic-rate taxpayers, 28% for higher-rate taxpayers
 - Only 10% for first £10m of lifetime gains on owner-managed businesses
- Policy has gone round in circles
 - Tension between encouraging investment and preventing avoidance
- Exemptions:
 - Main homes, pensions, ISAs
 - Any gains unrealised at death

Inheritance tax

- Levied at 40% on estates above £325,000
 - Since 2007, any unused allowance passed to surviving spouse → £650,000
- Threshold frozen from 2009-10 to 2017-18: 22% real-terms reduction
 - Despite Prime Minister's stated desire to increase the threshold

Inheritance tax



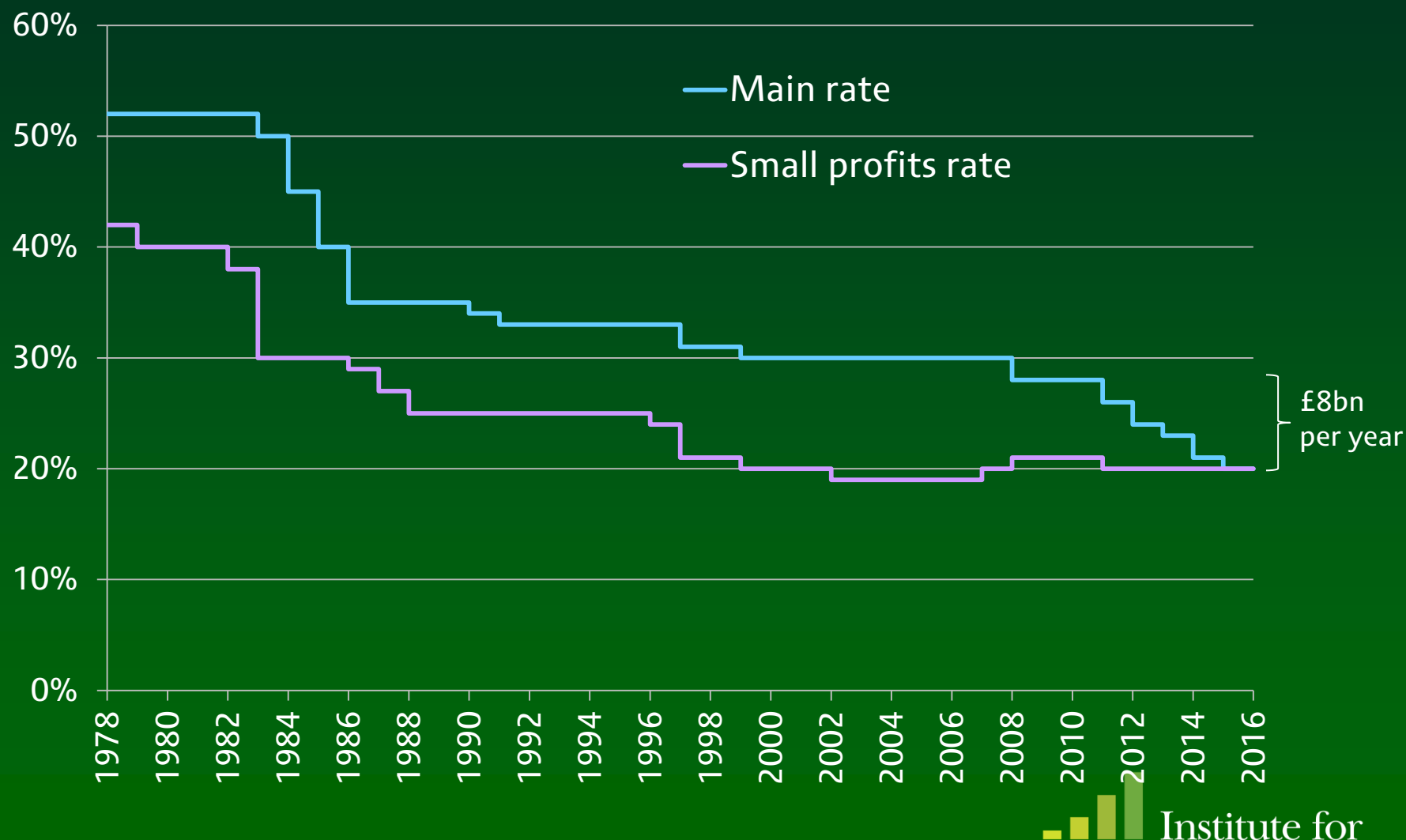
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 - Despite Prime Minister's stated desire to increase the threshold
- Gifts made in the seven years before death taxed on a sliding scale
 - Gifts made earlier than that escape tax altogether
- Exemptions: spouse, charities; agricultural land, some business assets
- Easier to avoid for the very wealthy than the moderately wealthy
- Unpopular
- Should either abolish or transform into tax on lifetime receipts
 - At the very least, remove some of most obvious avoidance opportunities

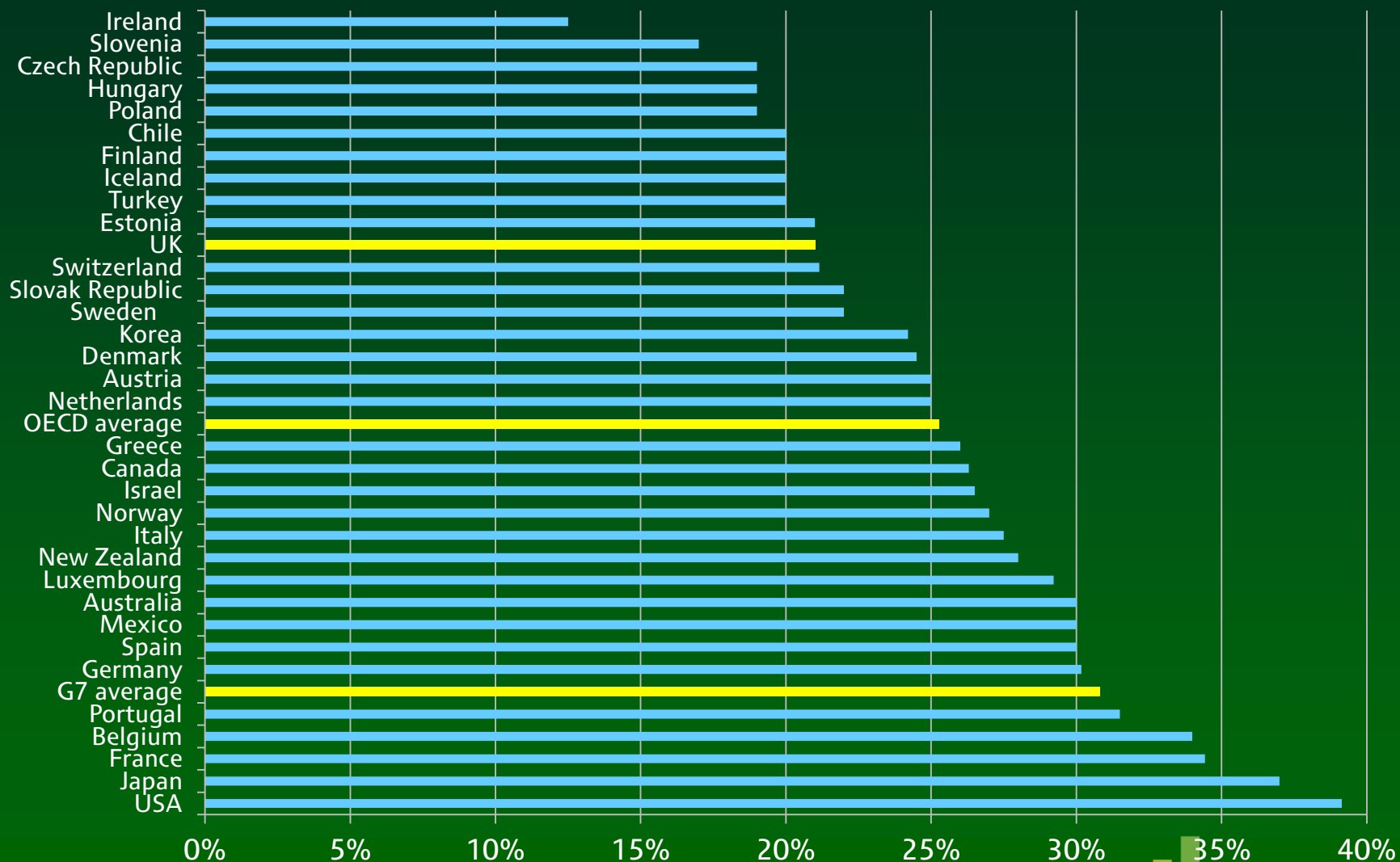
Corporation tax

- Revenue heavily reliant on a few big companies
 - 390 companies (<0.1% of taxpayers) accounted for 45% of revenue in 2012-13
- Unusually, current government published a ‘corporate tax roadmap’ soon after taking office and has largely stuck to it
- Recently moved to exempting foreign-source income from tax
 - Except some ‘passive’ income from low-taxed subsidiaries
- Concern over debt-equity bias, but little done about it

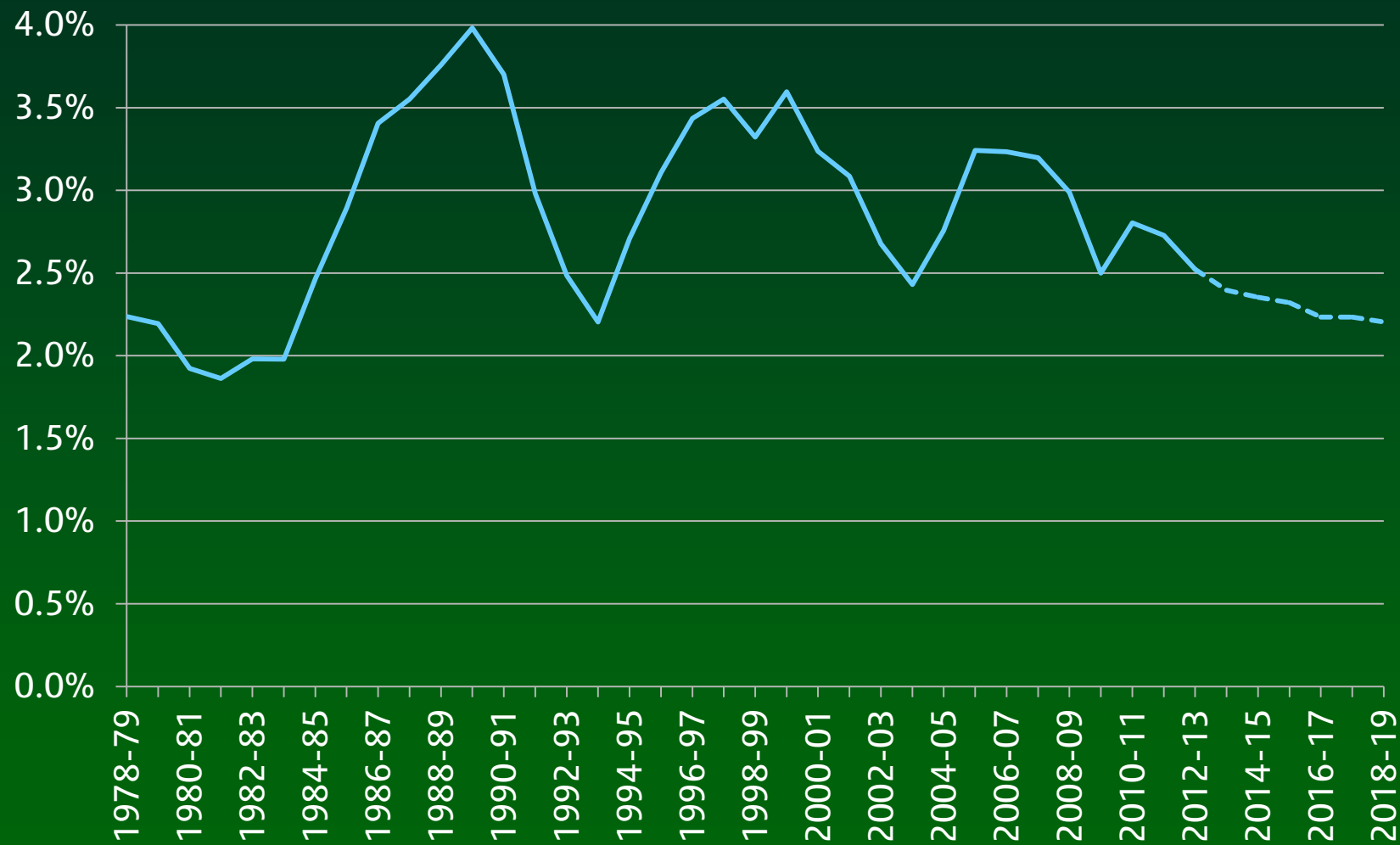
Corporation tax rates



Corporate income tax rates, 2014



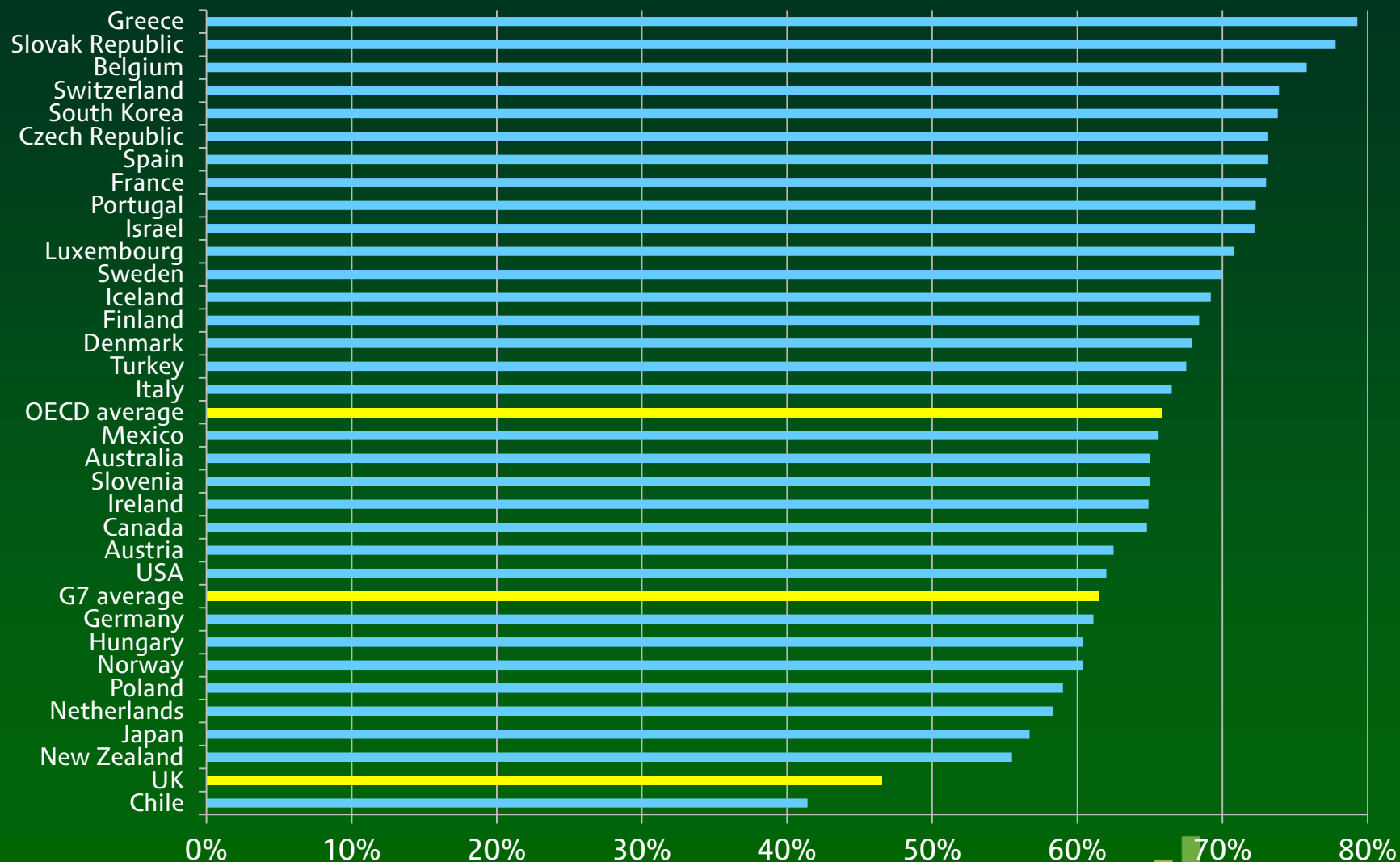
Corporation tax revenue, % of GDP



Capital allowances for depreciation

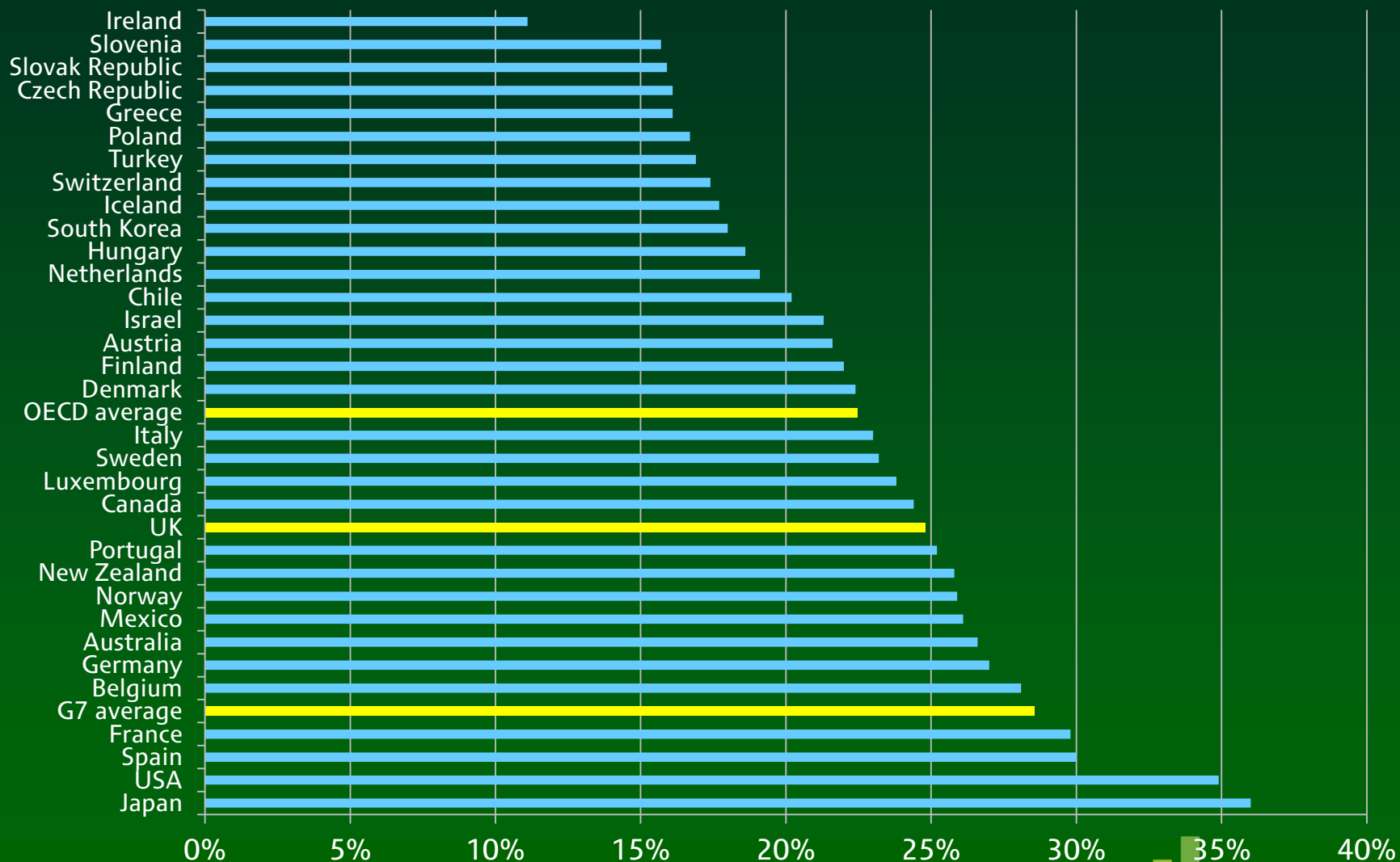
- Allowances vary between asset classes
 - Set down in law, not based on accounting depreciation
- Gradually made less generous
 - In line with international trend towards broadening corporate tax base
 - But UK's allowances look stringent by international standards

Present value of capital allowances, 2012



Note: weighted average of selected investments. See Bilicka and Devereux (2012), *CBT corporate tax ranking 2012* for details and other assumptions.

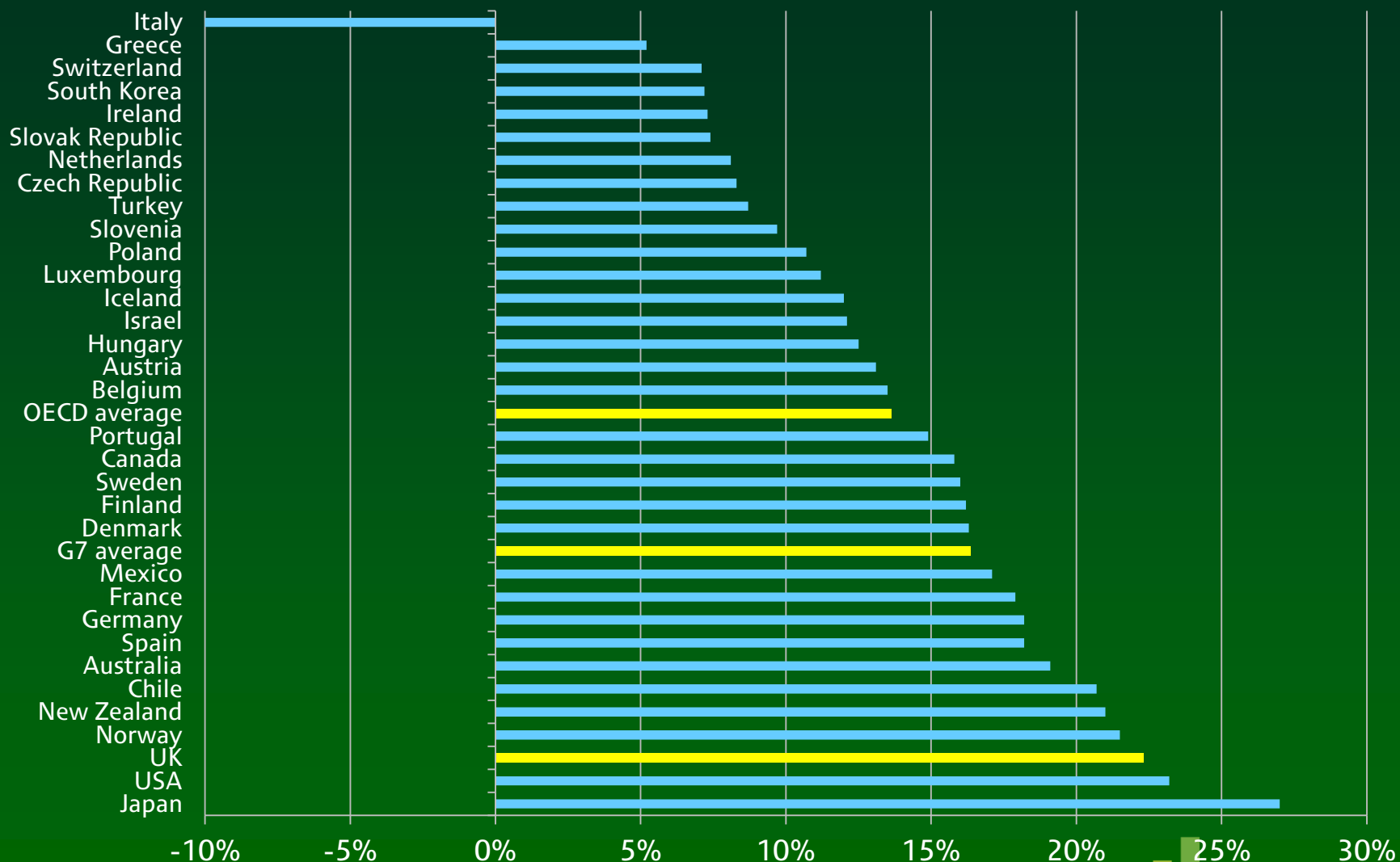
Effective average tax rates, 2012



Note: weighted average of selected investments. See Bilicka and Devereux (2012), *CBT corporate tax ranking 2012* for details and other assumptions.



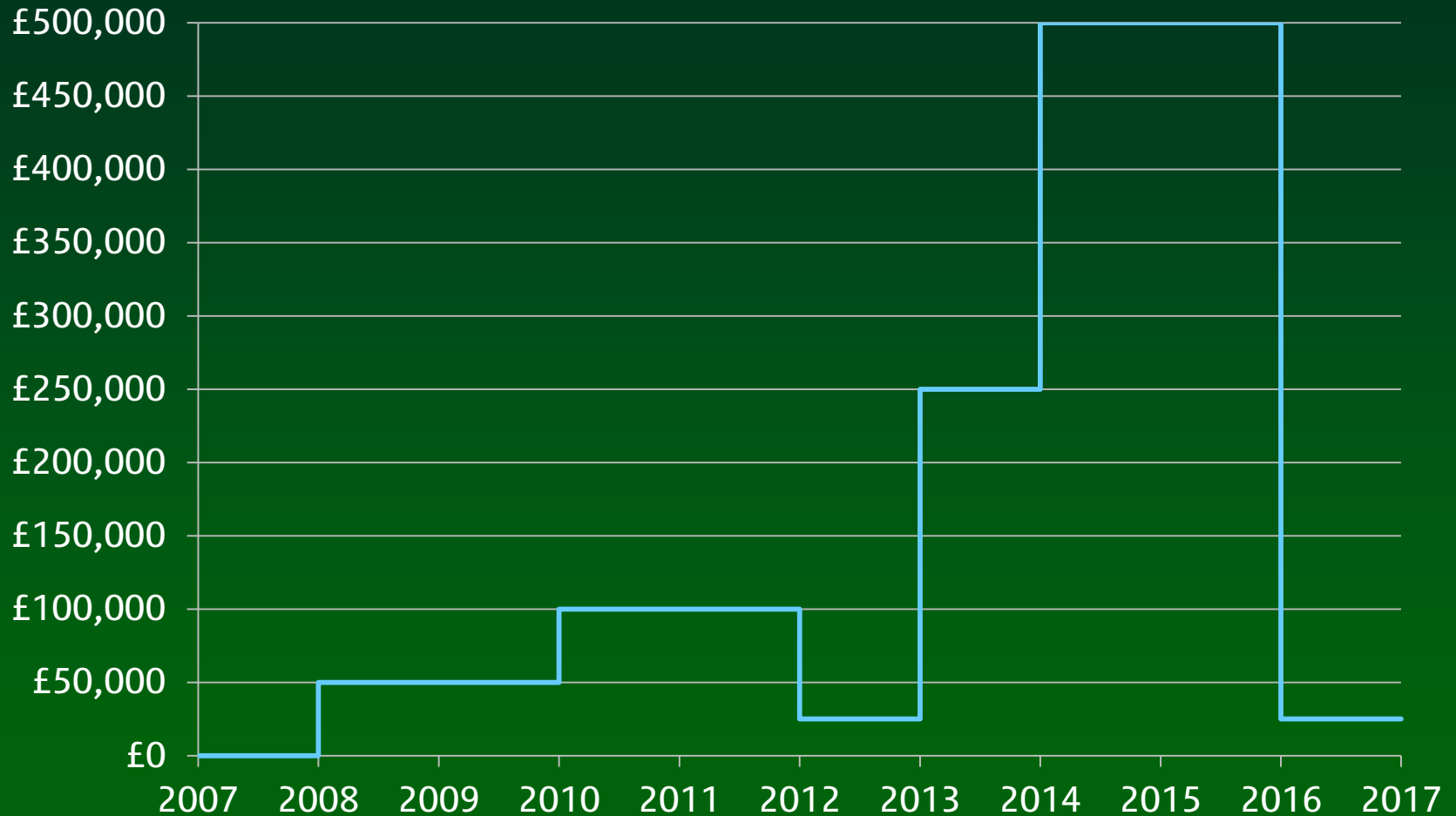
Effective marginal tax rates, 2012



Capital allowances for depreciation

- Allowances vary between asset classes
 - Set down in law, not based on accounting depreciation
- Gradually made less generous
 - In line with international trend towards broadening corporate tax base
 - But UK's allowances look stringent by international standards
- Since 2008, Annual Investment Allowance writes off some plant and machinery investment immediately
 - Generally covers all plant and machinery investment for small firms
 - Size of allowance has been very unstable

Annual investment allowance

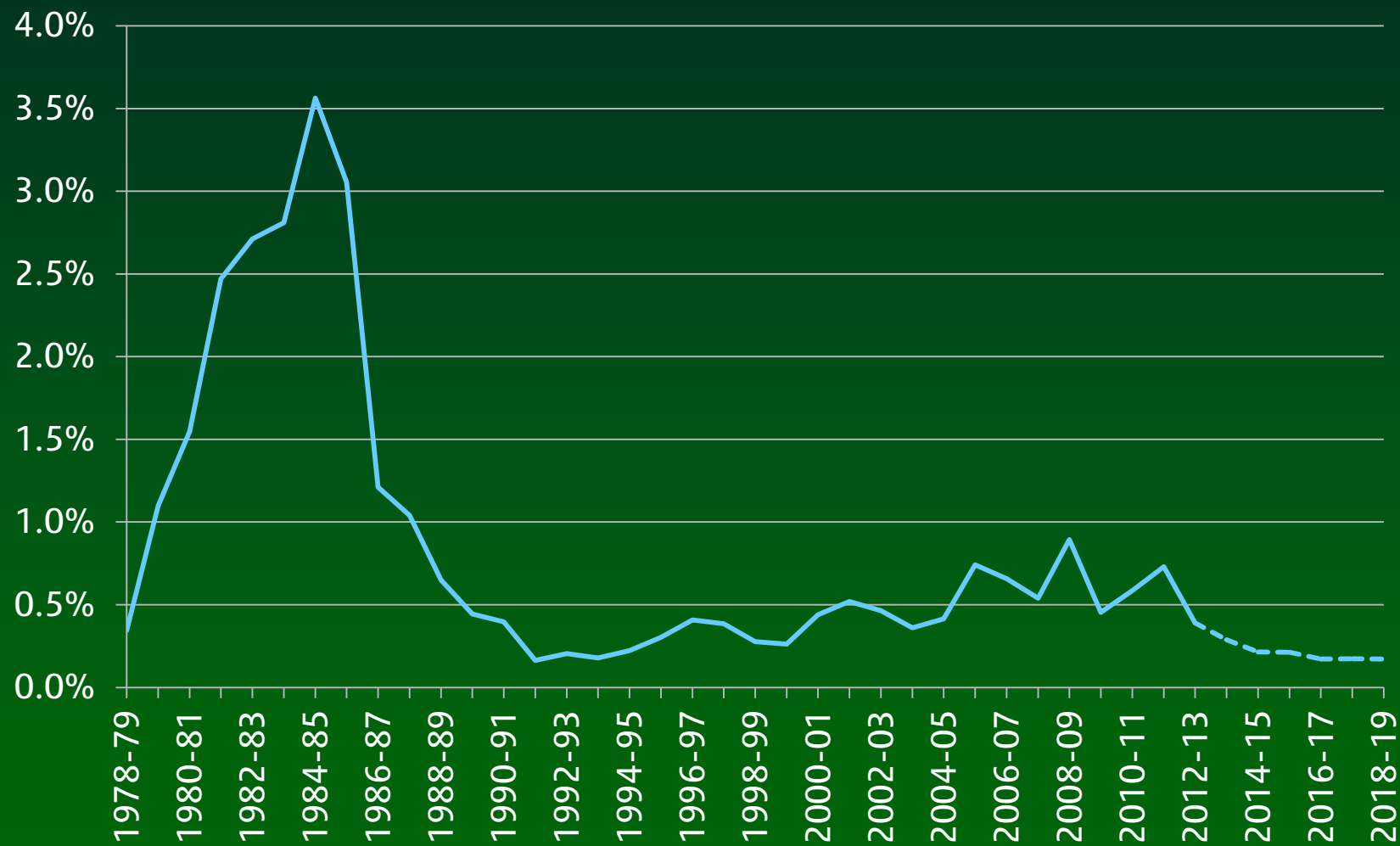


Tax treatment of intellectual property

- R&D relief
 - Introduced in April 2000 and expanded since
 - Additional relief over and above deducting 100% of R&D expenditure
 - More generous for small and medium-sized enterprises
- Patent Box
 - 10% tax rate on income from (products incorporating) patents
 - Being phased in from April 2013
 - One of 14 European countries to introduce such a 'box' for IP
 - May be well targeted at attracting mobile profits
 - Not well targeted at stimulating innovation
 - Big cost of apply to lots of income not generated by patent itself
 - Scope to avoid tax by including patented items in products



North Sea tax revenue, % of GDP



Tax treatment of North Sea oil & gas production

- Much higher rate of corporation tax, 62%
 - Plus petroleum revenue tax → 81% on profits from fields predating 1993
 - More generous capital allowances, generally 100%
- Both high rate and 100% allowances make sense
 - 100% allowances minimise discouragement to investment
 - Oil and gas are in fixed location → no need for rate to be competitive
- Policy in this area has been subject to frequent change
 - Instability here especially undesirable given long planning horizons
- Review of policy currently under way

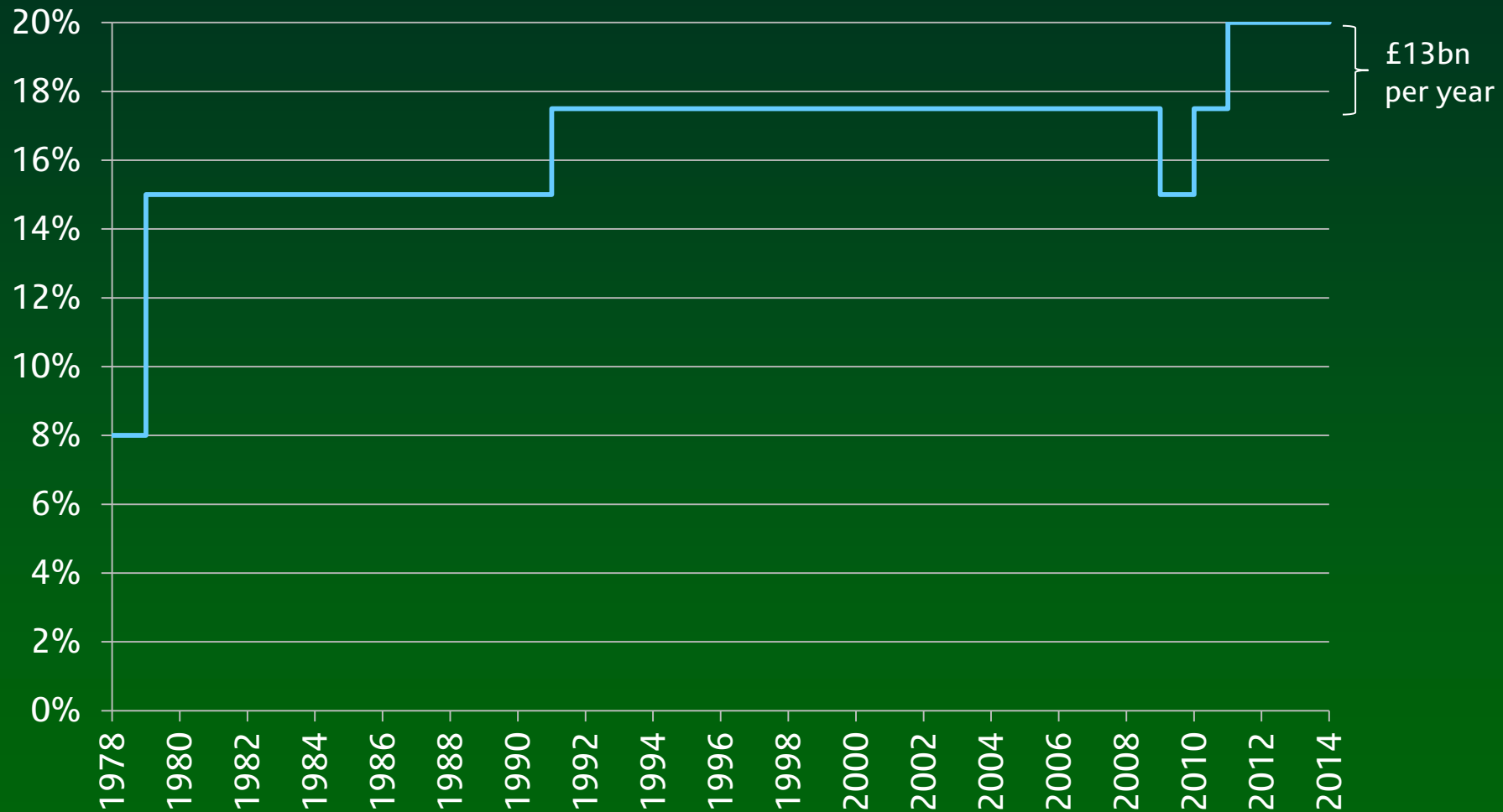
Base erosion and profit shifting (BEPS)

- A big political issue
 - Public anger that some firms sell a lot in the UK but pay little CT
- No-one knows how much revenue is being lost
- UK is enthusiastic participant in OECD project to counter BEPS
 - Tension with measures designed to attract profits to UK
- Likely to make some progress but not solve fundamental problem
 - How much of a multinational's profit derives from UK production?
 - 'Arm's-length' prices often not measurable

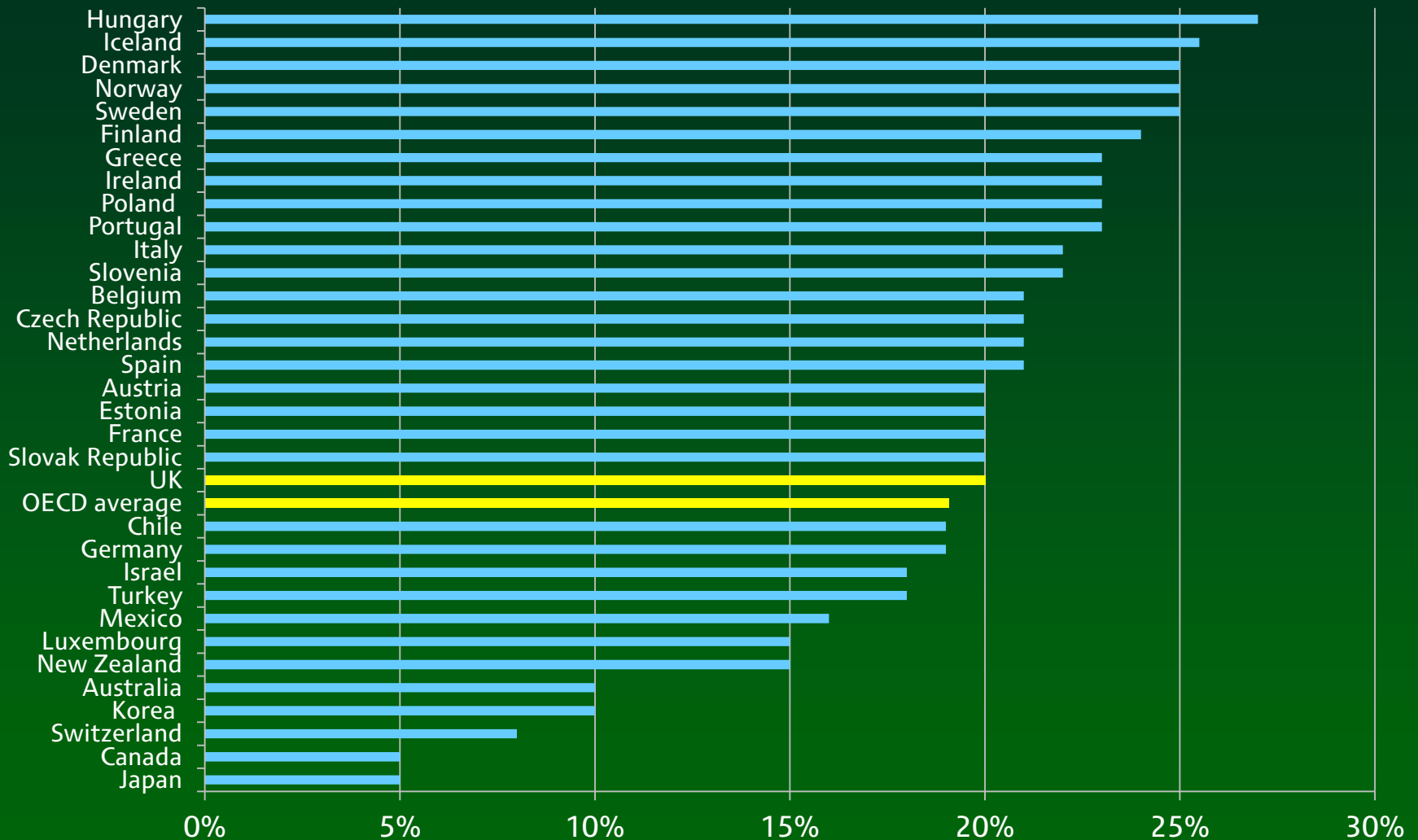
VAT

- The EU is a major player in VAT policy
 - All member states must have a VAT
 - Minimum 15% main rate
 - Use of reduced rates restricted
 - Scope of zero rates cannot be extended
 - Various exemptions mandatory
 - Standardised definitions, rules and procedures
- Still lots of scope for national variation within these boundaries

The main rate of VAT



VAT/GST rates, 2014

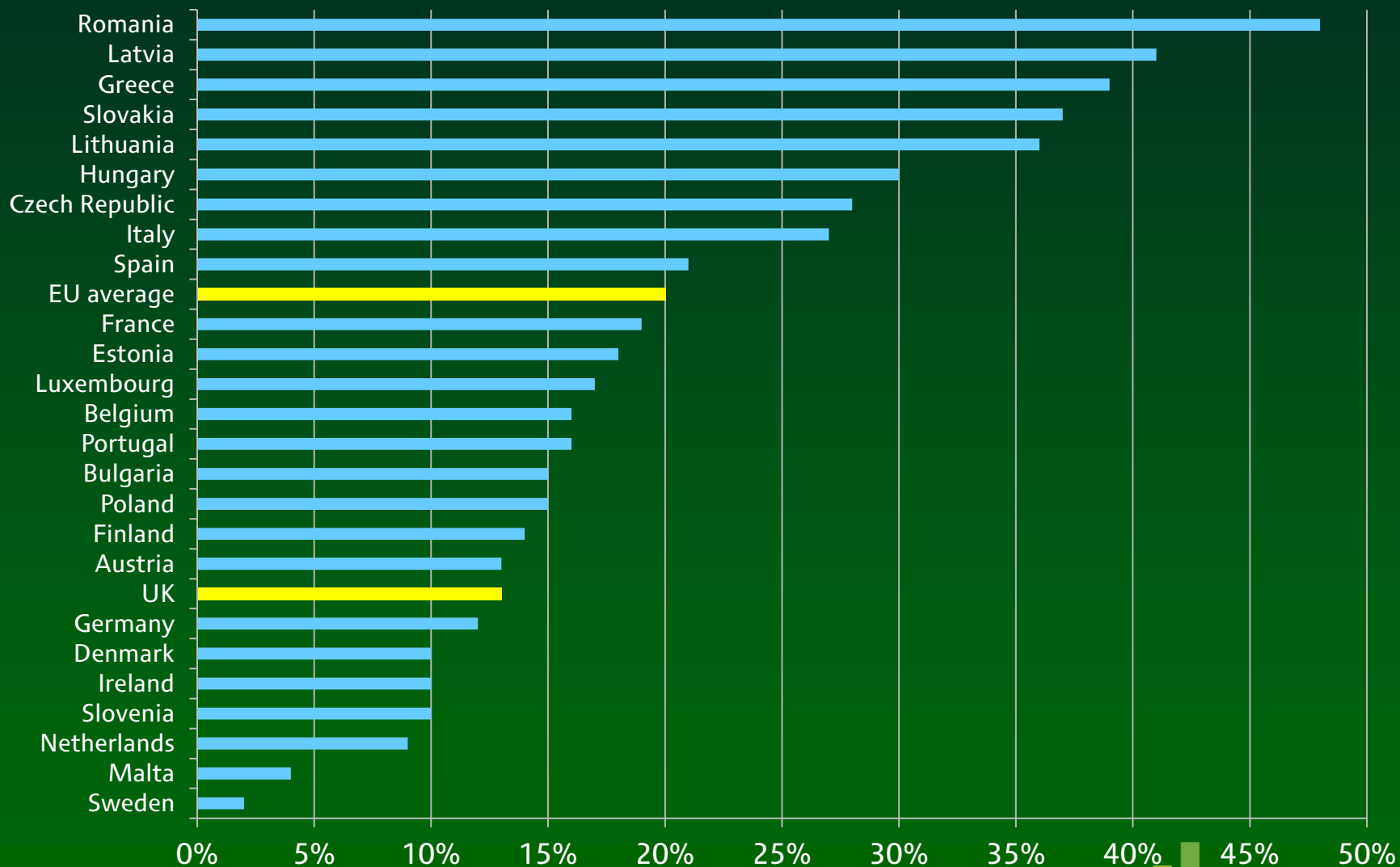


The VAT base

- UK applies a zero rate to more items than almost any other country
 - Most food, water, books, children's clothes, transport, new housing...
 - Cost £40bn in 2013-14 (vs. total VAT revenue of £107bn)
 - A complex and distortionary way to achieve redistribution – can do better!
- Reduced rate of 5% applies principally to domestic fuel
 - Looks particularly bad given environmental concerns
- Exemptions are the most damaging aspect of VAT
 - VAT paid on inputs cannot be recovered → distorts production patterns
 - Principally financial services, public services and the public sector
 - Mostly mandated by EU for practical reasons, but there are alternatives
 - Effective exemption via high registration threshold (£81,000) more defensible

Estimated VAT 'gaps' across the EU, 2011

% of theoretical liabilities



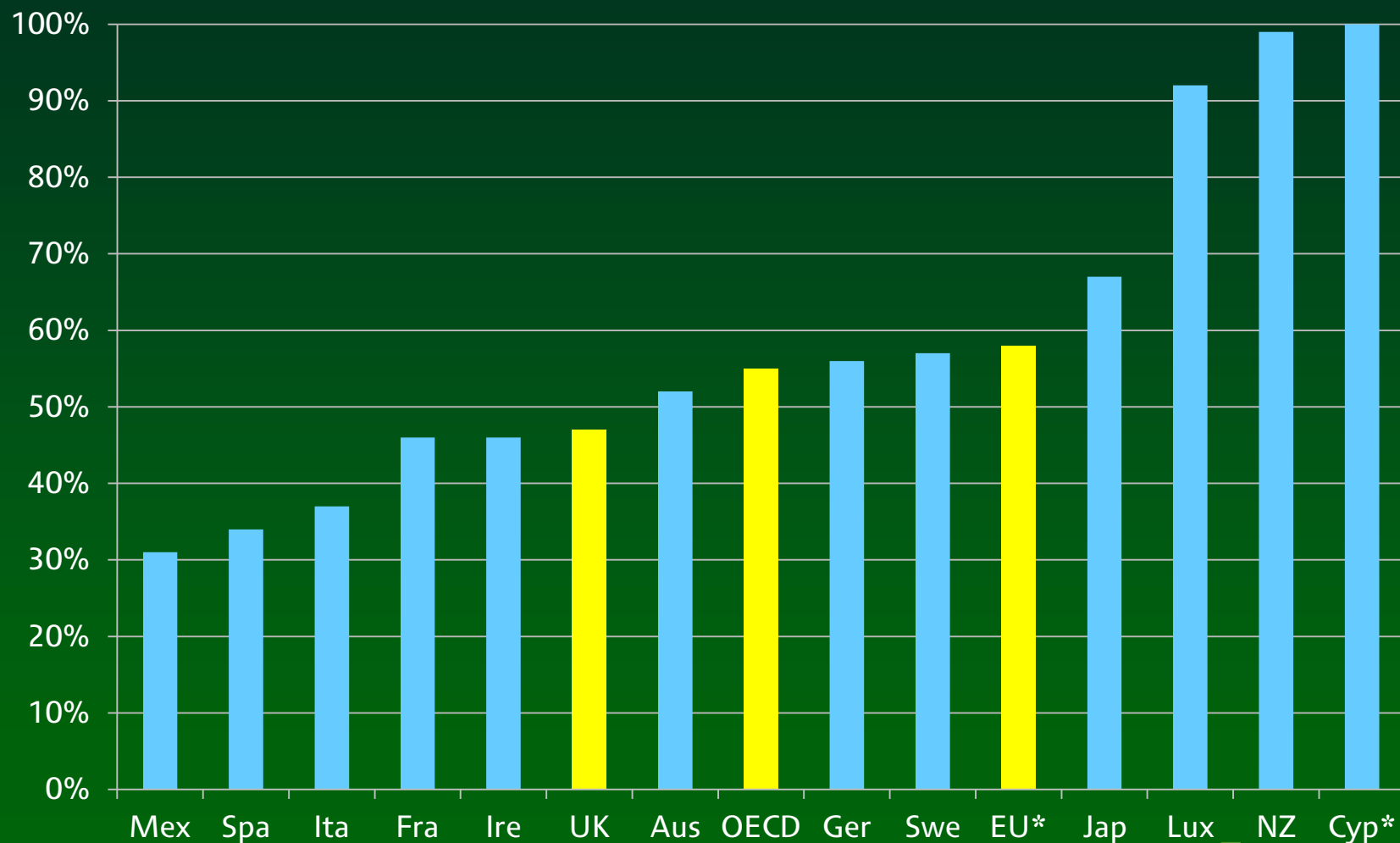
Source: CASE & CPB (2013), *Study to quantify and analyse the VAT Gap in the EU-27 Member States*

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VAT revenue ratios, 2009

VAT revenue as % of (main rate x total consumption expenditure)



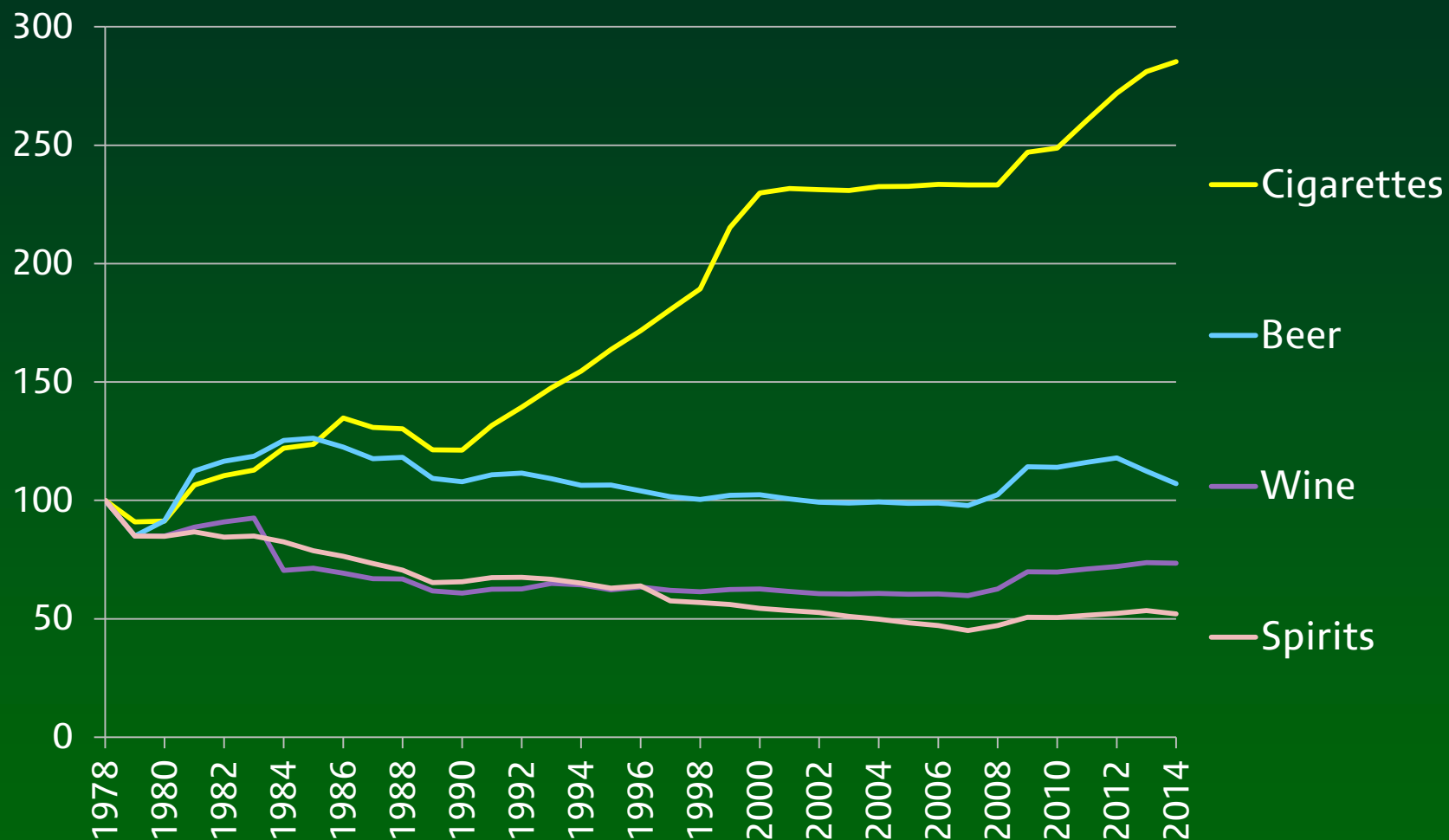
* 2008 figures



Other indirect taxes

- Alcohol and tobacco - £20.3bn
 - Among the highest rates in the EU

Real-terms alcohol and tobacco duties (1978=100)

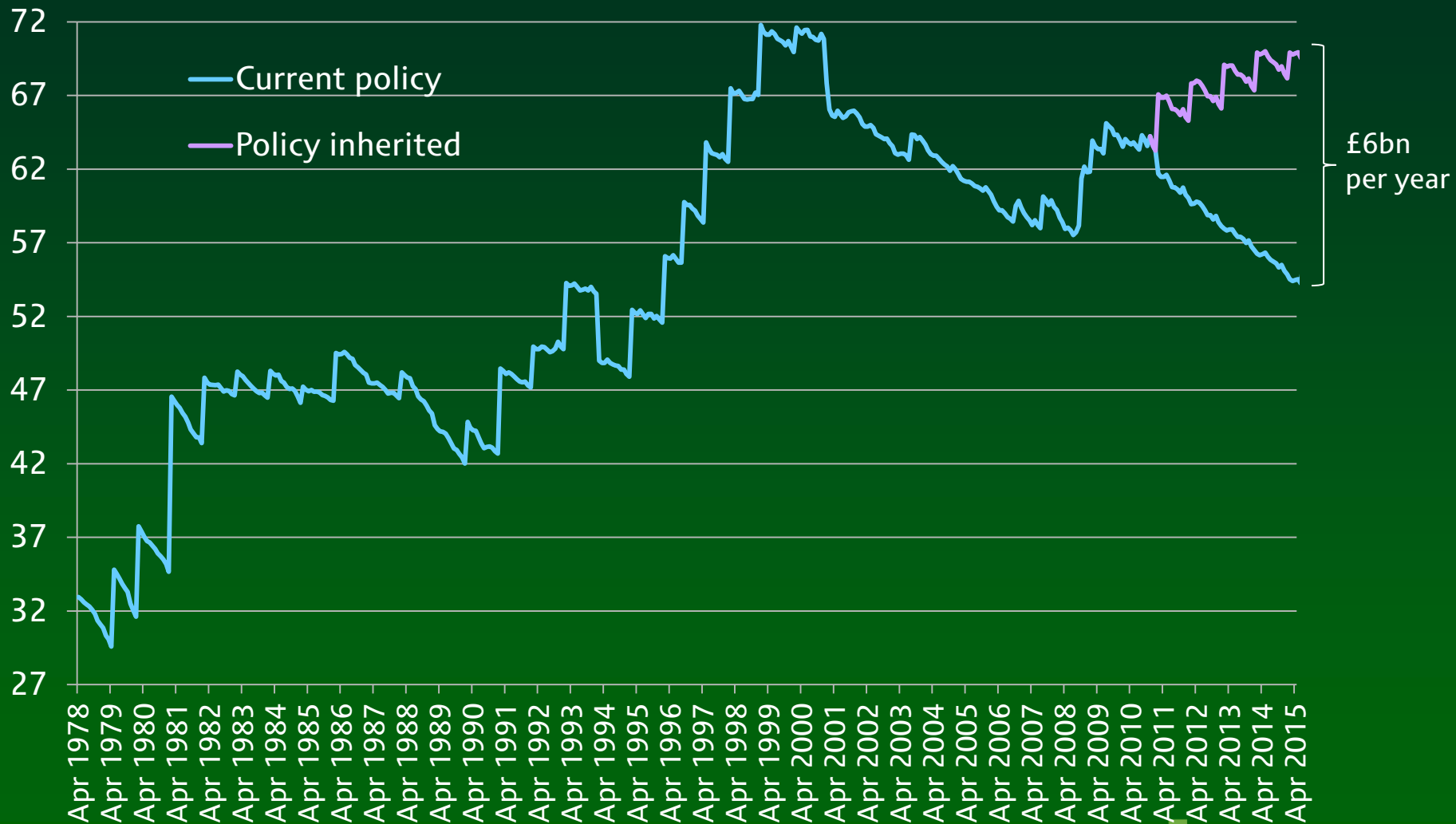


Other indirect taxes

- Alcohol and tobacco - £20.3bn
 - Among the highest rates in the EU
- Betting - £2.3bn
- Road fuel - £26.8bn

Real duty on a litre of petrol

Pence, April 2013 prices



Fuel duty: to uprate or not to uprate?

Dates uprating due before Budget 2011	Budget 2011	Autumn Statement 2011	June 2012	Autumn Statement 2012	Budget 2013	Autumn Statement 2013
Apr 2011						
Apr 2012						
Apr 2013						
Apr 2014						
Apr 2015						
Apr 2016						

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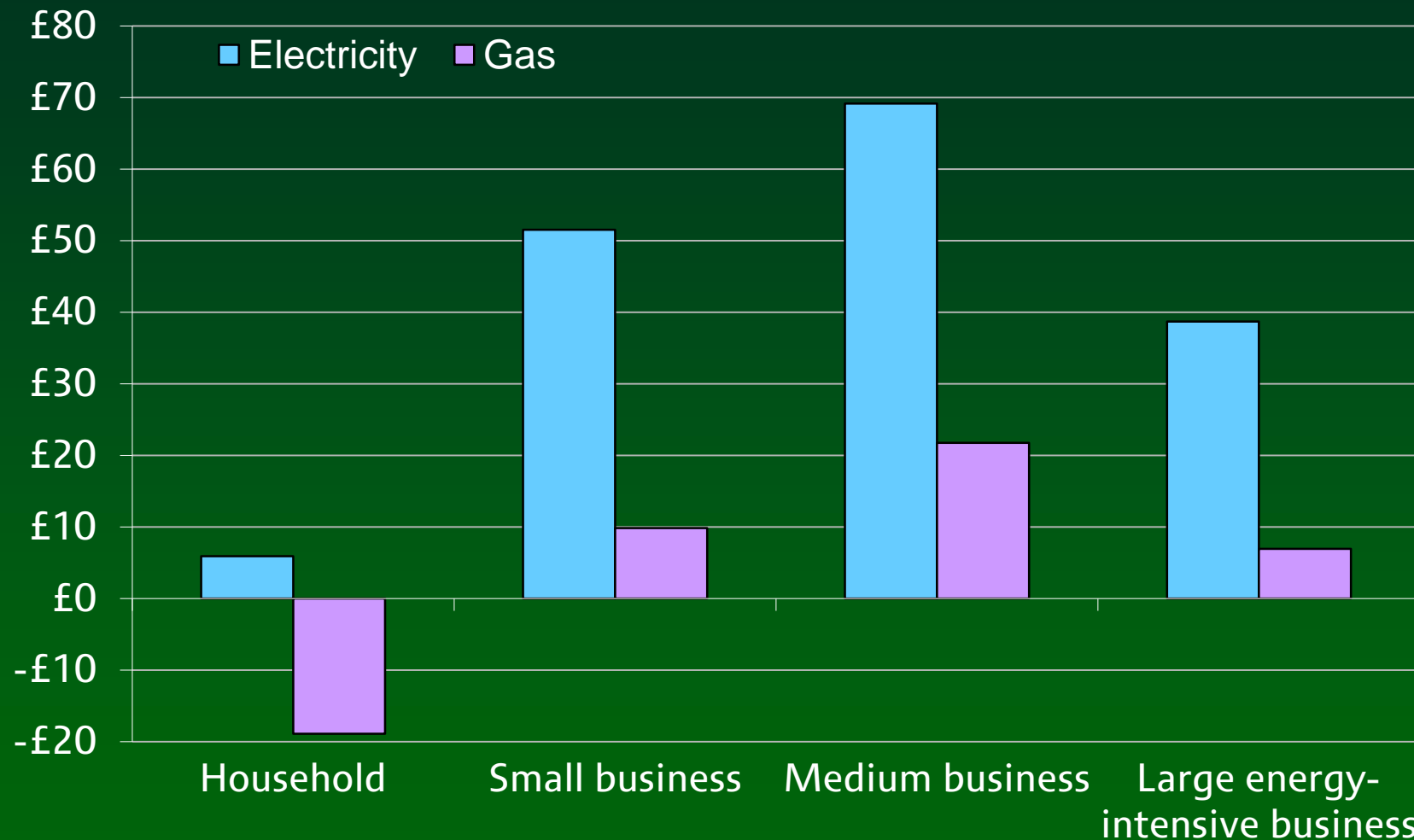
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Other indirect taxes

- Alcohol and tobacco - £20.3bn
 - Among the highest rates in the EU
- Betting - £2.3bn
- Road fuel - £26.8bn
 - Big swings of direction; no clear policy
 - Too high to reflect emissions; not well targeted at congestion
- Vehicle ownership - £5.9bn
- Small environmental taxes introduced more recently:
 - Air passenger duty (1994) - £3.2bn
 - Landfill tax (1996) - £1.3bn
 - Climate change levy (2001) - £2.0bn
 - Aggregates levy (2002) - £0.3bn
 - London congestion charge (2003) - £0.2bn

Implicit carbon tax, 2013

£ per tonne CO₂



Property and local taxes

Recap:

- No VAT on housing
- Income tax and CGT on rental housing but not owner-occupied
 - Though no tax relief on mortgage interest for owner-occupiers

3 taxes specifically on property:

- Council tax - £27.6bn
- Business rates - £26.9bn
- Stamp duty land tax - £12.7bn

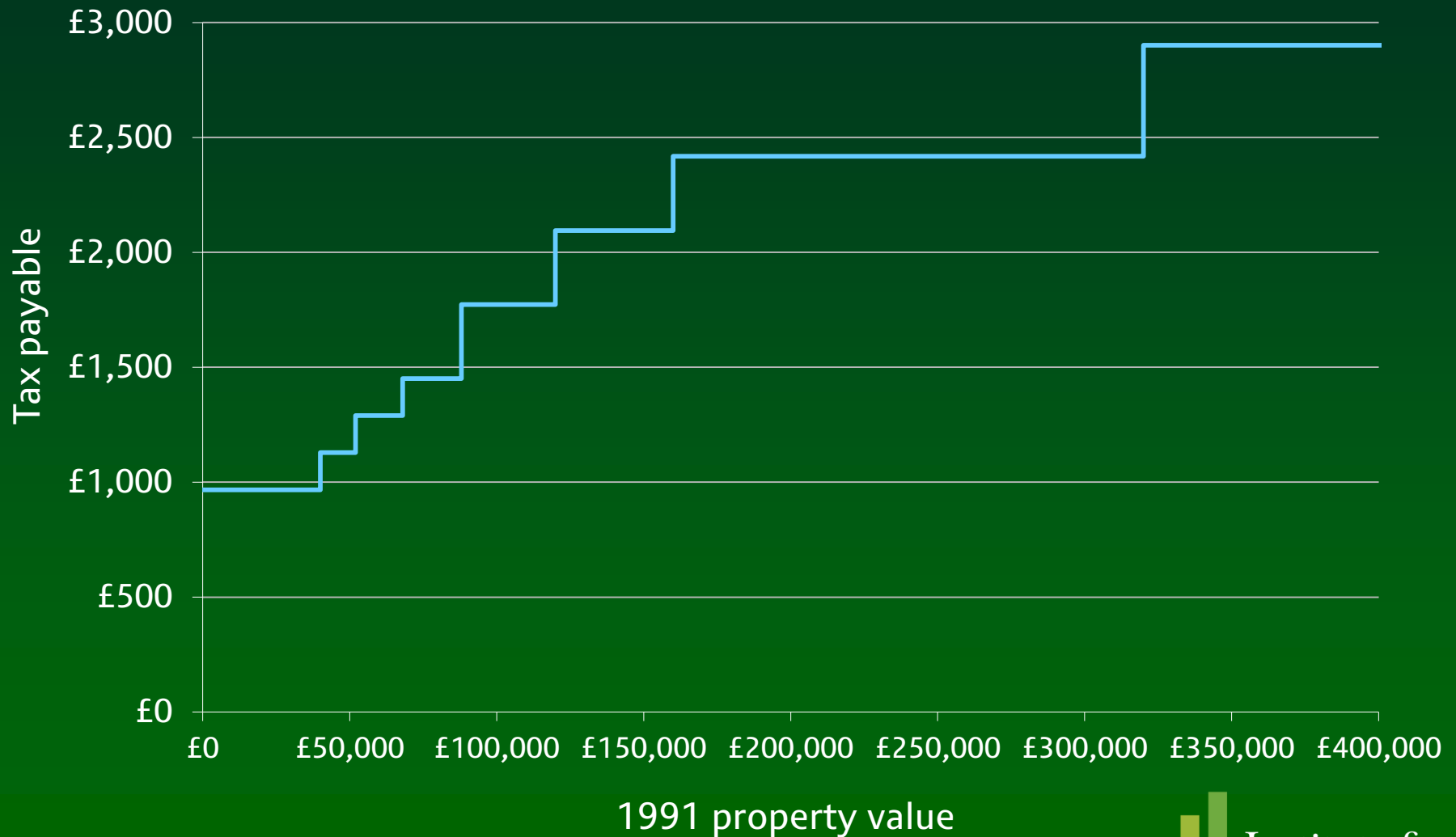
➤ The UK's three worst-designed taxes?

Council tax

- Replaced the short-lived and massively unpopular ‘poll tax’ in 1993
- Central government sets structure; local authorities choose rate
 - Though rises deemed ‘excessive’ by central govt now require referendum

Council tax, 2014-15

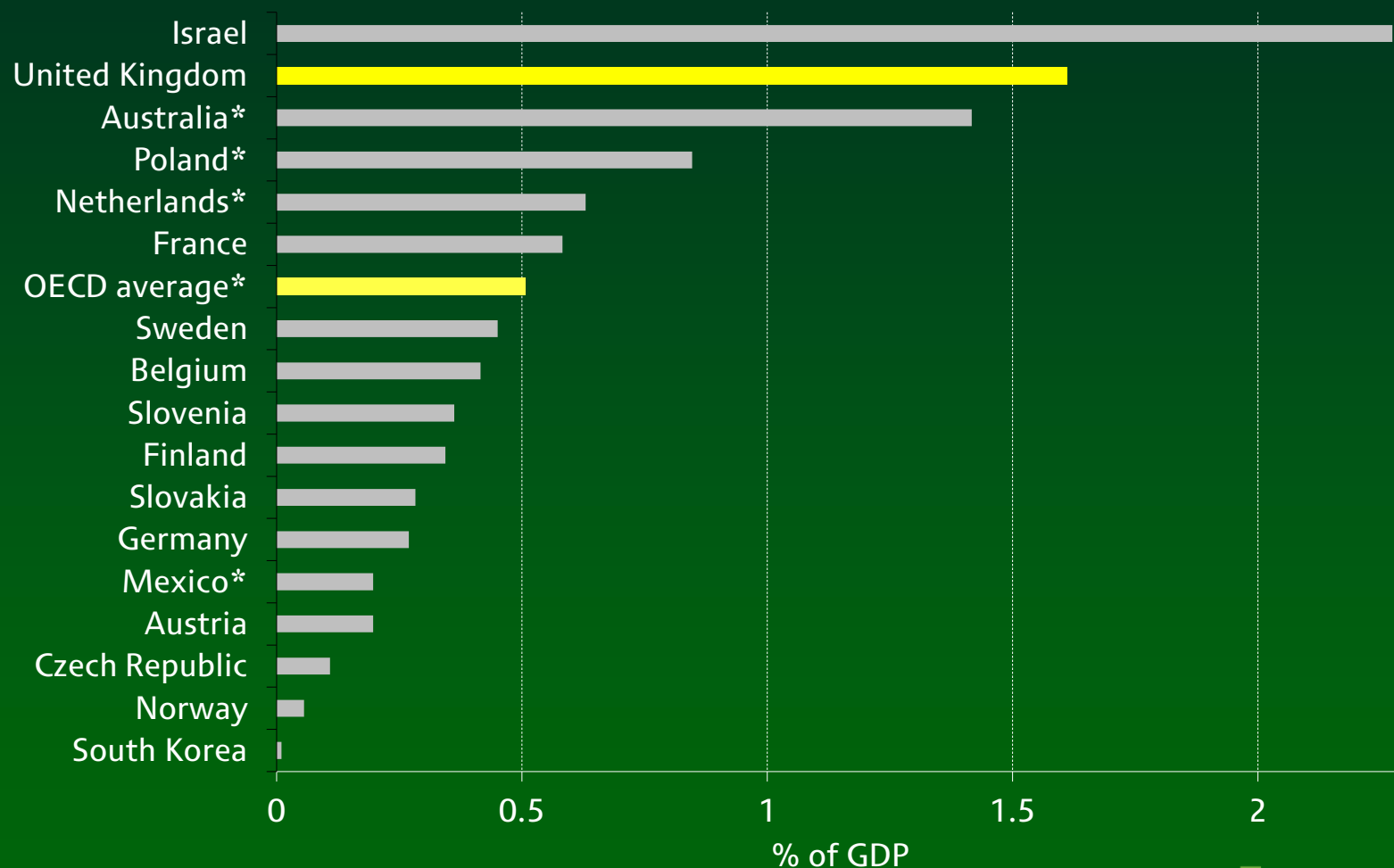
In English local authority setting England & Wales average Band D rate



Council tax

- Replaced the short-lived and massively unpopular ‘poll tax’ in 1993
- Central government sets structure; local authorities choose rate
 - Though rises deemed ‘excessive’ by central govt now require referendum
- Design has obvious weaknesses
 - Still based on 1991 property values in England and Scotland
 - Wide bands
 - Regressive
 - 25% discount for single occupancy
 - 2 of 3 main parties now propose a ‘mansion tax’ – but better to fix CT
- Discounts for low-income families
 - Working-age discounts localised in April 2013
- Unpopular
 - Central govts incentivised cash freezes since 2010 (2007 in Scotland)
- Northern Ireland has different (more sensible) tax

Receipts from recurrent taxes on non-domestic immovable property, 2011



* Data for 2010

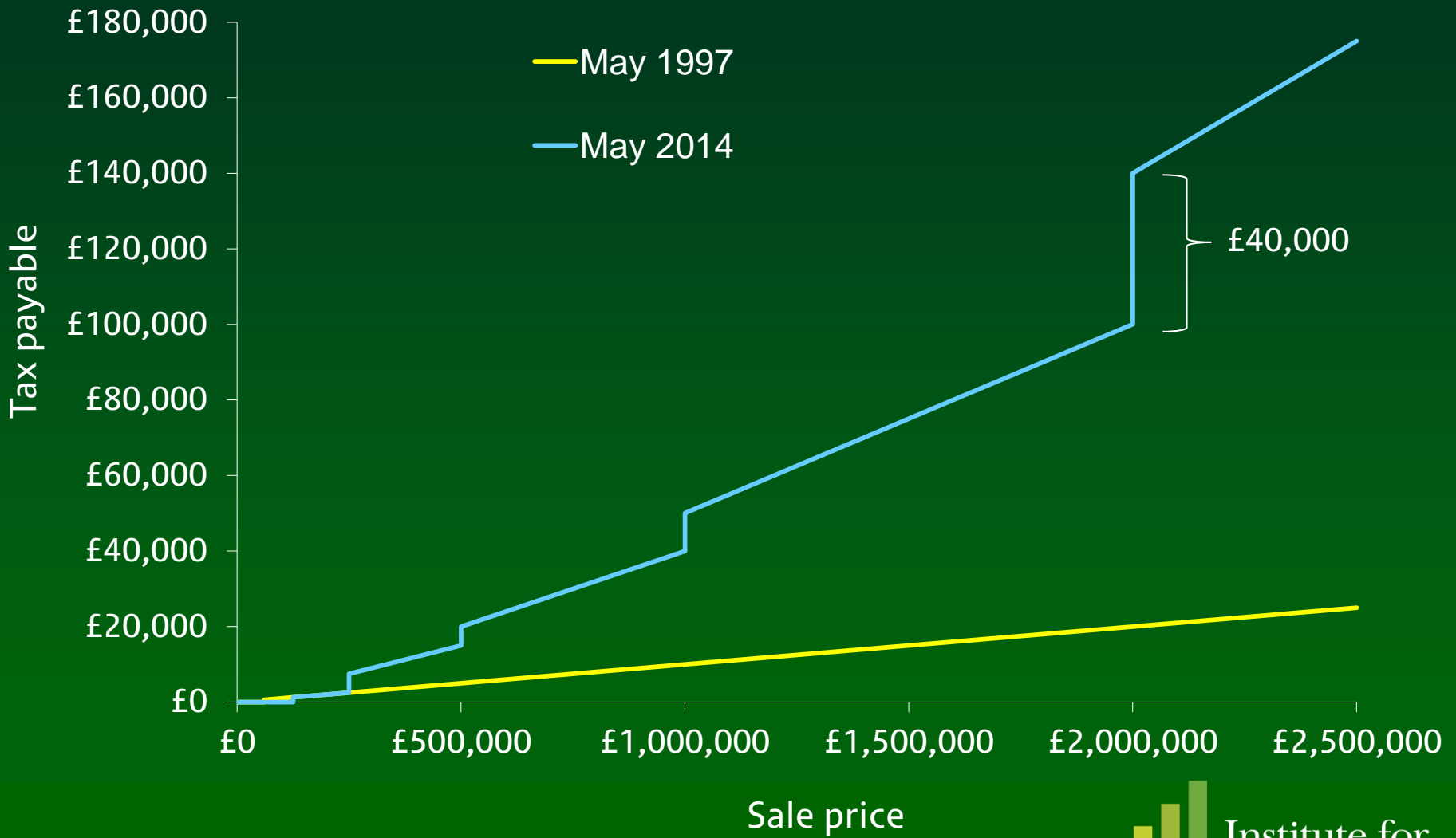


Business rates

- A percentage of estimated market rental value of properties
 - 48.2% for high-rent properties in most of England & Scotland in 2014-15
 - Reduced for low-rent properties
 - Rise in average bills linked to RPI inflation – bills didn't fall in recession
- Removed from local government control in 1990
 - Though recent reform lets local govt keep some revenue from base growth
- Had been admirably stable until recently...
 - 5-yearly revaluation delayed for the first time
 - Rate failed to keep pace with inflation for the first time
 - 'Temporary' doubling of small business rate relief, extended 4 times
 - Temporary relief for retail properties introduced
- Discourages development and use of business property
 - Taxing value of land (excluding buildings) would not do this



Stamp duty land tax



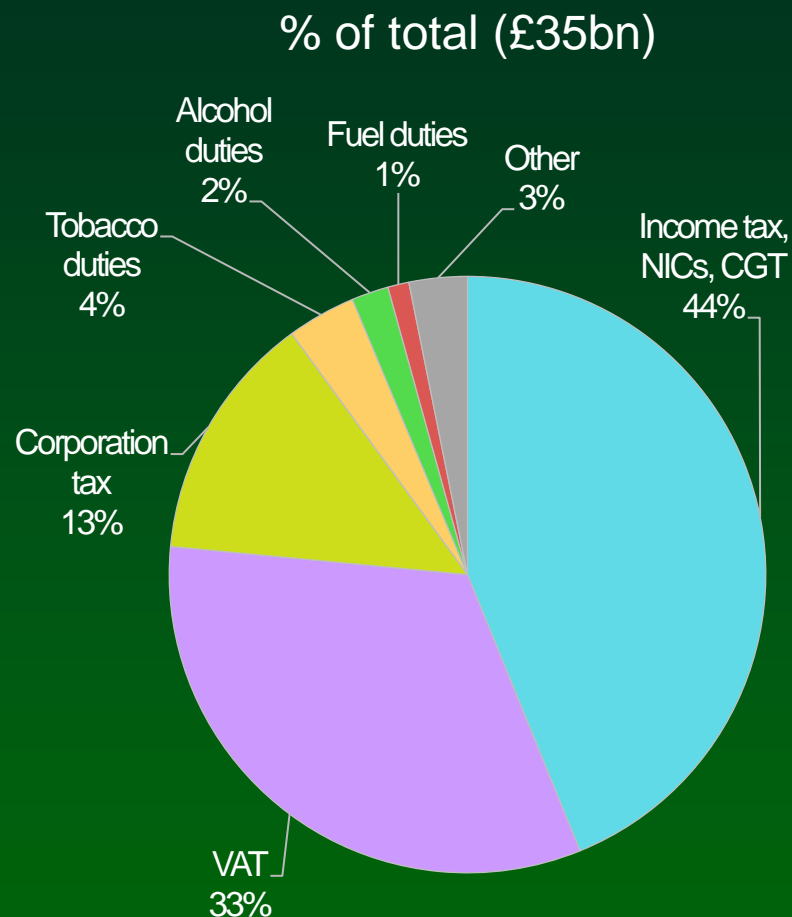
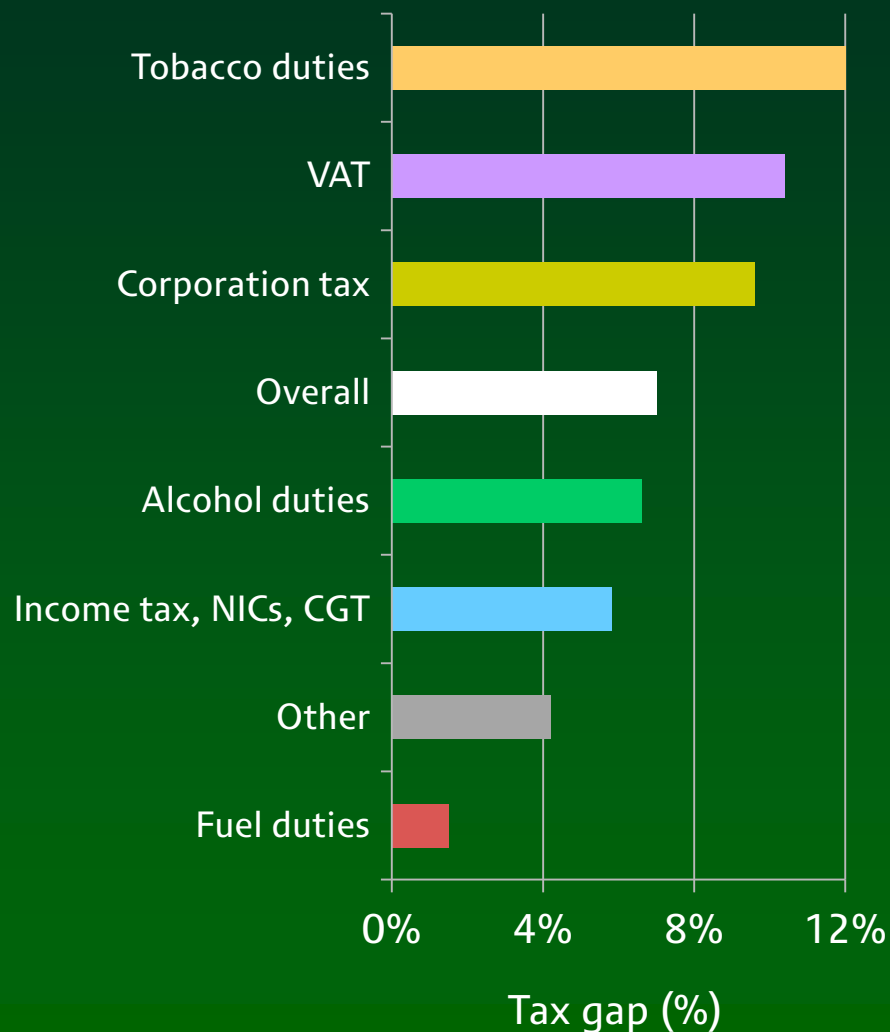
Stamp duty land tax

- ‘Slab’ structure absurd
 - £1 higher price can mean £40,000 higher tax bill
- More fundamentally, transactions should not be taxed at all
 - Why impose heavier tax on properties that change hands more often?
 - Assets should be held by the people who value them most
 - Reduced labour mobility one symptom of this more fundamental problem
- Stamp duties should not be part of the tax system
 - But don’t want to give up revenue / give windfall gains to current owners
 - So look to replace with better taxes rather than simply abolish

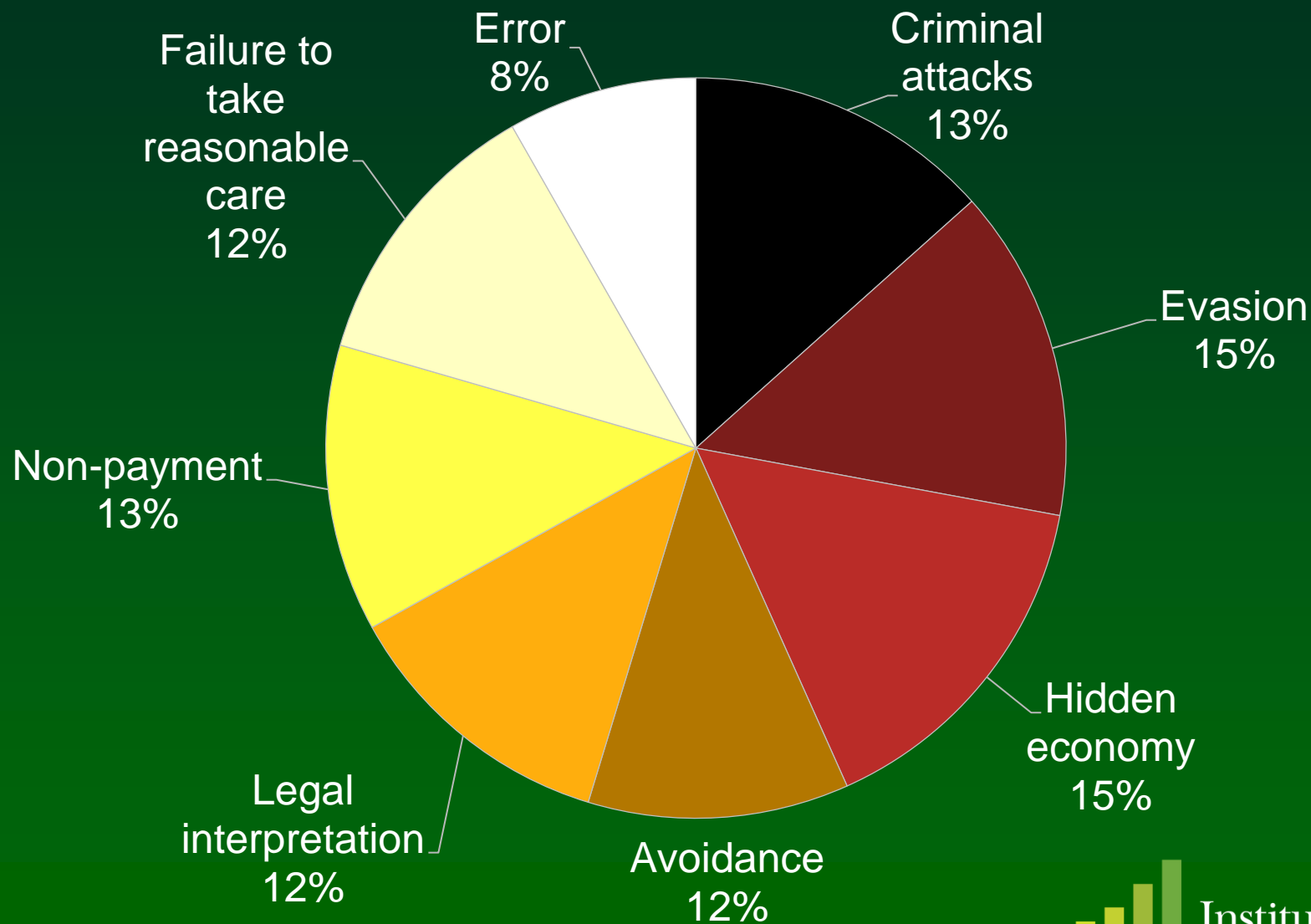
Some issues that cut across taxes

- Avoidance and evasion
 - ‘Tax gap’ is a concern

Estimated 'tax gaps', 2011-12



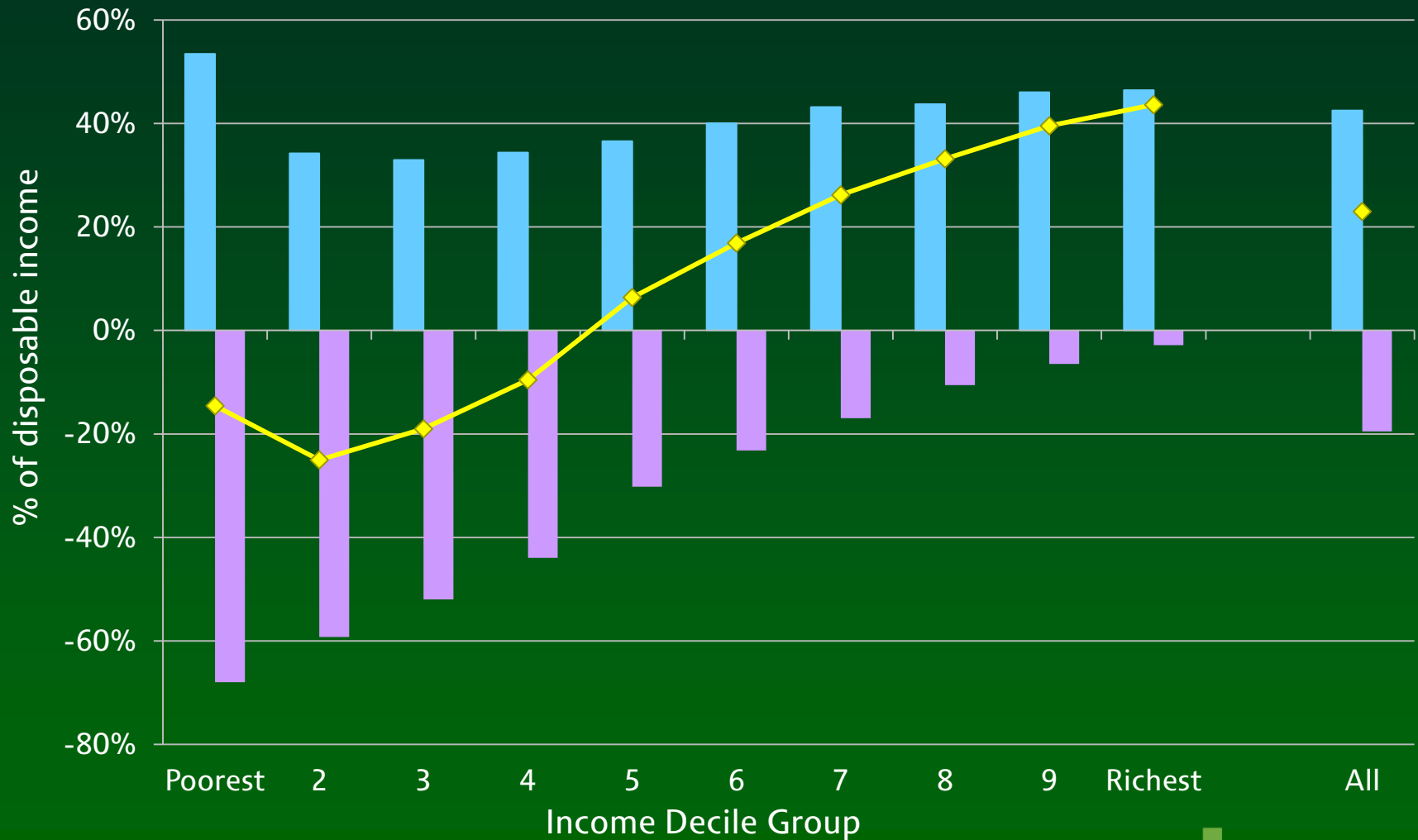
Composition of tax gap by behaviour, 2011-12



Some issues that cut across taxes

- Avoidance and evasion
 - ‘Tax gap’ is a concern
 - A raft of measures in every Budget and Autumn Statement
 - And a new General Anti-Abuse Rule (GAAR) since July 2013
- Distributional effects of the system as a whole

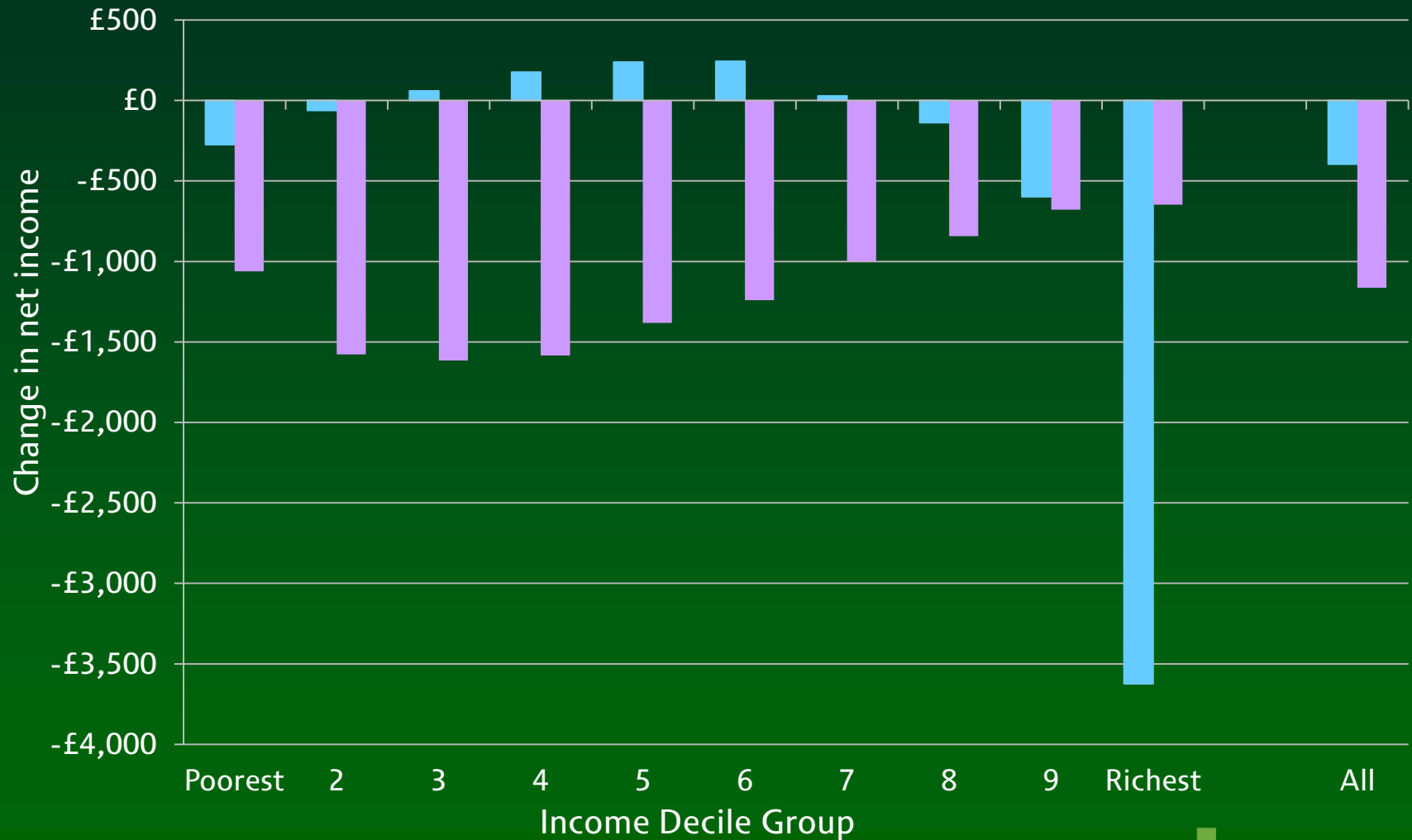
Distributional effect of the tax and benefit system 2012-13, excluding most 'business taxes'



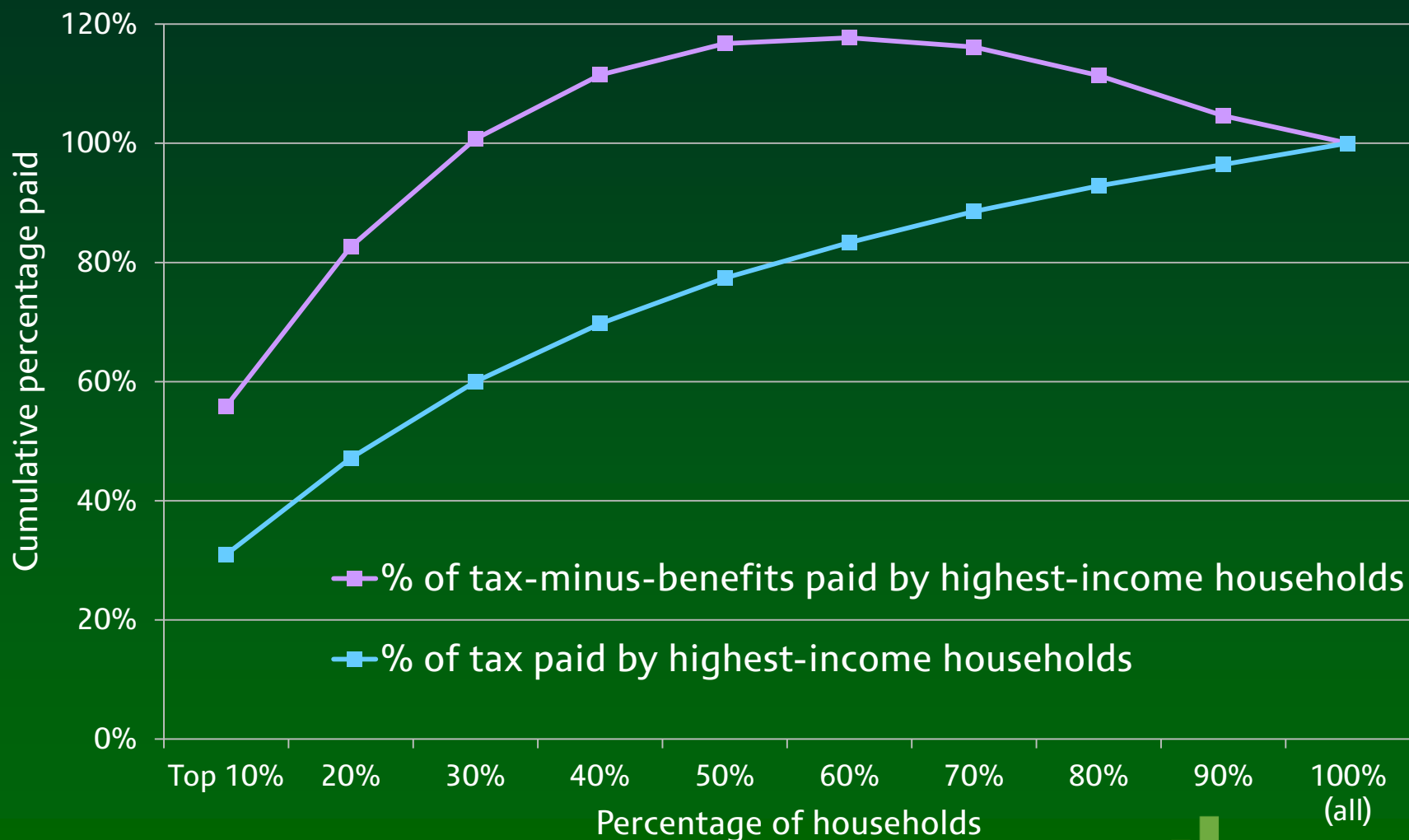
Source: Author's calculations from ONS (2014), *The effects of taxes and benefits on household income, 2012/2013*

Impact of tax and benefit reforms

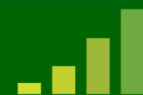
Implemented June 2010 - April 2015 inclusive



Cumulative shares of tax liability, 2013-14



Note: excludes corporation tax, business rates, stamp duties, CGT and IHT.
Source: Figure 9.4 of *The IFS Green Budget: February 2013*



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Some issues that cut across taxes

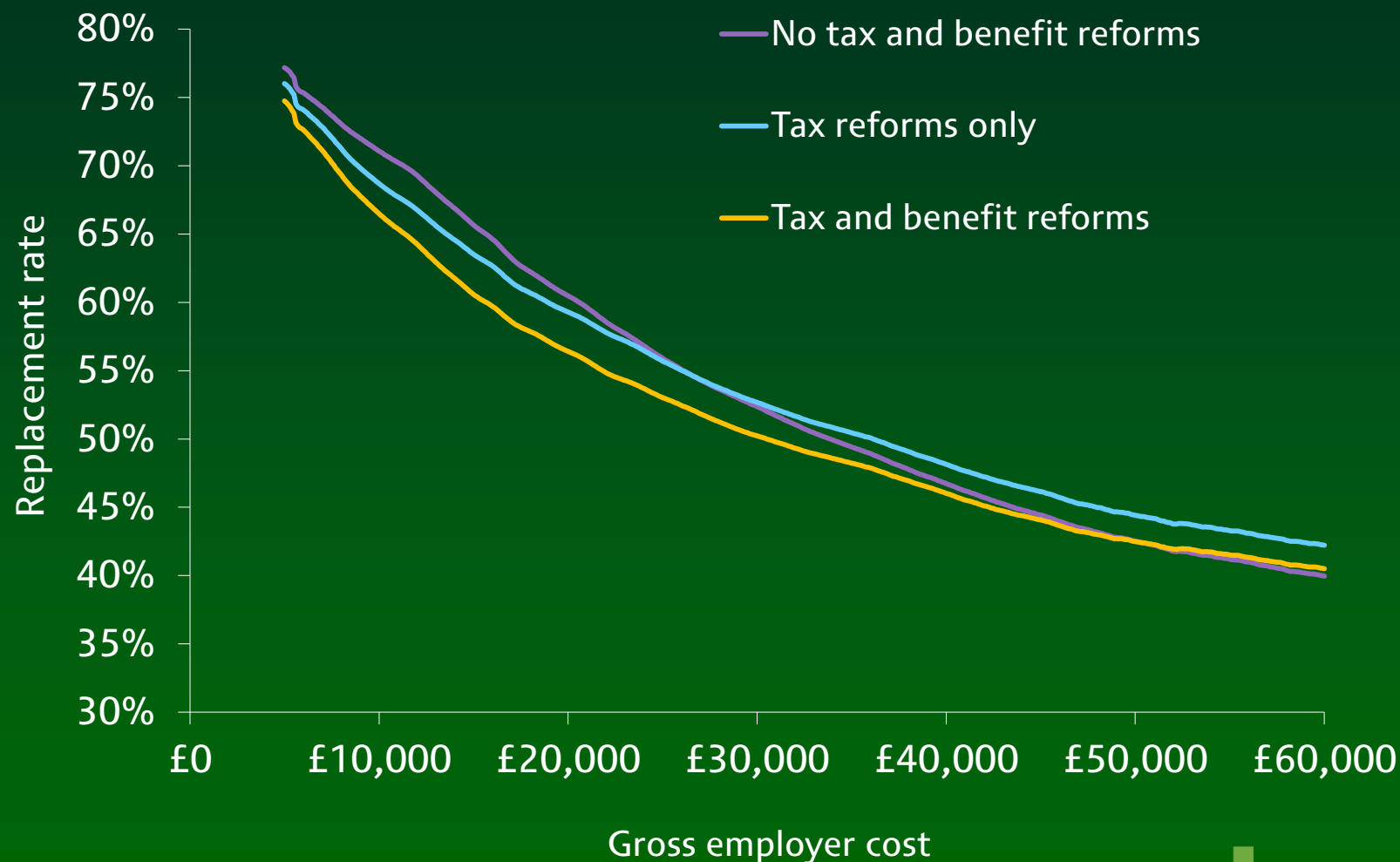
- Avoidance and evasion
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- Work incentive effects of the system as a whole

Two kinds of financial work incentives

- Incentive to be in paid work at all
 - Replacement rate (RR): out-of-work income / in-work income
 - Participation tax rate (PTR): proportion of total earnings taken in tax and withdrawn benefits
 - Incentive for those in work to increase their earnings
 - Effective marginal tax rate (EMTR): proportion of an extra £1 of earnings taken in tax and withdrawn benefits
- ❖ In all cases, higher numbers = weaker incentives

Average RR by earnings, 2015

With and without coalition government reforms



Source: Adam and Browne (2013), *Do the UK government's welfare reforms make work pay?*

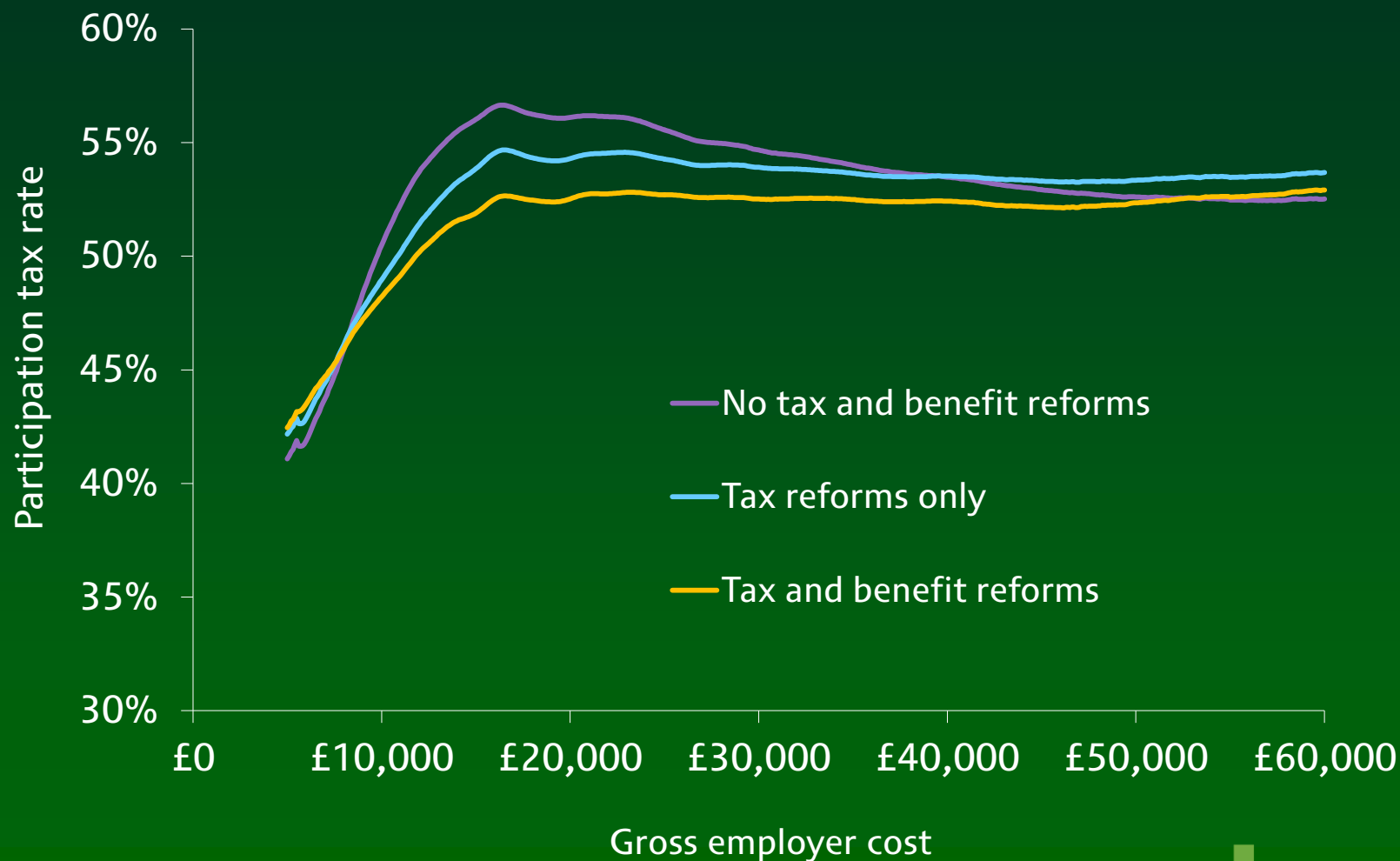
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Average PTR by earnings, 2015

With and without coalition government reforms

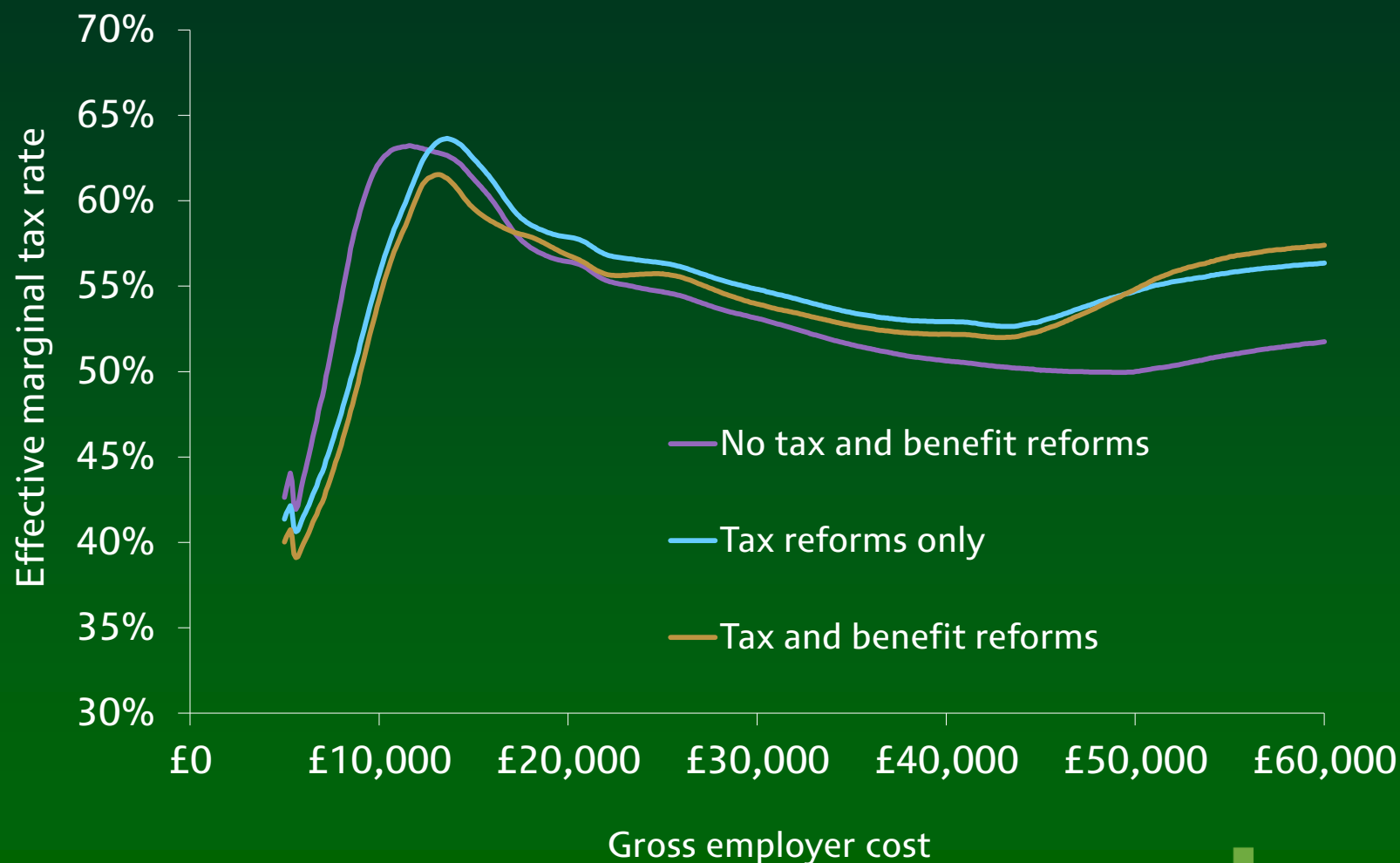


Source: Adam and Browne (2013), *Do the UK government's welfare reforms make work pay?*



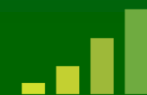
Average EMTR of workers by earnings, 2015

With and without coalition government reforms



Source: Adam and Browne (2013), *Do the UK government's welfare reforms make work pay?*

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- Distributional effects of the system as a whole
- Work incentive effects of the system as a whole
- Choice of legal form
 - Employment is penalised relative to self-employment and incorporation

Marginal tax rates by legal form, 2014-15

	Employed	Self-employed	Small company
Basic rate	40%	29%	20%
Higher rate	49%	42%	40%

Part of an international trend?

YES:

- Cuts in top and basic rates of income tax
- SSC rates up even as income tax rates down
- Shift from family to individual taxation
- Shift from taxes on specific goods towards VAT
- Corporate tax rates cut, base broadened
- Introduction of environmental taxes

NO:

- Unusual in removing mortgage interest relief
- Centralisation

The coalition government's priorities for tax

- Current government has increased tax overall
 - Biggest contributors: VAT increase and anti-avoidance measures
- Yet still found money for tax cuts in its three priority areas
 - £12bn - personal allowance
 - £8bn - headline rate of corporation tax
 - £6bn - fuel duty
- Two of these three were ambitions clearly stated in advance
 - Fuel duty more piecemeal
- Little sign of a coherent strategy for the tax system as a whole

Room for improvement

Ideas from the Mirrlees Review

- Merge income tax and National Insurance
- Broaden the VAT base (with appropriate compensation package)
- Major overhaul of property taxation
- More consistent carbon price; target motoring taxes on congestion
- Reform the taxation of savings and profits
 - Full allowance for amounts saved/invested
 - Apply same overall statutory rate to income from all sources

Tax policy-making

- Hyperactive
 - Perceived need to pull rabbits out of the hat in Budgets, Autumn Statements and party conferences (as well as elections)
 - Exacerbated by rise of 24-hour news coverage
- Taxes tend to rise in post-election Budgets
- Some recent improvements in institutional arrangements
 - Independent Office for Budget Responsibility
 - More transparency re policy costings
 - Somewhat better consultation
- Very centralised
 - Tax policy-making very concentrated in the Treasury
 - Council tax is the only (mostly) local tax: only 4% of revenues
 - Some devolution of powers to Wales and Northern Ireland
 - As for Scotland...

Scotland has just voted against independence

- But radical change still likely
 - Main political parties all promising much more devolution, quickly
- Scotland has had some tax-setting powers for years
 - Full control over council tax and business rates → but done little
 - Vary basic rate of income tax by up to 3 percentage points → not done
- Already due to get more
 - Stamp duty land tax → replacing with (slightly) more sensible tax
 - Landfill tax → little change planned
 - Vary all rates of income tax (together, on unchanged tax base) → given haven't used existing powers, how valuable is this?
- What else will be devolved?
 - Each party's proposals so far slightly different
 - Recent rhetoric has sounded radical, but not specific
 - More devolution to the rest of the UK too?



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UK tax policy

Stuart Adam