



Institute for  
Fiscal Studies

## *Tax By Design: The Mirrlees Review*

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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
  - Childcare, 'sin taxes' 'green taxes'
- Distributional arguments for differentiation are weaker

# VAT in the UK

- UK zero-rates most food, water, reading matter, 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)

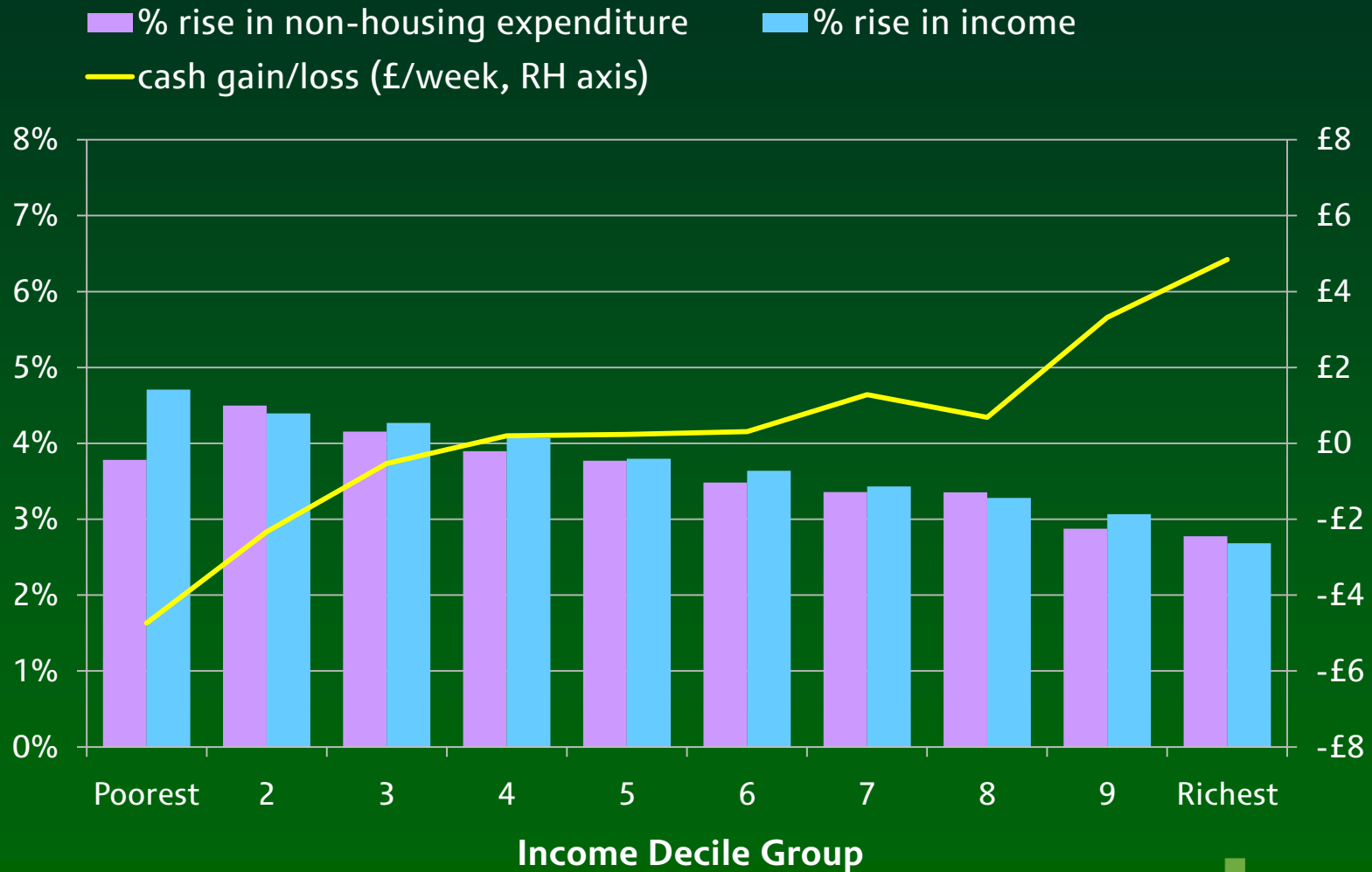
- We simulate removing almost all zero and reduced rates
- Raises £24bn (with a 17.5% VAT rate) if no behavioural response
- Reduces distortion of spending patterns
  - If uniformity were optimal, could (in principle) compensate every household and have about £3bn left over
- But on its own, would be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

## Broadening the VAT base (2)

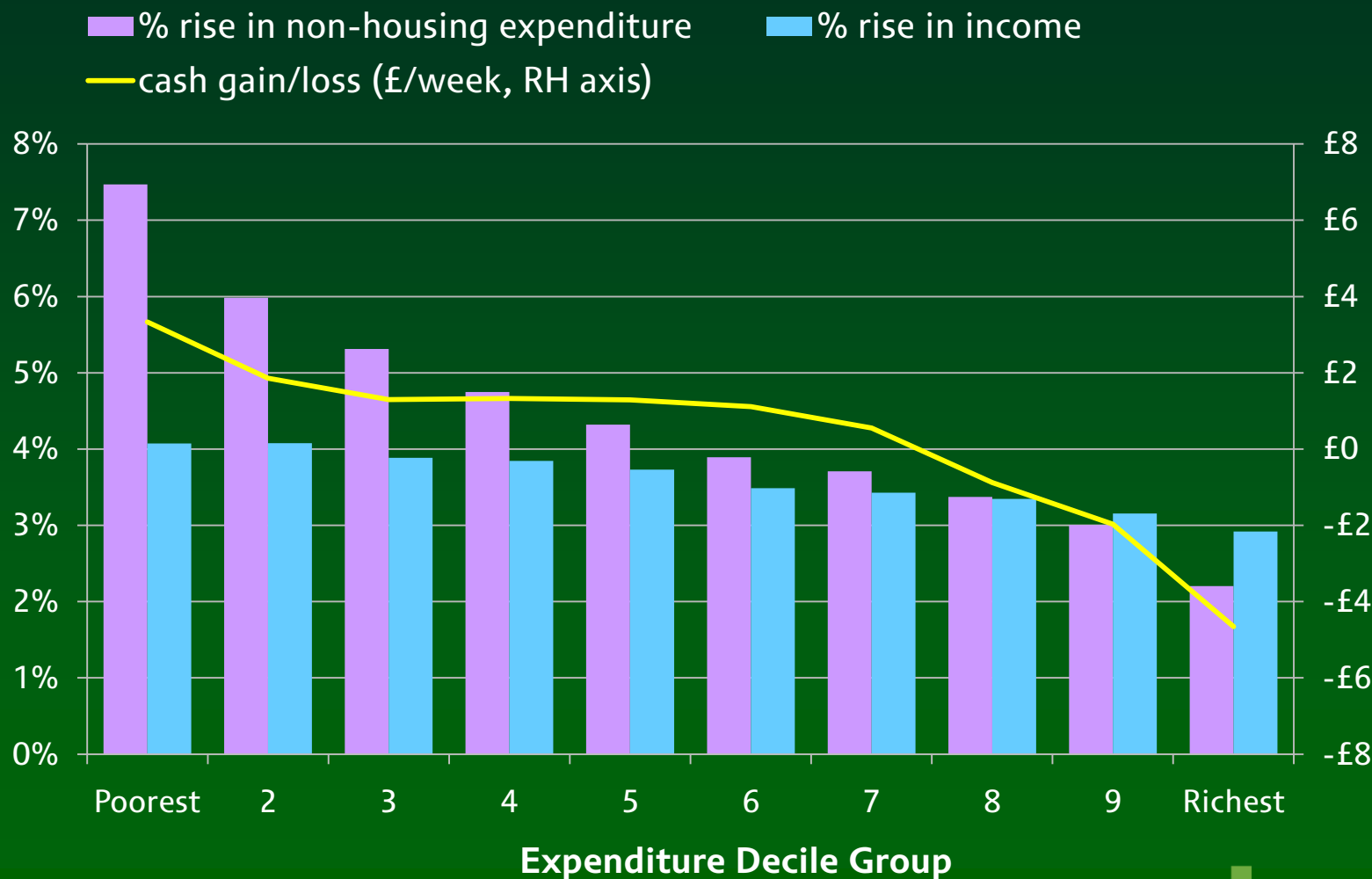
We illustrate one way of using the money:

- 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



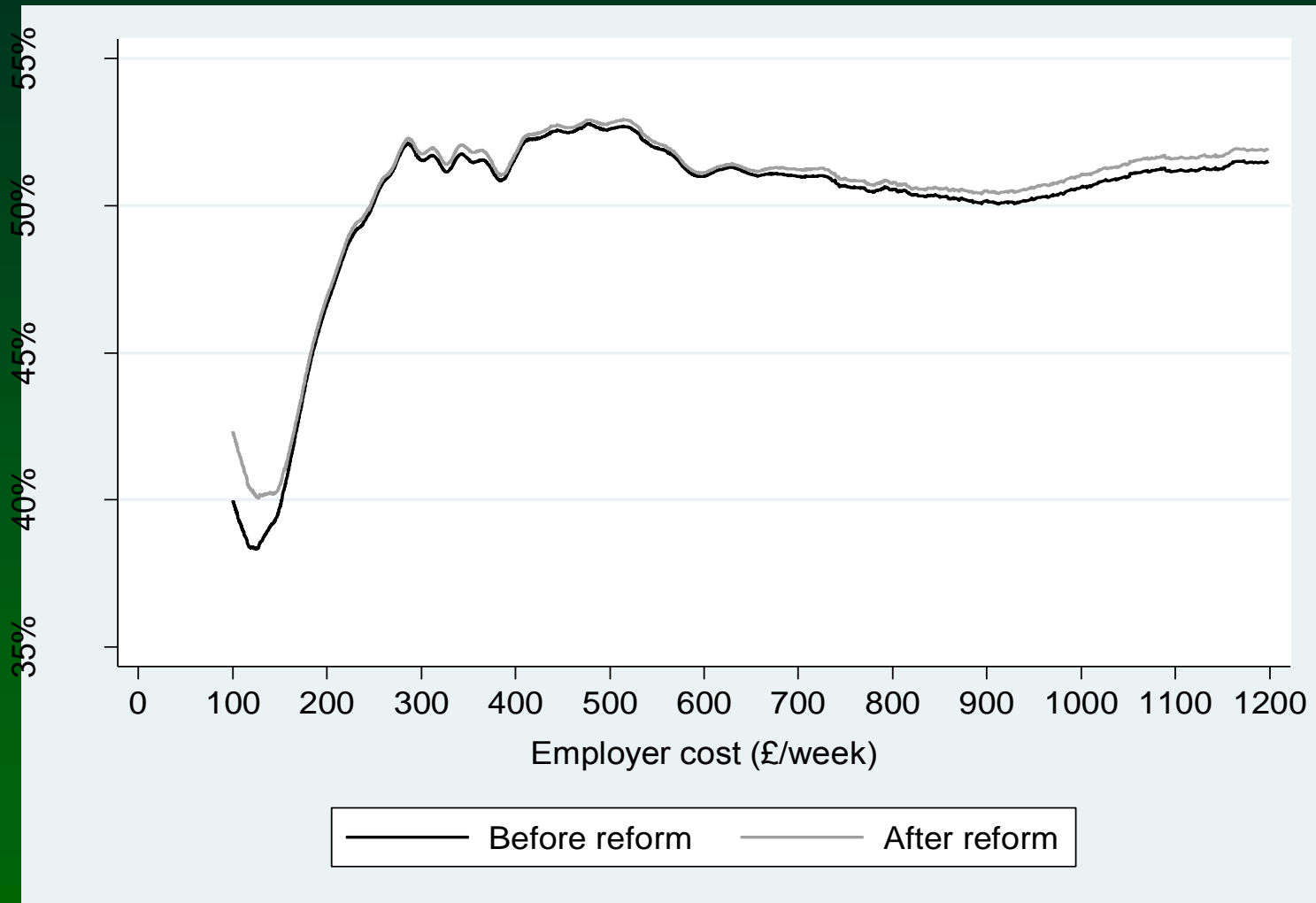
# VAT reform: effects by expenditure





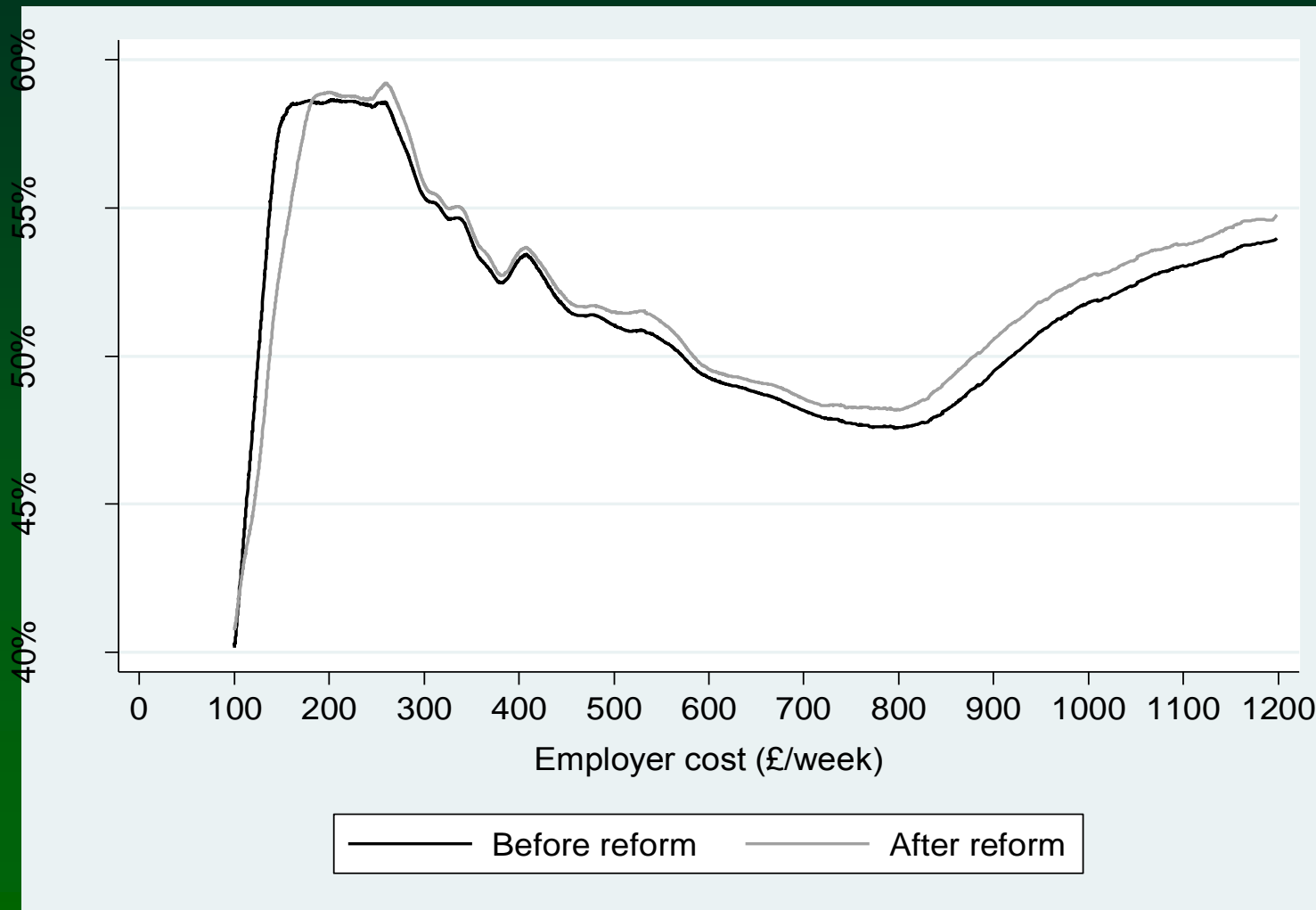
# VAT reform: incentive to work at all

## 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

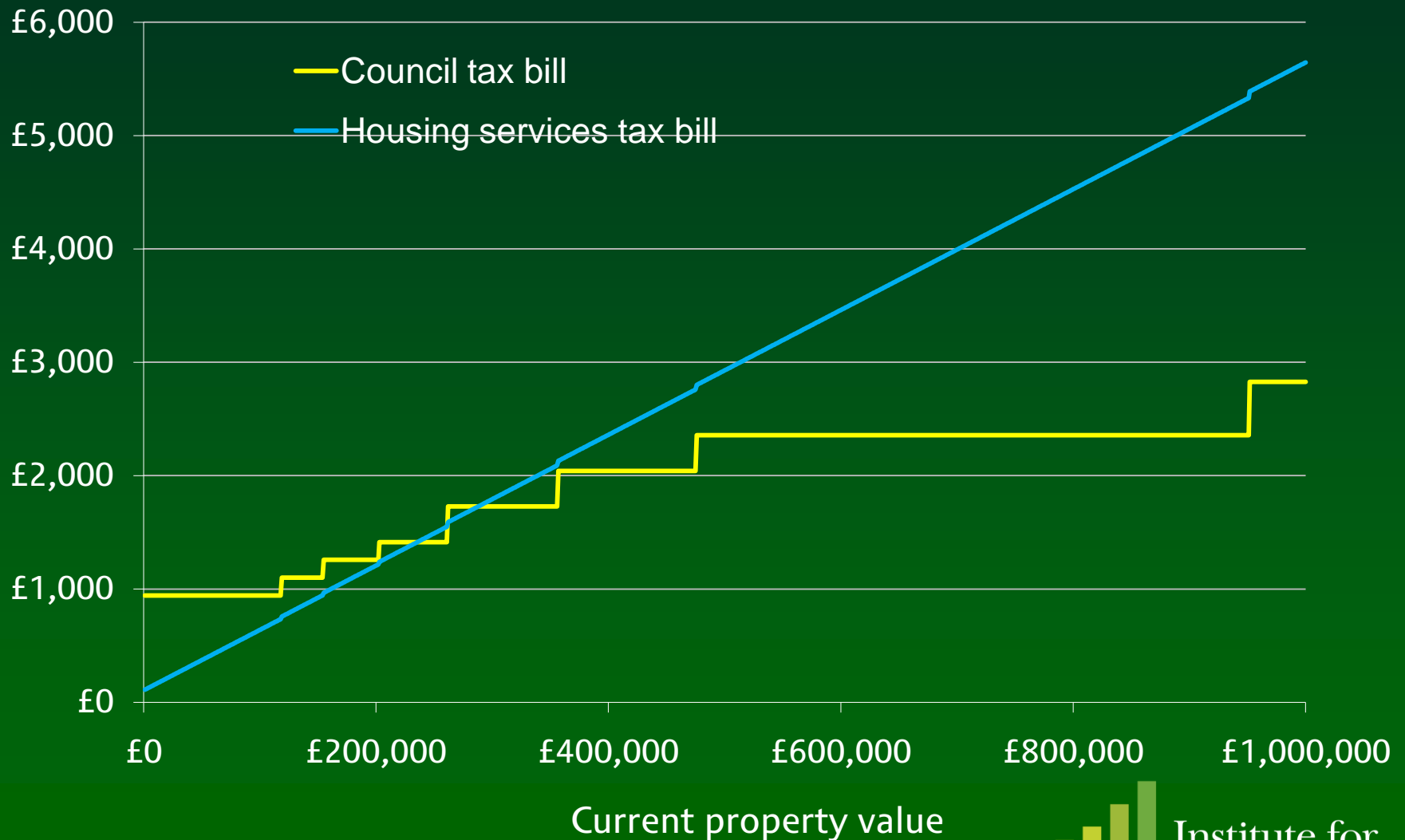
# Taxing consumption of housing services

- 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
  - Government estimates potential welfare gains at 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