Taxation in the UK

James Browne
Institute for Fiscal Studies

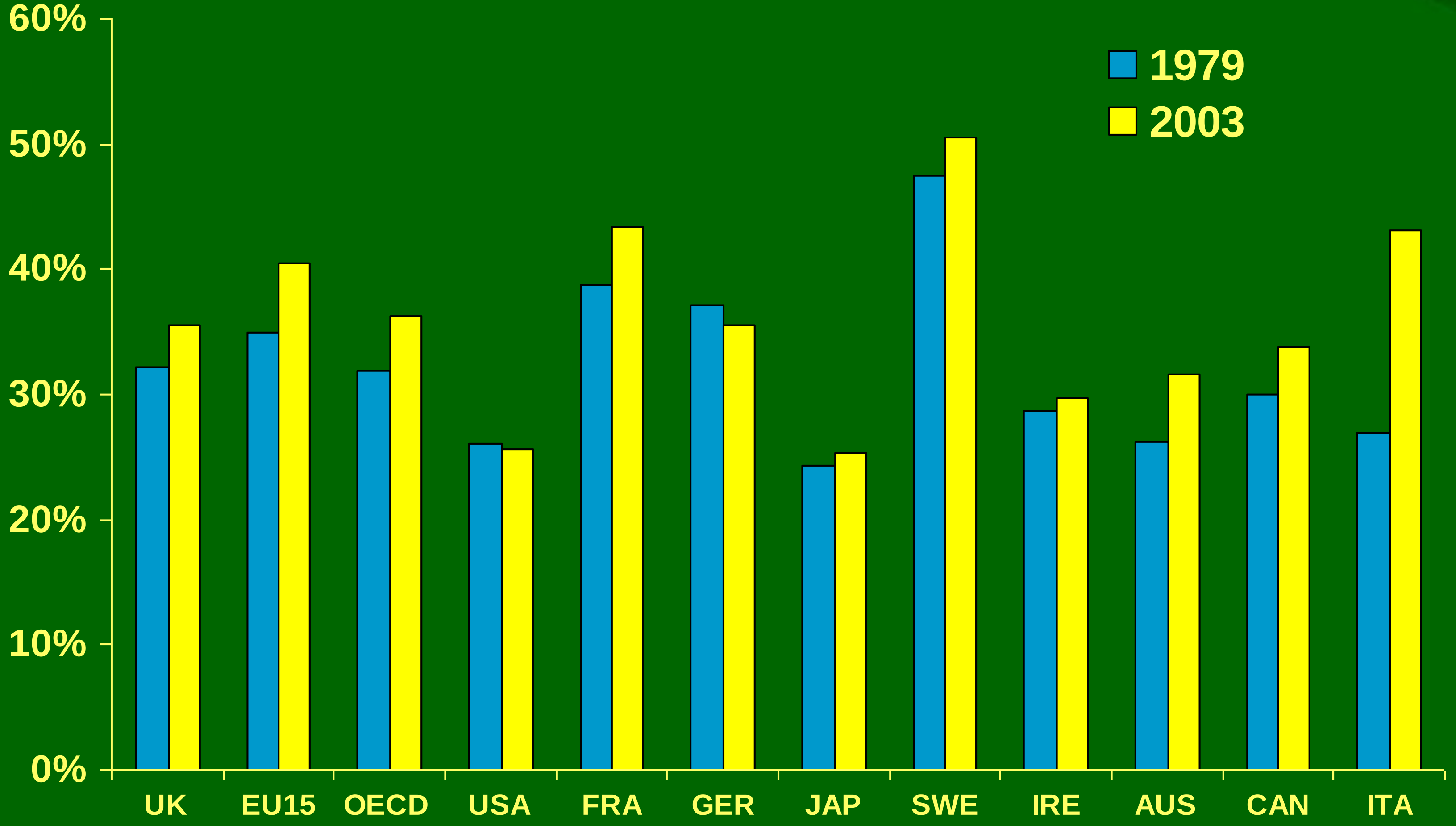
Outline

- Overview of the UK tax system in historical, international and theoretical contexts:
    1. Level and composition of revenues
    2. Structure of the major taxes
    3. Economic aspects of the overall tax (and benefit) system:
        - Effect on the income distribution
        - Effect on work incentives
        - How close to an expenditure tax?
- For more on 1 and 2 see S. Adam and J. Browne, *A Survey of the UK tax system*
    - www.ifs.org.uk/bns/bn09.pdf

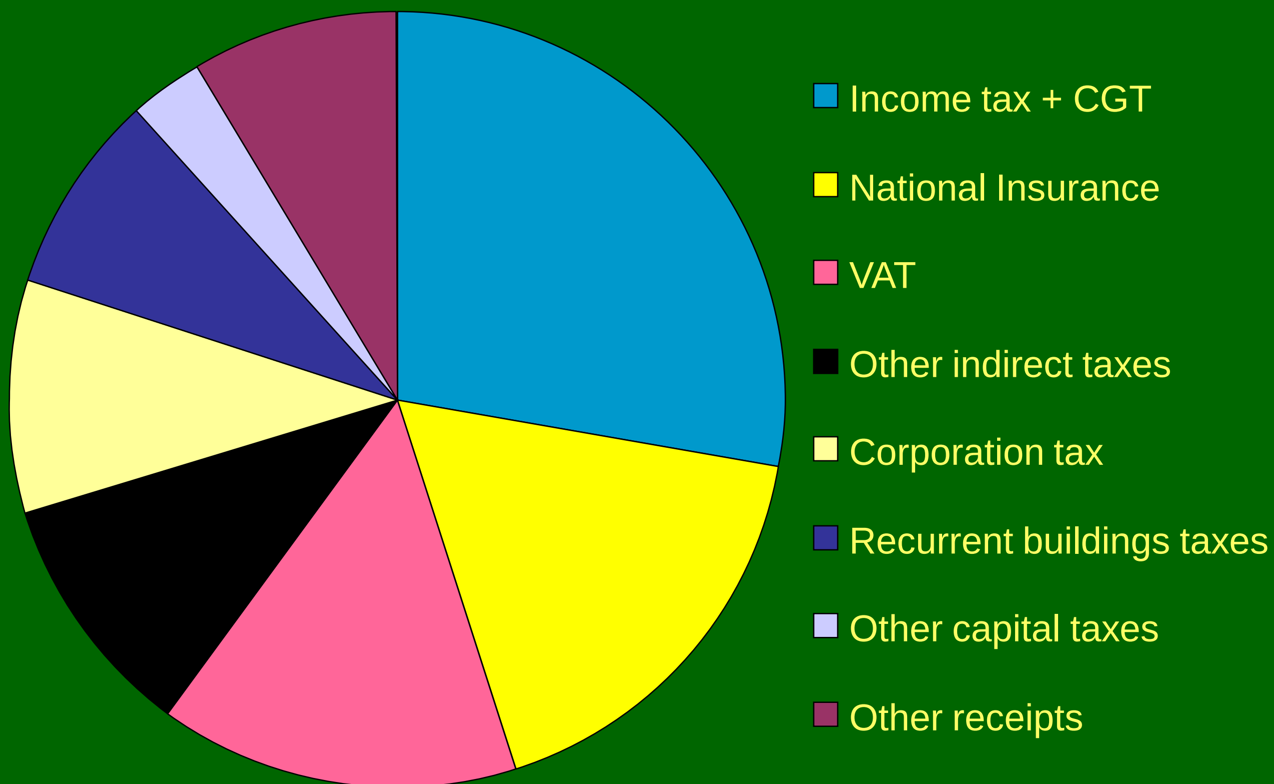
The tax burden in the UK

Tax to GDP ratios

Taxes and social security contributions

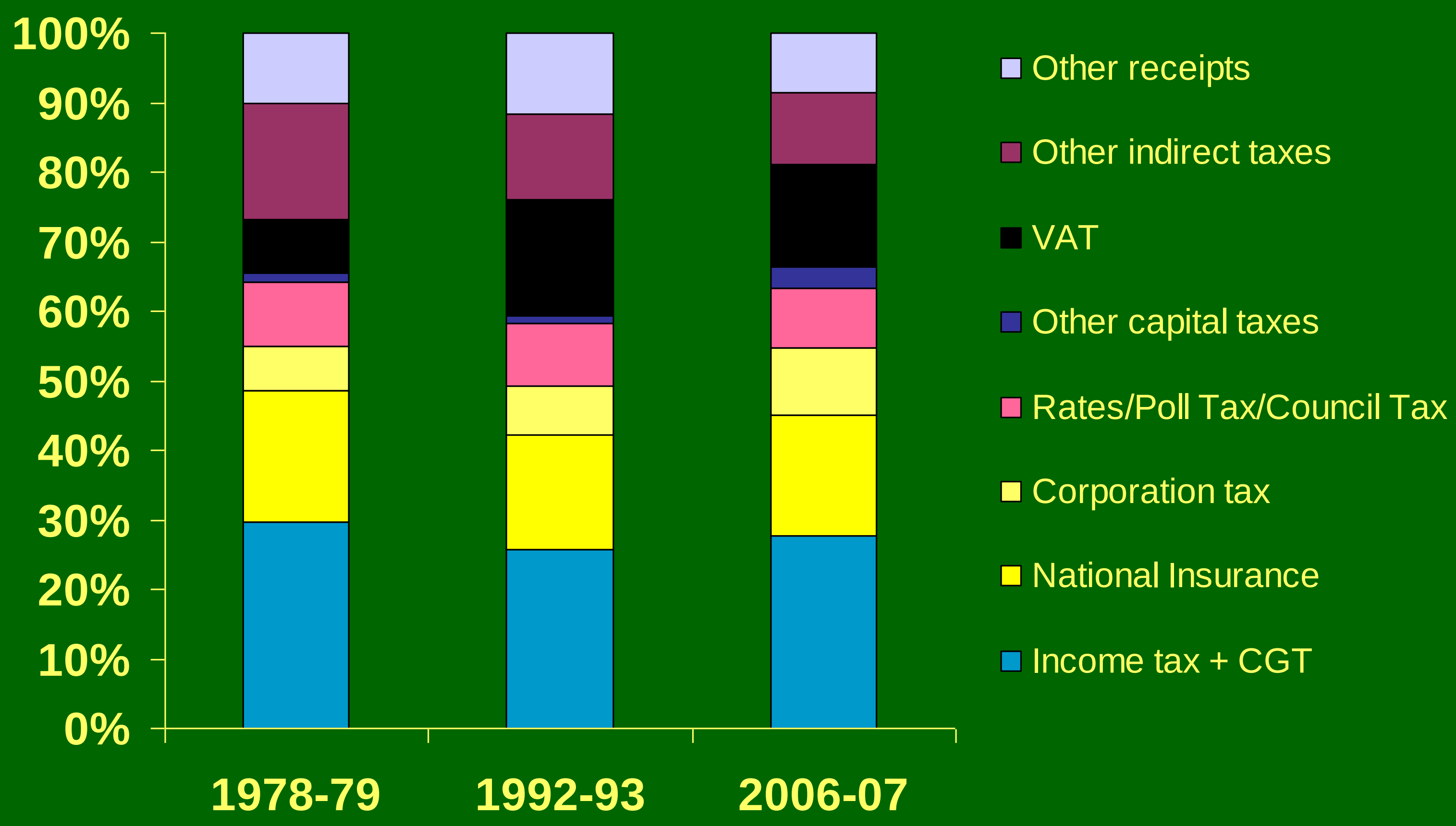


Sources of government revenue, 2006/07



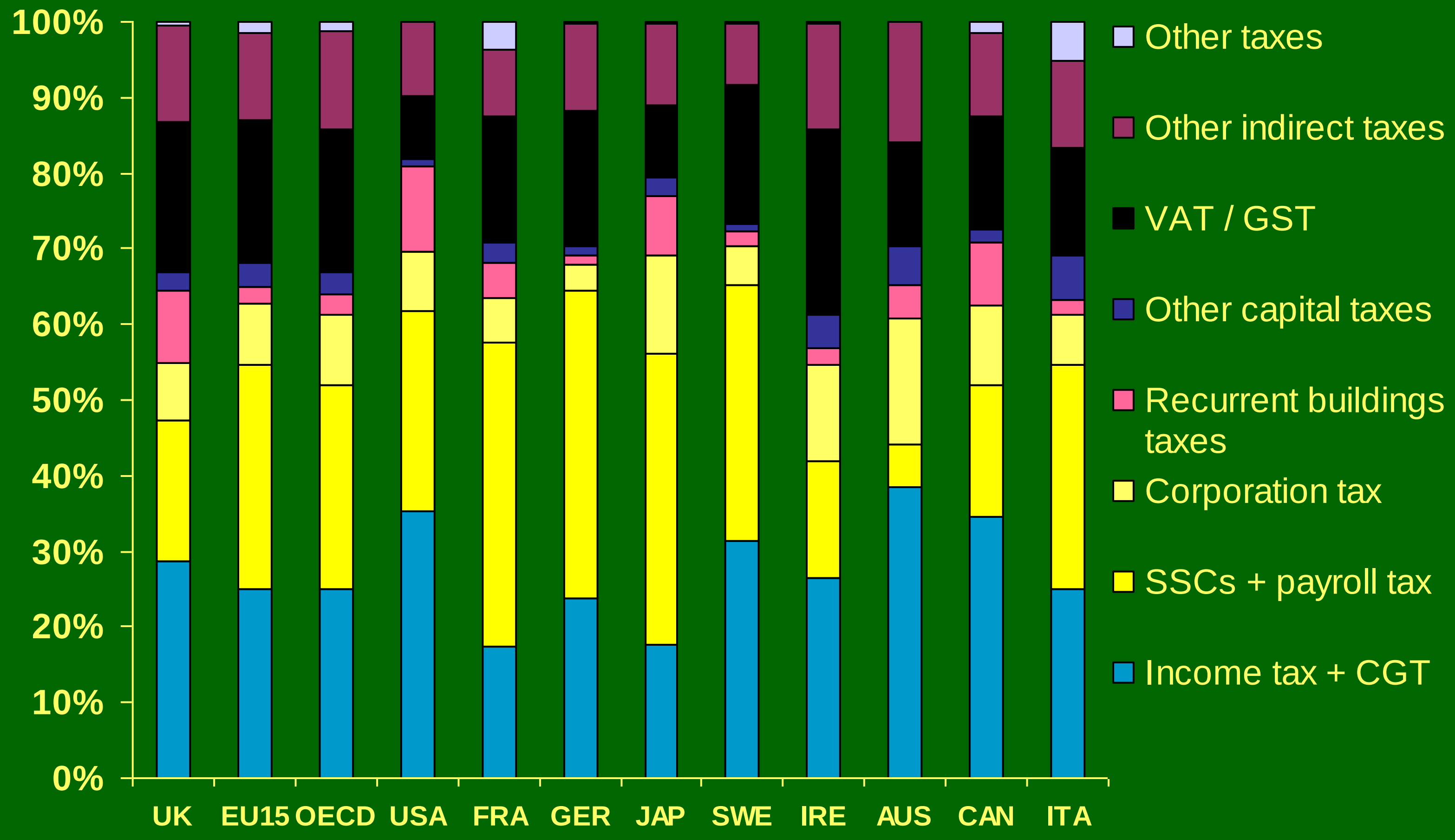
Composition of revenues

Current receipts



Composition of revenues 2003

Taxes and social security contributions



Income tax schedule

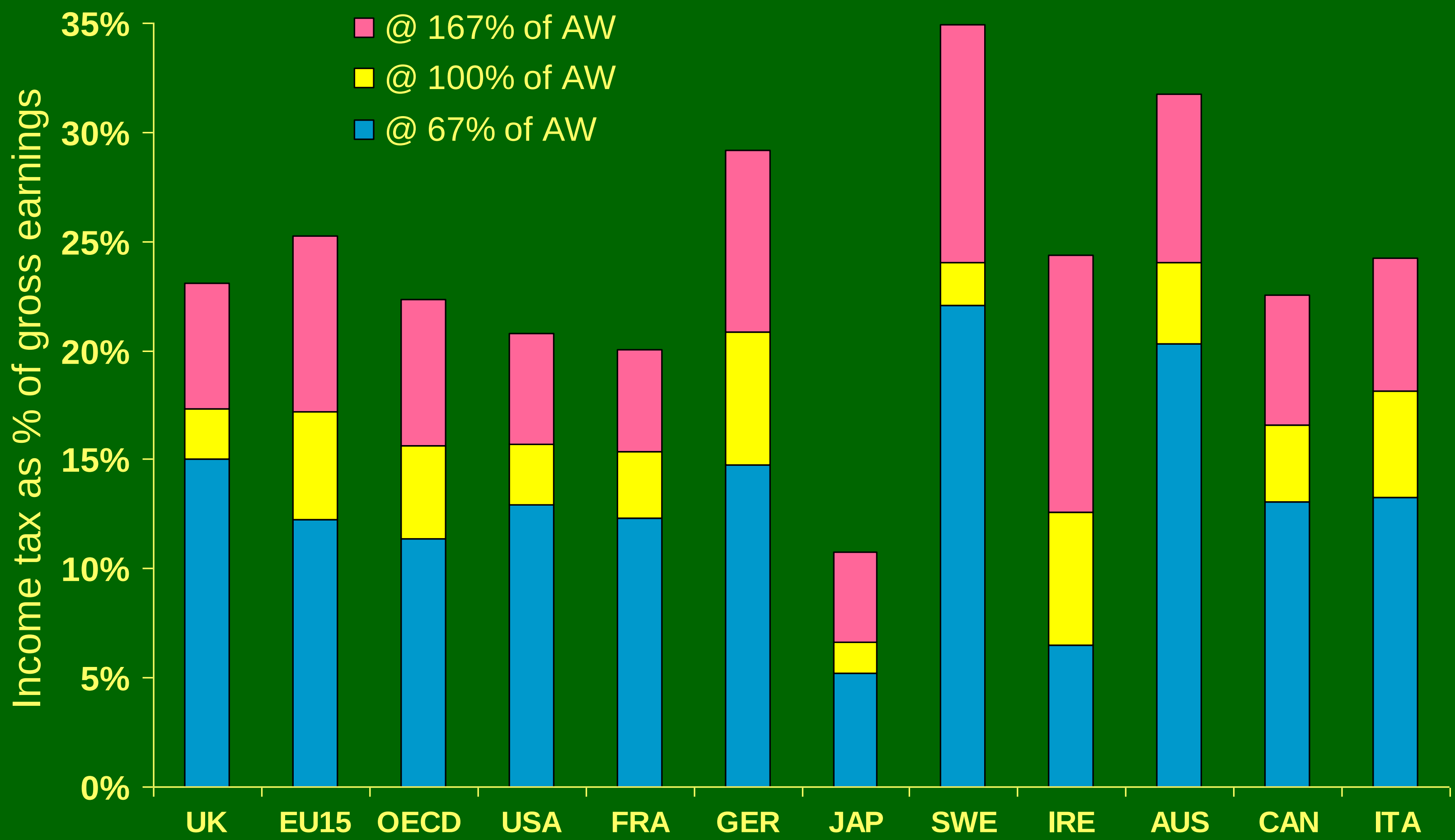
For earned income, 2006 prices

Changes to income tax structure

- Big reduction in top rates (83/98% → 40%)
  – the start of an international trend
- Reduction in basic rate (33% → 22%, 20% in April 2008)
  – part of an international trend
- Starting rate abolished, came back again but will go in April 2008
  – international trend is to reduce number of rates
- Large-scale fiscal drag
  – some increase in no. of taxpayers
  – massive increase in no. of higher-rate taxpayers

The income tax burden

For single worker at multiples of average full-time earnings

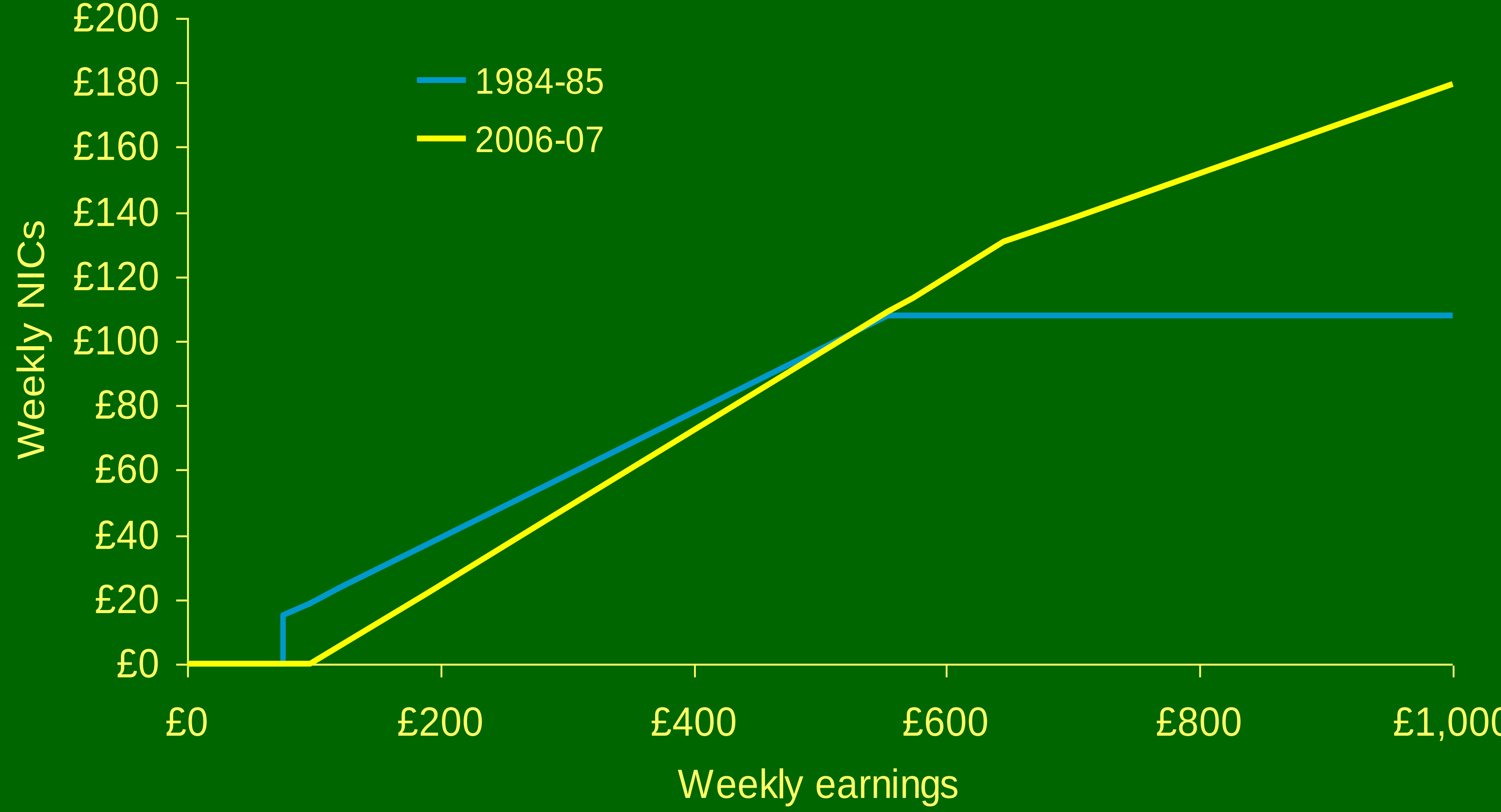


Changes to treatment of families

- Independent taxation introduced 1990
  - part of an international trend away from family taxation
- Abolition of additional tax allowances for married people and those with children
- Shift towards providing support for children and low earners through tax credits
  - but major delivery problems with latest (2003) reforms

National Insurance schedule

Combined employer and employee NICs, 2006 prices



Changes to National Insurance

More like income tax:

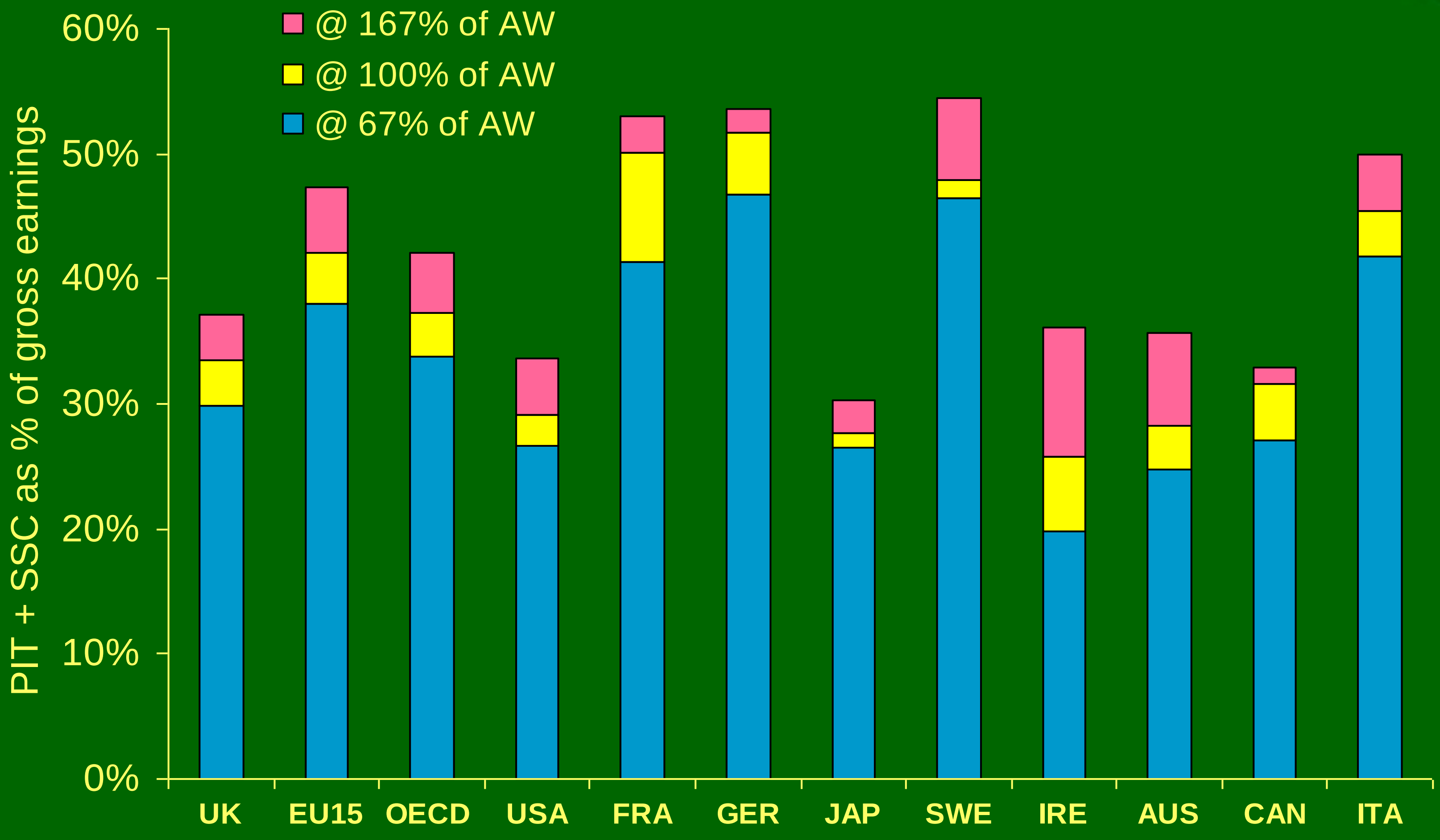
- Abolition of ‘entry fee’
- Contributions now continue above the upper earnings limit
- Alignment of entry point with income tax personal allowance
- Upper earnings limit to be aligned with income tax higher rate threshold in 2009
- Benefits in kind now subject to National Insurance
- Contributory principle undermined

Social insurance and the contributory principle

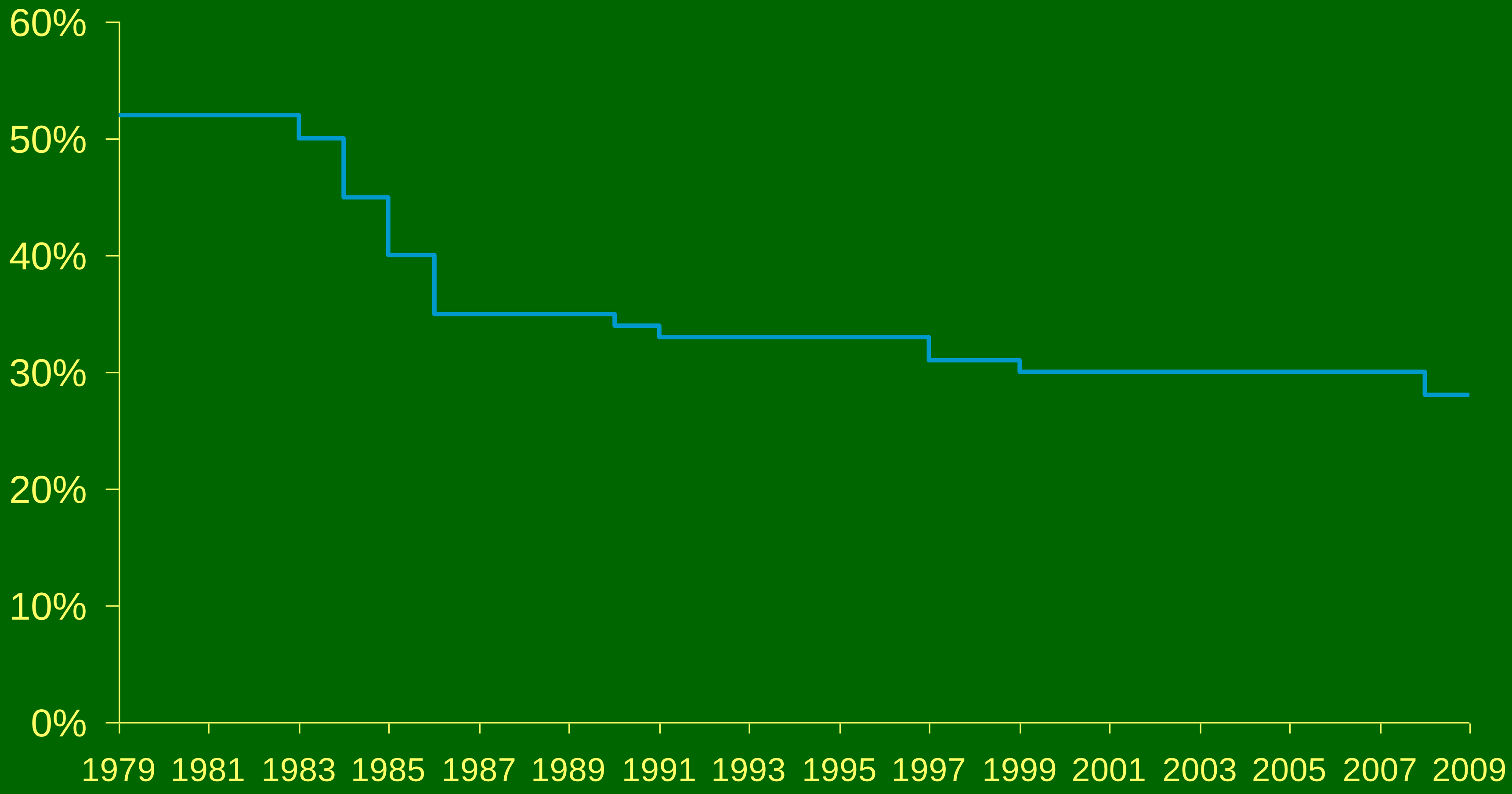
- In Britain, National Insurance is closer to a Beveridge system – payments give entitlements to flat rate benefits
- Link between contributions and payments has become less important over time, on both contributions and payments side
- Contrasts with Bismarckian system where insurance payments give entitlements to benefits that replace previous earnings
- This tends to require higher tax rates, but despite this may have smaller effect on work incentives

Total burden of income tax and NI

For single worker at multiples of average full-time earnings



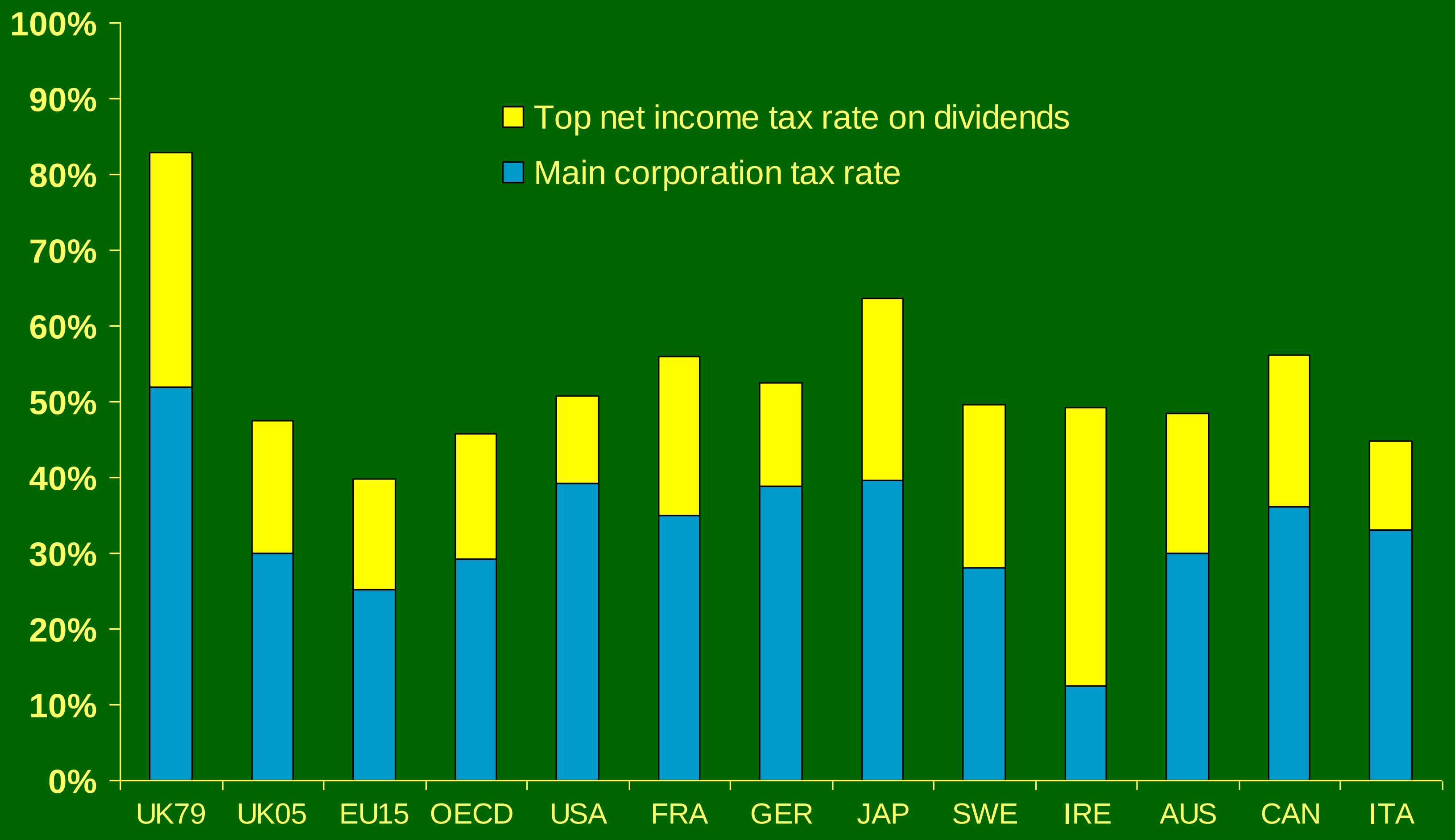
Main corporation tax rate



Changes to corporation tax

- Main and small companies rates cut (52% → 28%, 40% → 22%) , part of a continuing international trend
- Share of revenue kept up though
- This is partly because of reduced capital allowances
  - aim is to tax profits = revenue – expenses (includes capital consumption)
  - allowances exist to compensate companies for depreciation
  - difficult to know what the true economic rate of depreciation is though
  - allowances may not adequately compensate companies for depreciation of capital therefore (will return to this later)

Taxation of corporations and shareholders 2005

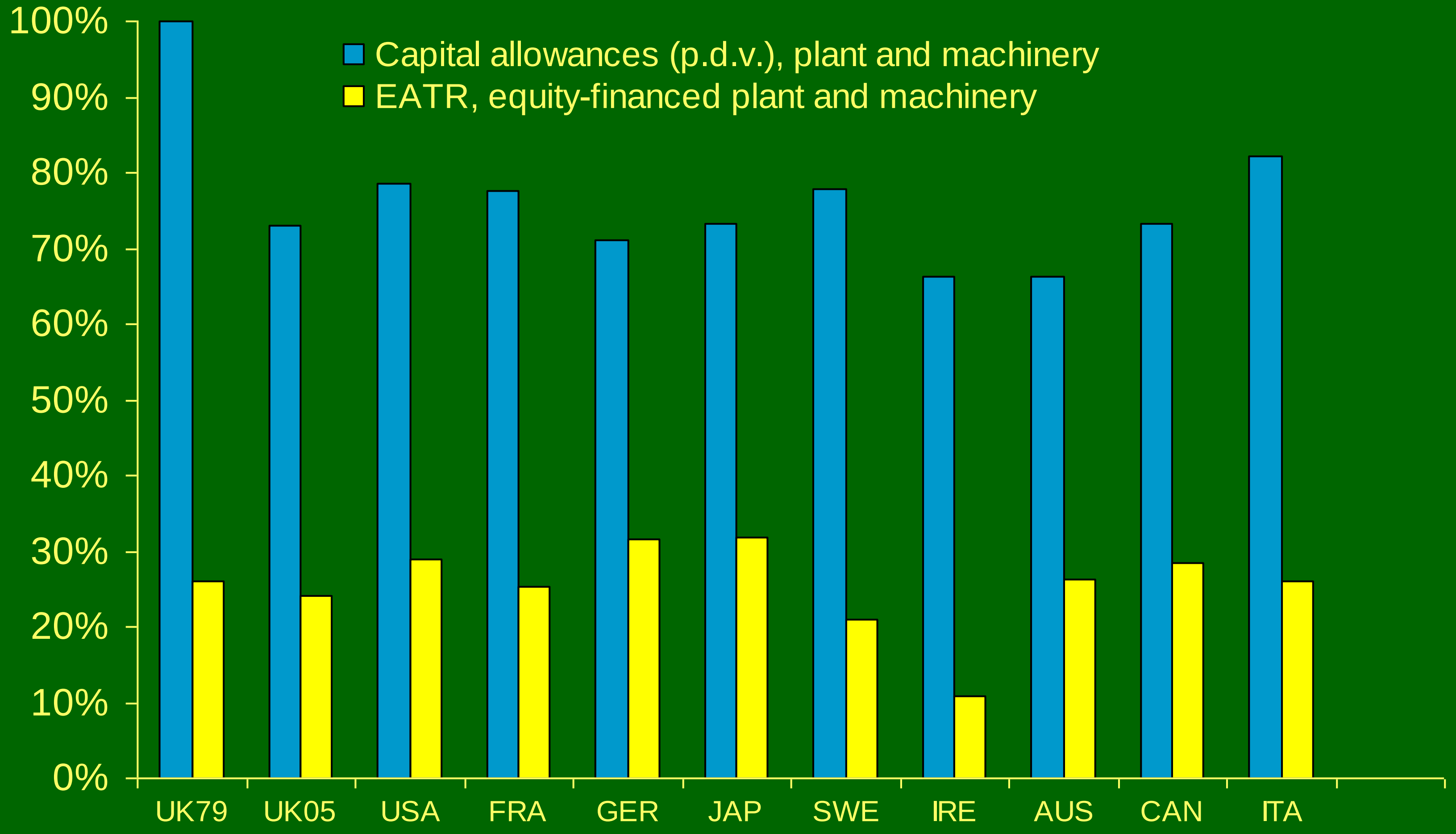


An example of how not to make tax policy

- In 2002, government announced 0% corporation tax for firms with profits of <£10k
- Self employed can incorporate their businesses and keep all the shares themselves
  - self employed have to pay income tax and NI on income
  - if they incorporate, they have to pay income tax & NI on wages paid to themselves…
  - …and have to pay corporation tax and income tax (at a lower rate) on dividends paid to themselves
  - So 0% corporation tax rate made incorporation more beneficial despite the costs involved
- But the Chancellor said that this was an abuse of the system and in 2005 increased the rate to 19% again!

The corporate tax burden

Effective average tax rates and capital allowances 2005

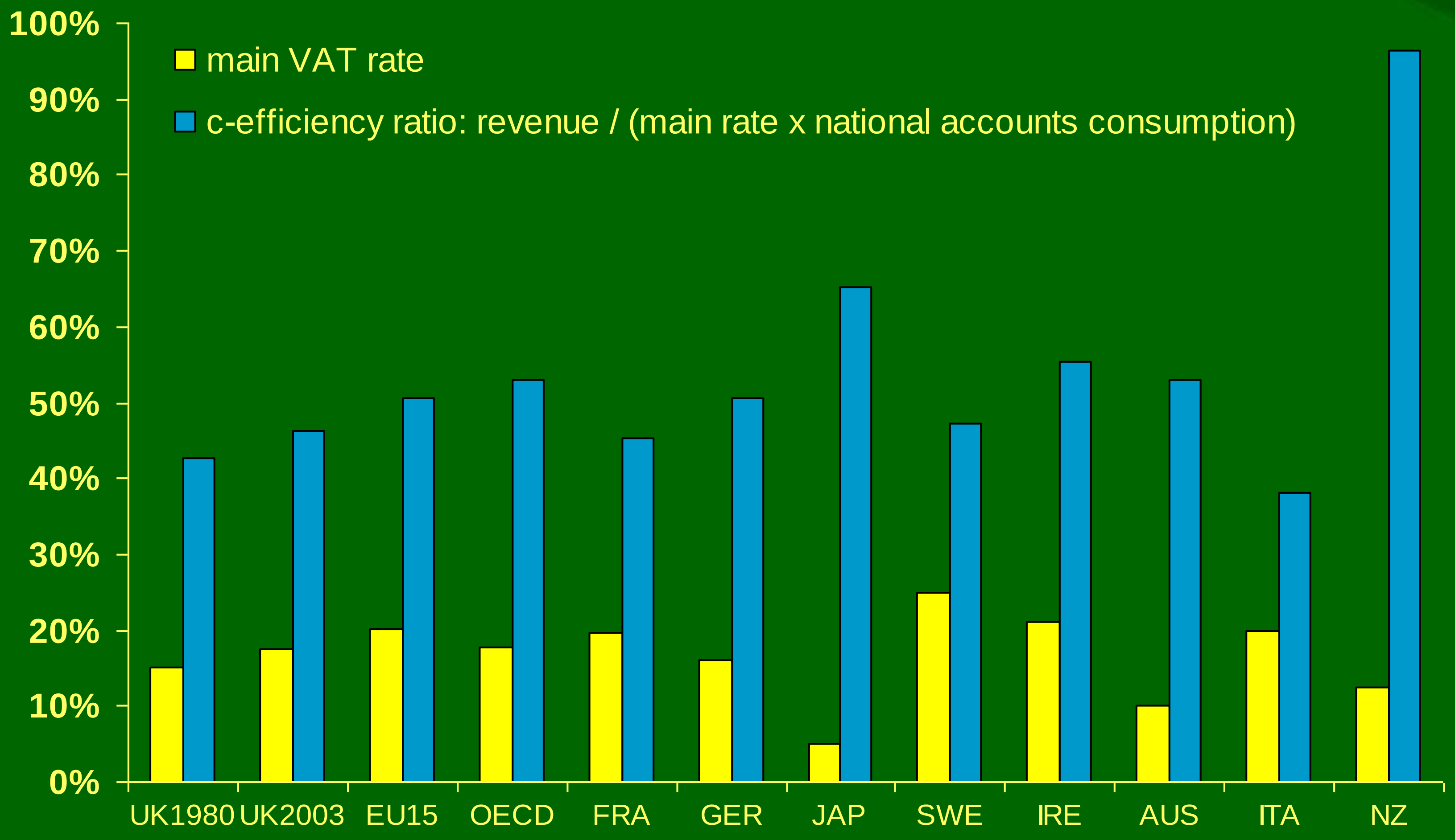


Source: Klemm (2005)

VAT

- Main rate 8%→15% in 1979 and →17.5% in 1991
  - in both cases to pay for reductions in other taxes
  - part of international move towards uniform VAT
- Atkinson and Stiglitz result from optimal tax theory – if there is weak separability between leisure and all other goods, uniform sales tax optimal
- But the UK has lots of zero rated items

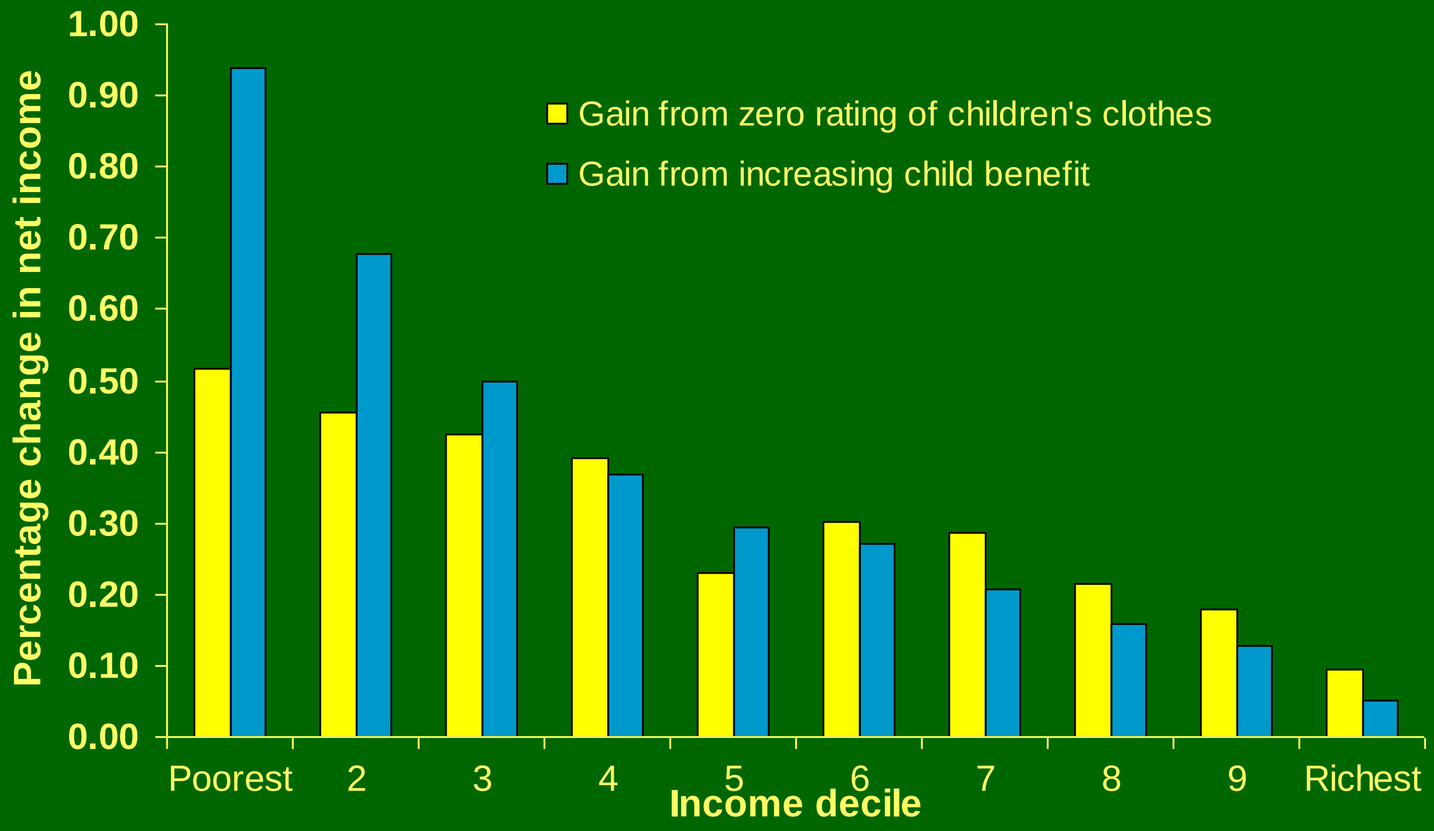
VAT rates and bases



VAT

- Zero rating of items often defended on grounds of redistribution
- Atkinson-Stiglitz result shows that this argument is flawed - always better to use other means of redistribution (assuming consumption and leisure separable and ignoring externalities/merit good arguments)
- So taxing all goods uniformly and increasing a universal grant will always bring the system closer to optimality
- E.g. in UK, end zero rating of children's clothes and increase child benefit

Child benefit more redistributive than zero rating of children's clothes



Excise duties

- Fuel, alcohol and tobacco
- Rates increased, yet share of revenues declined (as in most other countries)
- Fuel protests in 2000 led to lower rates of fuel duty
- Serious concerns about smuggling, especially with spirits
  - Believed that raising rates would not increase revenue
  - Rate frozen in cash terms since 1997
  - But may also be because taxed more highly than wine & beer per unit of alcohol

Environmental taxes

- Various new environmental taxes introduced:
  - Air passenger duty (1994)
  - Landfill tax (1996)
  - Climate change levy (2001)
  - Aggregates levy (2002)
  - London congestion charge (2003)
- None of these raised more than £1bn in 2005
  - compared with £24bn (+ VAT) from fuel duty

Property / local taxes

- Council tax:
  - Replaced poll tax in 1993 (previously domestic rates)
  - Based on property values (banded, no revaluation) with discounts for 1-person households and low-income families
  - UK's only local tax (councils set average rate only)
- Business rates:
  - Proportion of estimated market rent (unbanded, revalued) with discounts for businesses with low rents
  - Central government now sets the proportion
- Lyons enquiry into possible reforms to council tax
  - Suggested revaluation, more council tax bands, maybe allocating a proportion of income tax revenues to councils

Part of an international trend?

YES:

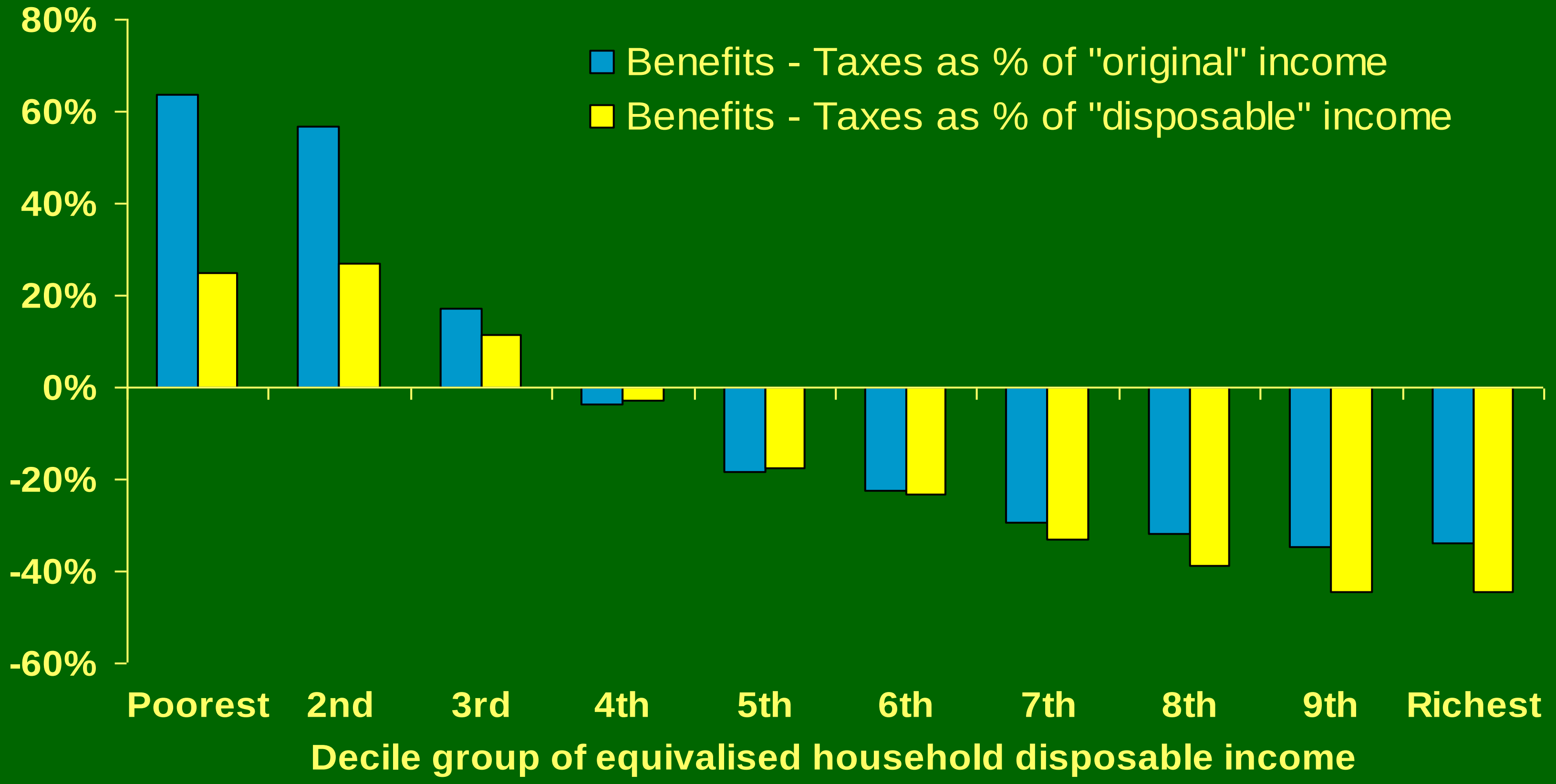
- Cuts in top and basic rates of income tax
- Shift from duties on specific goods towards VAT
- Corporate tax rates cut, base broadened
- Shift from family to individual taxation
- In-work support through the tax system
- SSC rates up even as PIT rates down
  - But for different reasons: UK seems largely political, while elsewhere caused by rises in commitments (health, pensions etc) for which SSCs earmarked
- Introduction of environmental taxes

NO:

- (Re-)introduction of starting rate of income tax
  - International trend (and UK in the 80s) to reduce number of bands
- Unusual in removing mortgage interest relief
- Increasing centralisation not matched elsewhere

Distributional effect of the tax and benefit system

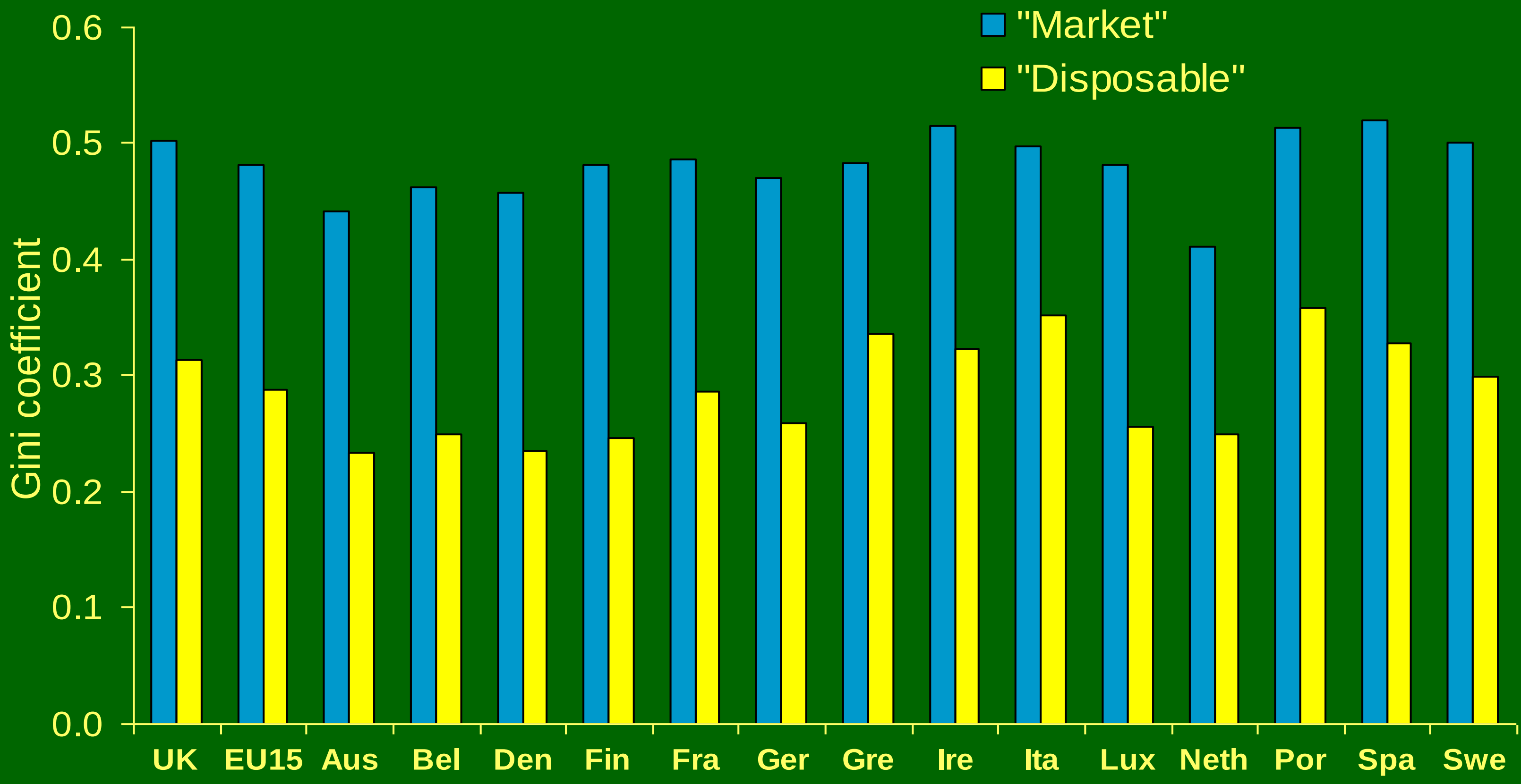
Excluding most 'business taxes'



Source: Authors' calculations from ONS (2006)

Effect of tax and benefit system on income inequality

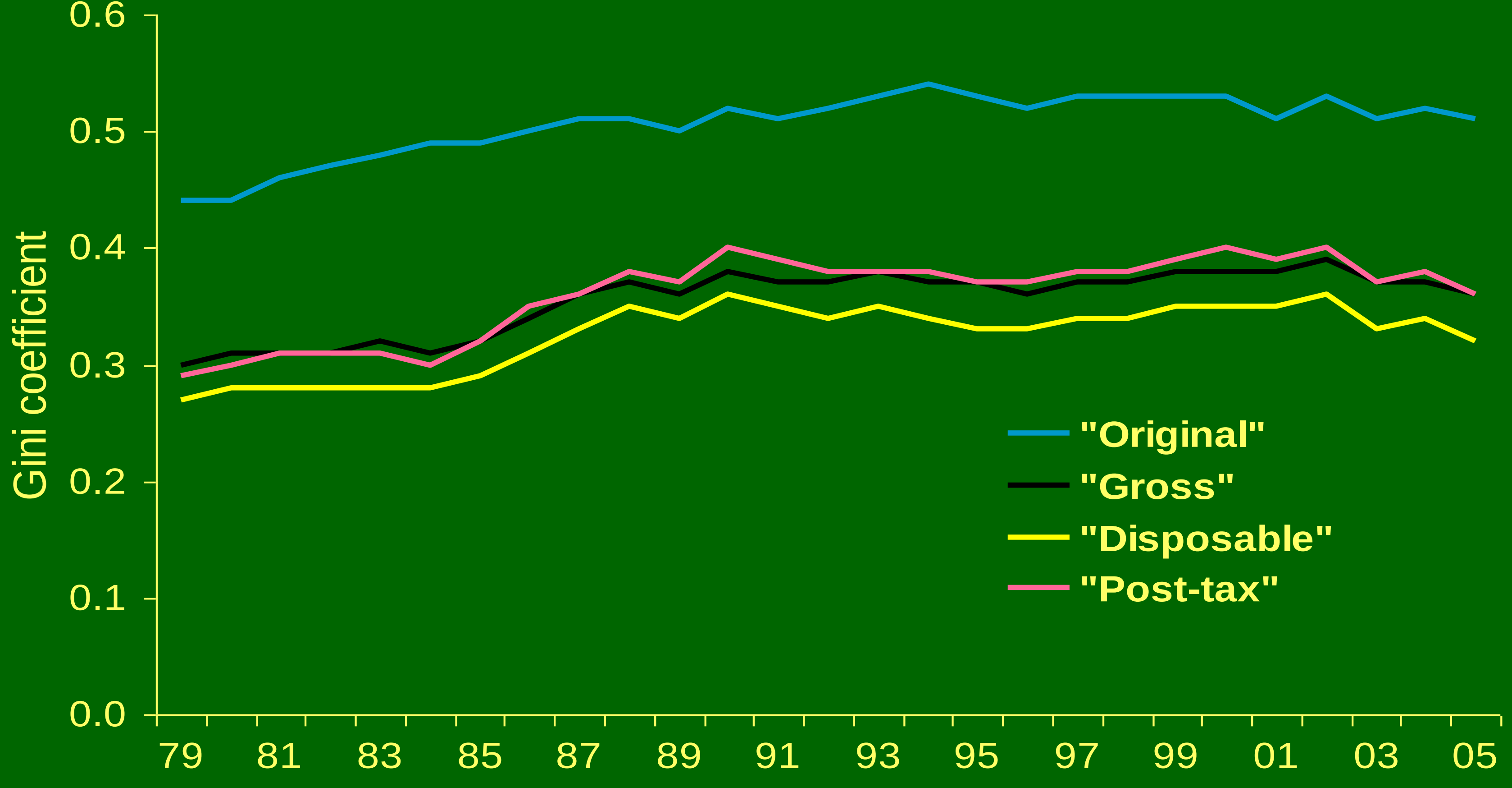
1998, personal taxes and benefits only



Source: Immervol, Levy, Lietz, Mantovani, O'Donoghue, Sutherland and Verbist (2005)

Effect of tax and benefit system on income inequality

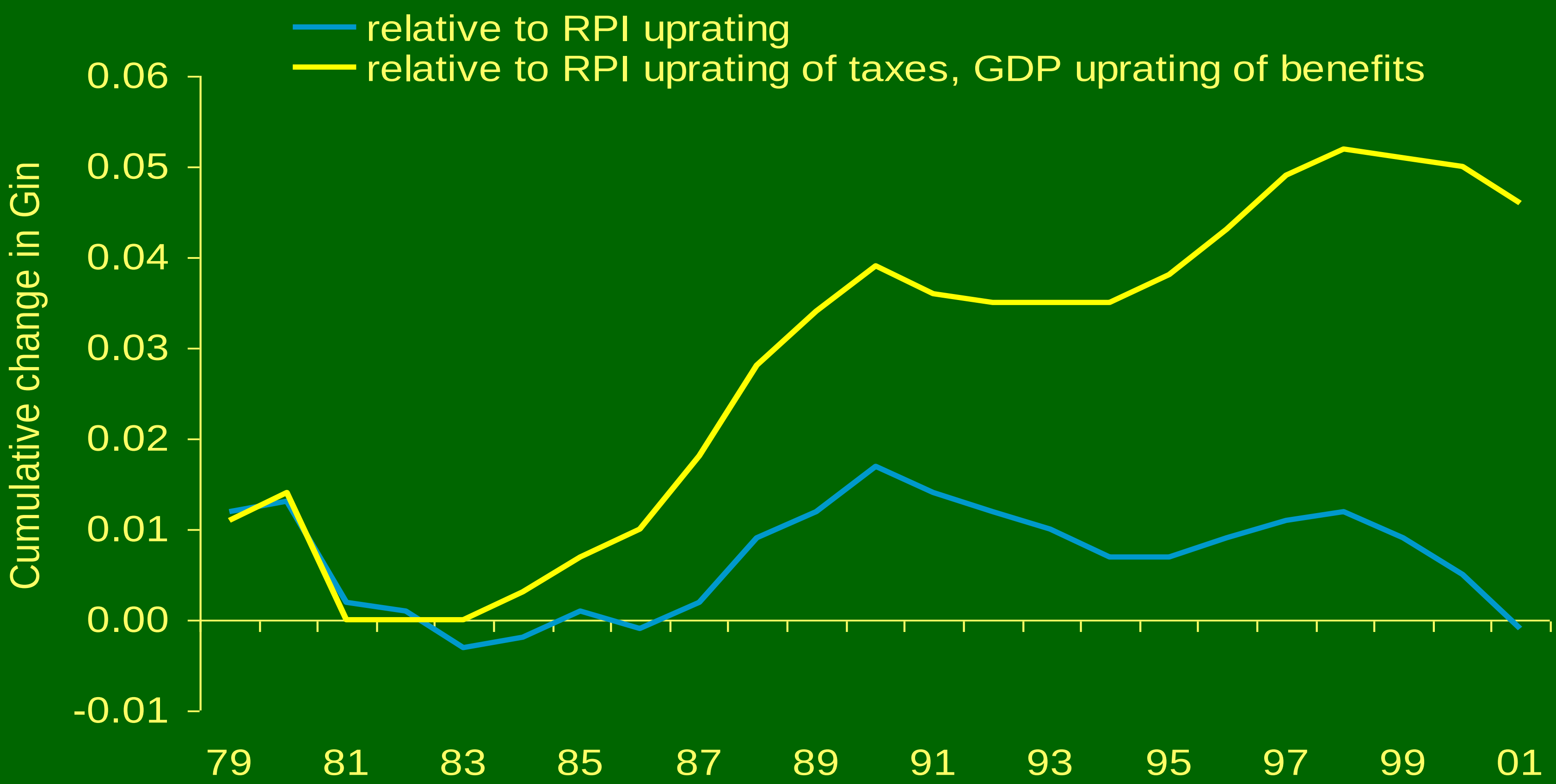
Excluding most ‘business taxes’



Source: ONS (2002, 2006)

Effect of tax and benefit changes on income inequality

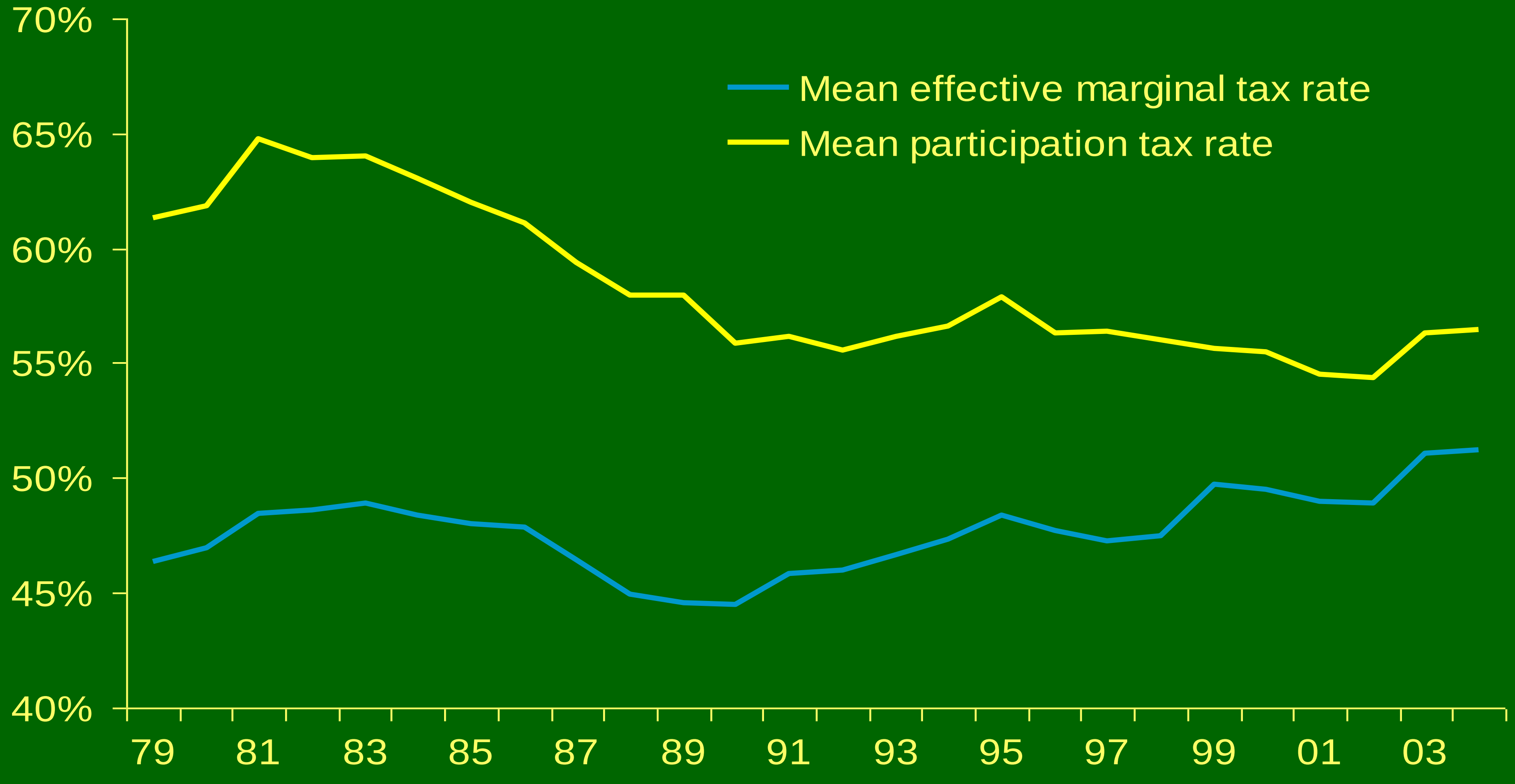
Personal direct taxes and benefits only, 1997-98 population



Source: Clark and Leicester (2004)

Work incentives among workers

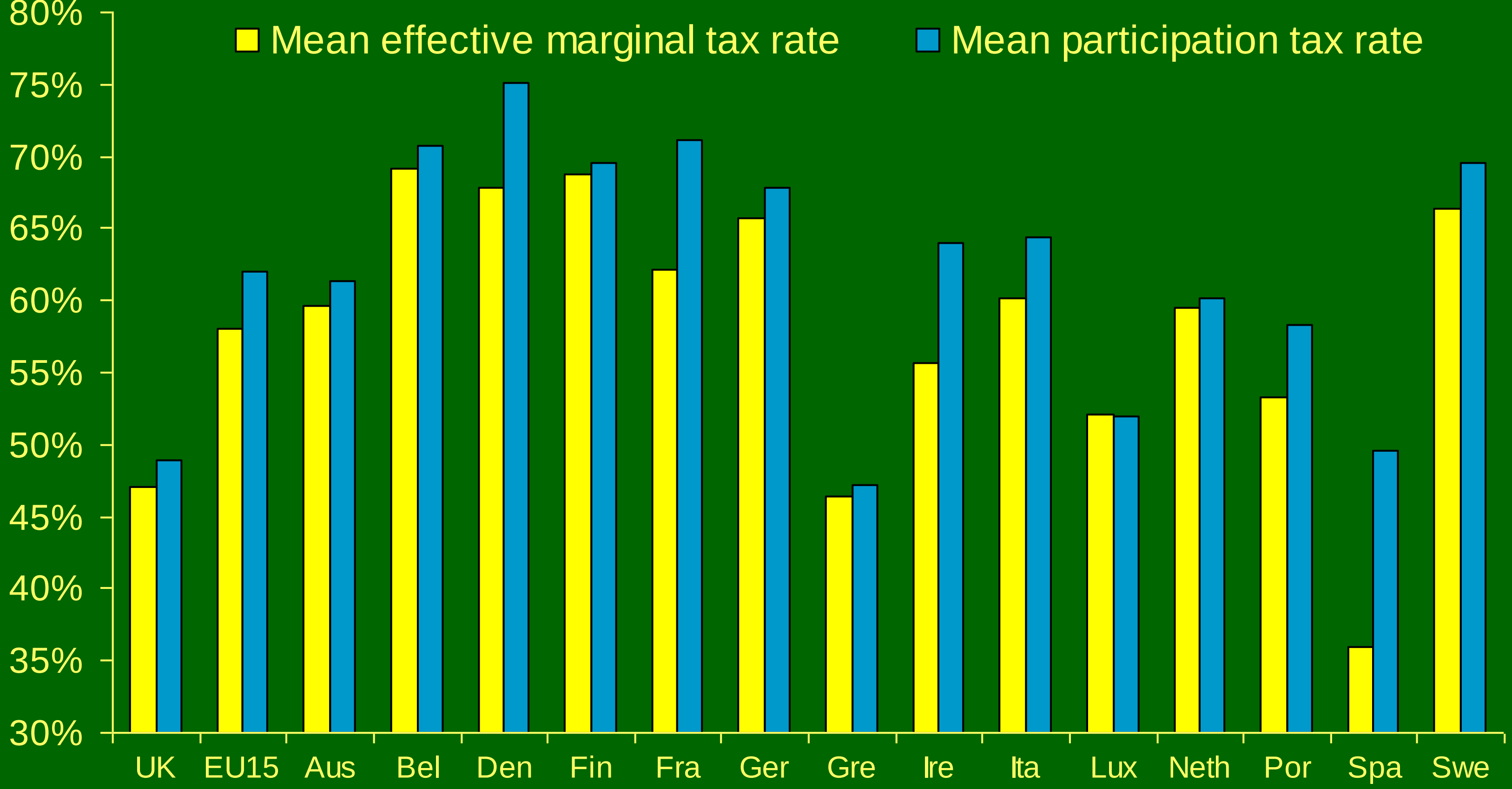
Personal taxes and benefits only



Source: Adam (2005)

Work incentives among workers

1998, personal taxes and benefits only



Source: Immervol, Kleven, Kreiner and Saez (2005)

Taxation of savings

- Atkinson-Stiglitz result again – uniform commodity taxation implies tax on consumption should be the same in both periods (again, if leisure and consumption weakly separable)
- This implies a zero net tax rate for savings
- This is called an expenditure tax
- Caveats
  - ignores the fact that there is labour income in different periods – no reason that leisure in different periods should have same tax schedule
  - may be optimal to have age-specific schedules or make future tax schedule conditional on current decisions

Expenditure tax - implementation

- Not just a sales tax – can be progressive
- Remember that C = Y – S
- Two ways of implementing it
  - **EET treatment:** e.g. pensions in the UK
    - Contributions: **E**xempt from tax (or tax relief on contributions)
    - Returns: **E**xempt from tax
    - Withdrawals: **T**axed (on whole amount)
  - **TEE treatment:** e.g. ISAs
    - Contributions made out of: **T**axed income
    - Returns: **E**xempt from tax
    - Withdrawals: **E**xempt from tax
- Identical if investments zero net present value

Expenditure tax at the corporate level

- Various ways of operating it:
  - 100% first year capital allowances (i.e. count all investment as an expense when first made, but no depreciation allowances)
  - used to have this in the UK for plant and machinery
  - capital allowances that reflect true economic depreciation
  - Allowance for Corporate Equity – allow dividends that represent the normal return to capital as an expense (but no capital allowances)

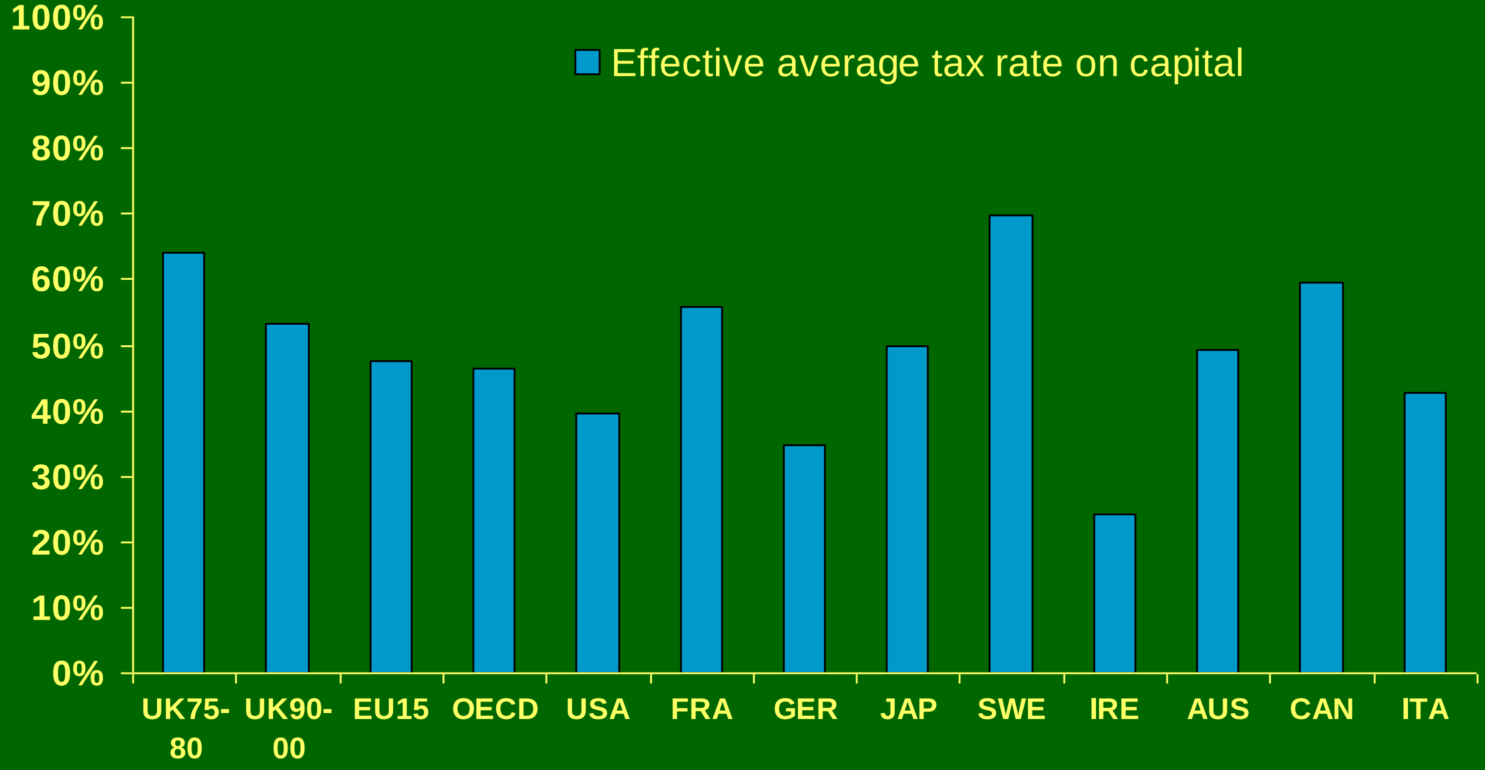
Towards an expenditure tax

How close is the UK?

Different approaches:

1. Aggregate revenue-based measures
   - How much more revenue is raised than under expenditure tax treatment?
   - Compared with TEE (EC / Carey & Rabesona) or EET (Gordon & Slemrod) treatment?
   - Ignores distortion caused by different assets being treated differently

Average tax rates on capital



Source: Carey and Rabesona (2002)

Towards an expenditure tax
How close is the UK?

Different approaches:

1. Aggregate revenue-based measures
   - How much more revenue is raised than under expenditure tax treatment?
   - Compared with TEE (EC / Carey & Rabesona) or EET (Gordon & Slemrod) treatment?
   - Ignores distortion caused by different taxes being treated differently
2. Treatment of individual asset types
   - Again, need to also consider distortions from different types of investment being taxed differently
   - Little feel for the overall level of capital taxation

Tax treatment of different savings types

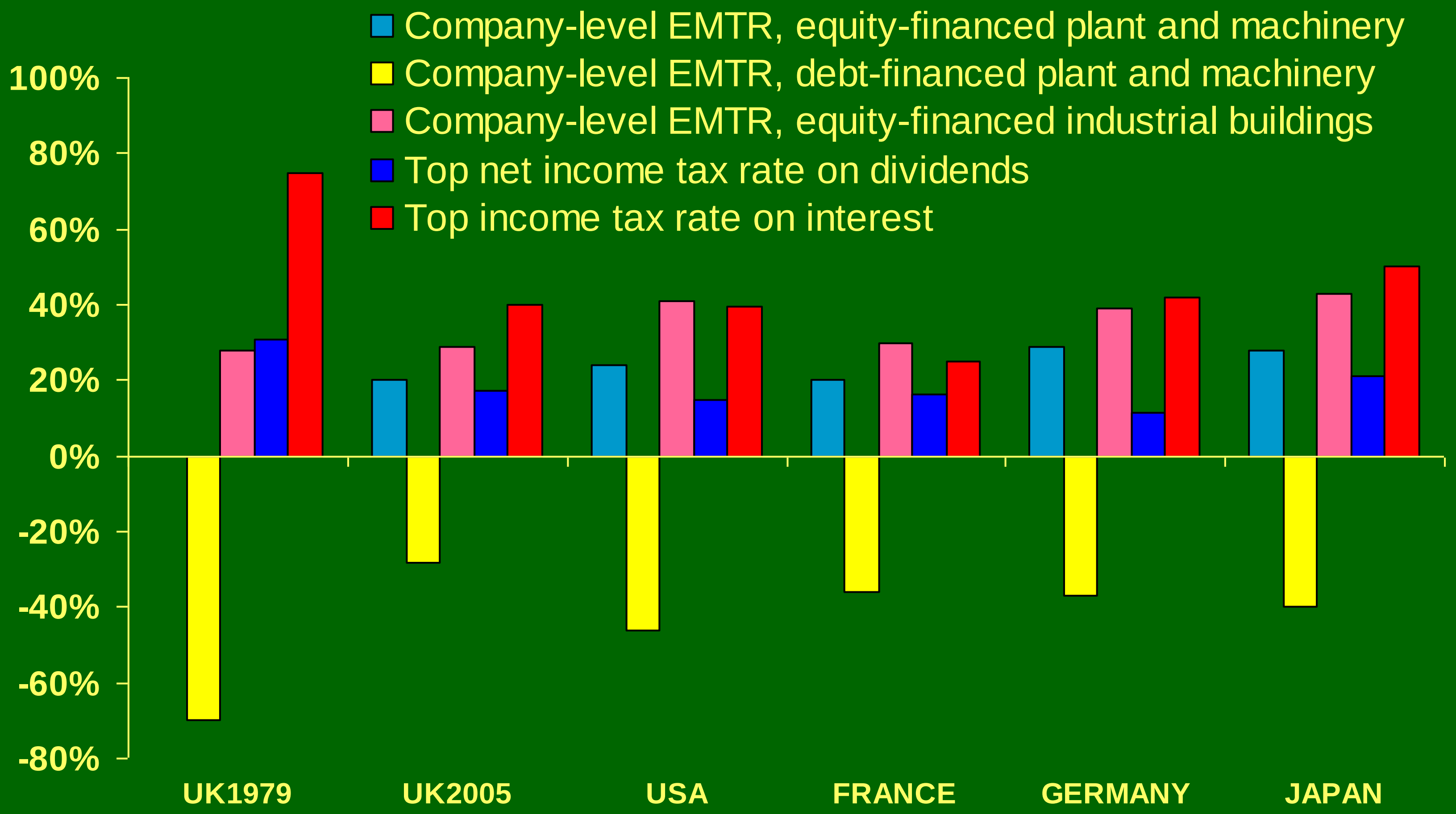
- Pensions have EET treatment
- ISAs, owner occupied housing, durables have TEE treatment – this covers almost everything for most people
- Abolition of dividend tax credit for exempt taxpayers (pension funds and ISAs), which was a capital subsidy ("£5bn a year…") if corporate taxes ignored
- But other savings accounts and shares have TTE treatment
- This is just in income tax though: need to consider
  - Council tax (taxing returns from housing)
  - Stamp duty (transactions based tax)
  - Inheritance Tax (if bequests not accidental)
  - Means tested benefits effectively impose a high rate of tax on saving

Towards an expenditure tax
How close is the UK?

Different approaches:

1. Aggregate revenue-based measures
   - How much more revenue is raised than under expenditure tax treatment?
   - Compared with TEE (EC / Carey & Rabesona) or EET (Gordon & Slemrod) treatment?
   - Ignores distortion caused by different assets being treated differently
2. Treatment of individual asset types
   - Again, need to also consider distortions from different types of investment being taxed differently
   - Little feel for the overall level of capital taxation
3. Effective tax rates on different investments (King & Fullerton)
   - Accurate measure for a particular investment
   - Endless possible permutations:
     different forms of investment, tax-exempt shareholders, foreign investors/companies, finance via debt vs equity vs retained profits, different assumptions (inflation, true depreciation, profits, etc),…

Tax rates on investments



Source: Klemm (2005)

Changes to treatment of savings

Closer to uniform tax-free treatment at personal level:

- Uniform rate of zero for pensions, ISAs, durables
- Removal of tax relief on life assurance and mortgage interest (EEE treatment)
  - The removal of mortgage interest relief is an achievement that few countries have been able to emulate

Further away from expenditure tax at corporate level:

- 100% capital allowances for plant & machinery ended

Summary

- Some successful attempts to reform the tax system in recent years, but still many areas in need of reform
- Debatable to what extent tax and benefit reforms are responsible for increased inequality
- Incentive to work at all stronger despite marginal effective tax rates being higher
- Closer to expenditure tax treatment at the personal level, further away at corporate level