

Preface

Thirty years ago, the Institute for Fiscal Studies (IFS) published a seminal review of the UK tax system, the fruits of a commission chaired by the Nobel Laureate Professor James Meade. Explaining the motivation for the review, Dick Taverne, then Director of IFS, lamented: ‘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’.

Unfortunately, this critique still holds true today. In some important respects, the tax system has evolved in the way that the Meade Report recommended, but it remains the product of often incoherent piecemeal changes rather than strategic design. The tax system has also struggled to adapt to profound changes in the economic, social, and institutional environment in which it operates. And tax design has not benefited as much as it could from advances in theoretical and empirical understanding of the way features of the system influence people’s behaviour.

For all of these reasons, we felt that the time was ripe once again to ask an expert commission to take a hard look at the tax system: to try to identify the characteristics that would make for a good tax system in an open economy in the 21st century; and to suggest how the British tax system in particular might be reformed to move closer to that ideal. In doing this, we have been, if anything, even more ambitious than our esteemed predecessors on the Meade Report.

Whilst Meade focused largely on direct taxes, we set out to look across the whole tax system. Indeed, the insight that the tax system needs to be seen as a whole underlies our entire approach. And whilst we retain a clear focus on the UK, we have also tried to ensure that our conclusions are relevant internationally—we have taken more than just a UK-centred approach.

In addition, this volume is not the only output of the review. In a companion volume, *Dimensions of Tax Design*, published in 2010, small teams of experts from IFS and around the world addressed a number of key themes in tax design. That volume contains an immensely rich and varied set of analyses. The papers there provide comprehensive and state-of-the-art

surveys of the economic thinking in the main areas of tax design. They also provided invaluable inspiration for this, the final report.

From the outset, the intention of the review was to take a ‘big picture’ view of tax design, asking what society wants the tax system to achieve and how best it might be structured to accomplish that. In this final report, we have tried both to set out an overarching vision for the tax system and to suggest some desirable incremental reforms. The starting point has been to look at the economics of the tax system, although we have received a great deal of useful input from tax lawyers, advisers, and practitioners, as well as those involved currently and in the past with the practicalities of tax design and implementation. Inevitably, some of those who spend most of their time thinking about tax design and implementation from these perspectives might have identified different priorities and have taken different approaches if they were to have undertaken this review themselves. Economists cannot claim to have all the answers to good tax design—and some of our answers will pose new questions. But thinking hard about the economics of the tax system is essential if it is to work effectively.

In addition to administrative practicality and the difficulty of turning economic intentions into robust legislative language, proposals for tax reform are, of course, constrained by politics—not least the unfortunate observation that those who lose from tax reforms tend to be vengeful while those who gain from them tend to be ungrateful. But there is no point in a review of this sort confining itself only to recommendations that we could confidently expect to receive immediate and enthusiastic support across the political spectrum—this would be a very short report if it did. Whilst we have tried to take explicit account of the political economy of tax reform in setting out a possible path to a better system, there will always be a tension to some extent between what is economically desirable and what is politically practical.

In thinking of a worthy successor to James Meade to chair a review of this ambition, there was one obvious choice: the Nobel Laureate and founder of the modern theory of optimal taxation, Professor Sir James Mirrlees. This volume is very much the joint work of Sir James and a distinguished team of eight other economists and one lawyer, who have been working together on the review for four years. In addition to myself, this team contains some of

the most pre-eminent public economists in the UK, and indeed the world. It has been both a pleasure and a privilege working with them.

Even a team such as this is dependent on others. Our thoughts and views have been influenced over the period of this review by discussions at conferences, seminars, meetings, and presentations far too numerous to list. All of the 63 authors who contributed to *Dimensions* have played an important part in forming and developing the ideas that underlie our conclusions, both through the contributions they wrote and through the many discussions we had with them. We are incredibly grateful to them all. Many staff at IFS with expertise in modelling and analysing tax policy have also played a vital role. And we have relied on them to keep everything else going at IFS whilst we have spent far longer than we ever intended on this endeavour.

So I am going to resist the invidious temptation to single out any individuals who have contributed to the content for thanks. The many dozens on whose wisdom, patience, and insights we have drawn know who they are and can be assured of our deep gratitude.

There are others who have made this volume possible, though, and they do deserve special thanks. Judith Payne has once again shown her extraordinary abilities as a copy-editor, and more than ever before has had to display equally extraordinary patience. Our publishers at OUP have also shown a degree of patience, for which we thank them. At IFS, Bonnie Brimstone and Emma Hyman have both provided the highest-quality support.

Finally, one of the most important and well-known lessons from economics is that there is no such thing as a free lunch. We must therefore express our heartfelt thanks to those who have paid for this one: the Nuffield Foundation and the Economic and Social Research Council. Both have long been much-valued supporters of IFS and we hope that they will think their investment in this project worthwhile. It just remains for me to echo Dick Taverne's words on the launch of the Meade Report: 'We hope and believe that this Report will be a rich quarry for tax reformers and a valuable reference point for students of taxation for decades to come'.

Paul Johnson
Director
Institute for Fiscal Studies

The Nuffield Foundation is a charitable trust with the aim of advancing social well-being. It funds research and innovation, predominantly in social policy and education. It has supported this project, but the views expressed are those of the authors and not necessarily those of the Foundation. More information is available at <http://www.nuffieldfoundation.org>.

The Economic and Social Research Council (ESRC) funds research and training in social and economic issues. It is an independent organization, established by Royal Charter, receiving most of its funding through the Department for Business, Innovation and Skills.



Contents

<i>List of Figures</i>	x
<i>List of Tables</i>	xiii
<i>About the Authors</i>	xv
1. Introduction	1
2. The Economic Approach to Tax Design	21
3. The Taxation of Labour Earnings	46
4. Reforming the Taxation of Earnings in the UK	73
5. Integrating Personal Taxes and Benefits	122
6. Taxing Goods and Services	148
7. Implementation of VAT	167
8. VAT and Financial Services	195
9. Broadening the VAT Base	216
10. Environmental Taxation	231
11. Tax and Climate Change	246
12. Taxes on Motoring	269
13. The Taxation of Household Savings	283
14. Reforming the Taxation of Savings	318
15. Taxes on Wealth Transfers	347
16. The Taxation of Land and Property	368
17. Taxing Corporate Income	406
18. Corporate Taxation in an International Context	429
19. Small Business Taxation	451
20. Conclusions and Recommendations for Reform	470
<i>References</i>	504
<i>Index</i>	525

Figures

Figure 1.1. Real income growth by percentile point, 1979 to 2009–10 (Great Britain)	9
Figure 3.1a. Employment rates by age in the UK over time: men	48
Figure 3.1b. Employment rates by age in the UK over time: women	49
Figure 3.2a. Employment by age in the UK, the US, and France in 2007: men	50
Figure 3.2b. Employment by age in the UK, the US, and France in 2007: women	51
Figure 3.2c. Average total hours of market work done in 2007 by age in the UK, the US, and France: women	52
Figure 3.3. Early retirement and inactivity by age and wealth quintile in the UK: men	52
Figure 3.4. A linear negative income tax schedule	59
Figure 4.1. Income tax schedule for those aged under 65, 2010–11	75
Figure 4.2. Composition of an example budget constraint in 2010–11	78
Figure 4.3. Distributional impact of the UK tax and benefit system in 2009–10	80
Figure 4.4. Distributional impact of different components of the UK tax and benefit system in 2009–10	81
Figure 4.5. The distribution of PTRs and EMTRs among UK workers, 2009–10	84
Figure 4.6. Average PTRs and EMTRs across the earnings distribution, 2009–10	86
Figure 4.7. Average PTRs across the earnings distribution for different family types, 2009–10	88
Figure 4.8. Average EMTRs across the earnings distribution for different family types, 2009–10	89
Figure 4.9. Effect of illustrative reforms on an example budget constraint in 2009–10	96
Figure 4.10. Gains/Losses across the income distribution	100
Figure 4.11. Effect of reform on average PTRs across the earnings distribution	102
Figure 4.12. Effect of reform on average EMTRs across the earnings distribution	102
Figure 4.13. Effect of reform on average PTRs across the earnings distribution, by age of youngest child	113

Figure 4.14. Effect of reform on average EMTRs across the earnings distribution, by age of youngest child	114
Figure 4.15. Effect of reform on average PTRs across the earnings distribution, by age	117
Figure 4.16. Effect of reform on average EMTRs across the earnings distribution, by age	118
Figure 5.1. Combined income tax and NICs schedules for those aged under 65, 2010–11	128
Figure 7.1. A simple illustration of carousel fraud	187
Figure 9.1. Effect of reform by income decile	222
Figure 9.2. Effect of reform by expenditure decile	223
Figure 9.3. Effective marginal tax rate before and after reform	225
Figure 9.4. Participation tax rate before and after reform	225
Figure 9.5. Effect of alternative reform package by income decile	227
Figure 9.6. Effect of alternative reform package by expenditure decile	228
Figure 11.1. Coverage of the EU Emissions Trading Scheme by UK sector	255
Figure 11.2. Allowance price evolution in the EU ETS, 2005–08	258
Figure 11.3. Share of non-durable expenditure devoted to domestic fuel, by expenditure decile	259
Figure 11.4. Losses from imposing VAT at 17.5% on domestic energy consumption, by income decile	260
Figure 12.1. Real petrol and diesel duty over time	277
Figure 13.1. Net income and net expenditure per household	287
Figure 13.2. Consumption and needs	288
Figure 14.1. Effective tax rates for a range of assets in selected years	324
Figure 15.1. Distribution of net household wealth, 2006–08	350
Figure 15.2. Distribution of net household wealth by age, 2006–08	351
Figure 16.1. Comparing a 0.6% tax on property values with council tax in a local authority setting average band D rate in England, 2009–10	386
Figure 16.2. Impact on house prices of replacing council tax with a 0.6% tax on property values in 2009–10	386
Figure 16.3. Modelled revenue-neutral reform to housing taxation	387
Figure 16.4. Gains/Losses across the English income distribution from modelled reform to housing taxation	388

Figure 16.5. Real house prices and trend from 1975 Q1 to 2010 Q2	394
Figure 17.1. Corporate tax rates in selected years and countries	407
Figure 17.2. Taxes on corporate income as a percentage of GDP in selected years and countries	408

Tables

Table 1.1.	Sources of UK tax revenue, 2011–12 forecasts	5
Table 1.2.	Weekly net household incomes in the UK, 2009–10	10
Table 1.3.	Percentages of men and women in work by age, 1979 and 2008	12
Table 2.1.	Position of individuals in the income distribution by quintile in 2008 in relation to 1991	25
Table 3.1.	Male 90–10 wage ratios across countries, 1980–2000	53
Table 3.2.	Hourly wage inequality in the UK and the US: real wage trends by percentile	54
Table 4.1.	Distribution of PTRs among workers, 2009–10	85
Table 4.2.	Distribution of EMTRs among workers, 2009–10	85
Table 4.3.	Average PTRs among workers by family type and housing tenure, 2009–10	90
Table 4.4.	Average EMTRs among workers by family type and housing tenure, 2009–10	91
Table 4.5.	Income tax schedule for those aged 65–75, 2010–11	106
Table 5.1.	Sequential versus simultaneous income assessments	143
Table 7.1.	A simple supply chain with 20% VAT	169
Table 7.2.	Estimated revenue cost of zero-rating, reduced-rating, and exempting goods and services, 2010–11	172
Table 8.1.	Cash-flow VAT with a 20% tax rate	198
Table 8.2.	Cash-flow and TCA approaches with a 20% tax rate and an 8% ‘pure’ interest rate	206
Table 10.1.	Environmental tax revenues, 2009–10	233
Table 11.1.	Probabilities of exceeding temperature increases, relative to 1850, at various stabilization levels of CO ₂ e	248
Table 11.2.	Greenhouse gas emissions by source and by end user, 2006	251
Table 11.3.	Implicit carbon taxes, 2009–10	253
Table 12.1.	Estimated marginal external costs of driving, 1998	270
Table 12.2.	Marginal external costs and taxes paid by road users	276
Table 13.1.	Fraction of financial wealth held in different assets in England, 52- to 64-year-olds, 2004	291

Table 13.2.	Comparison of savings tax regimes with normal returns (assumed 5%)	300
Table 13.3.	Comparison of savings tax regimes with excess returns (assumed 10% with normal at 5%)	302
Table 13.4.	The impact of progressive taxation (40% when saving, 20% on withdrawal)	304
Table 14.1.	Tax treatment of different assets (in 2010–11)	320
Table 14.2.	Effective tax rates on savings in different assets	322
Table 14.3.	Contribution to a range of assets required to match TEE return	323
Table 14.4.	Employee contribution to pension (ten-year investment) required to match £1 contribution to TEE vehicle for different combinations of working-life and retirement tax rates	329
Table 15.1.	Composition of estates by size (estates passing on death in 2007–08)	359
Table 16.1.	Council tax bands and rates in England	382
Table 16.2.	Average gains/losses and numbers gaining/losing from modelled reform to housing taxation	389
Table 16.3.	Characteristics of households in England by council tax band, 2009–10	390
Table 17.1.	Effects of the corporate income tax on a simple investment	414
Table 19.1.	Total tax and National Insurance contributions, by legal form, 2010–11	457
Table 19.2.	Marginal tax rates, by legal form, 2010–11	459
Table 20.1.	A good tax system and the current UK tax system	478
Table 20.2.	Main recommendations	495

About the Authors

Sir James Mirrlees is a Fellow of Trinity College and Emeritus Professor of Political Economy at the University of Cambridge, Laureate Professor at the University of Melbourne, and Distinguished Professor-at-Large at the Chinese University of Hong Kong. He is a Fellow of the British Academy and past President of the Econometric Society, the Royal Economic Society, and the European Economic Association, and has been awarded numerous honorary degrees. Working primarily on the economics of incentives and asymmetric information, he founded the modern theory of optimal taxation, and was the joint winner of the Nobel Prize for Economics in 1996. He was knighted in 1997 for contributions to economic science.

Stuart Adam is a Senior Research Economist at IFS. His research focuses on the design of the tax and benefit system, and he has written about many aspects of UK tax and benefit policy, including income tax and National Insurance, capital gains tax, tax credits, Incapacity Benefit, work incentives and redistribution, support for families with children, and local government finance.

Timothy Besley CBE is Kuwait Professor of Economics and Political Science at LSE and a Research Fellow at IFS. From 2006 to 2009, he was an external member of the Bank of England Monetary Policy Committee. His work is mainly in the fields of development economics, public economics, and political economy. He is a former co-editor of the *American Economic Review*, Fellow of the Econometric Society and of the British Academy, and a past President of the European Economic Association. He was a 2005 recipient of the Yrjö Jahnsson Prize, and was awarded the CBE in 2010 for services to social sciences.

Richard Blundell CBE is Research Director of IFS, where he is also Director of the ESRC Centre for the Microeconomic Analysis of Public Policy. He holds the David Ricardo Chair of Political Economy at UCL. His research has been mainly in the fields of microeconometrics, household behaviour, and tax policy evaluation. He is a Fellow of the British Academy, honorary

Fellow of the Institute of Actuaries, President of the Royal Economic Society, past President of the European Economic Association and of the Econometric Society, and former co-editor of *Econometrica*. A winner of the Yrjö Jahnsson Prize and the Frisch Medal, he was awarded the CBE in 2006 for services to economics and social science.

Stephen Bond is a Senior Research Fellow at Nuffield College, Oxford, a Programme Director at the Oxford University Centre for Business Taxation, and a Research Fellow at IFS. His main interests are in corporate tax policy and the effects of corporate taxation on the behaviour of firms. Other interests include empirical research on company investment and financial behaviour, and the development of econometric methods for the analysis of panel data.

Robert Chote is Chairman of the Office for Budget Responsibility. He was Director of IFS from 2002 to 2010. He was formerly an adviser and speechwriter to the First Deputy Managing Director of IMF. He was Economics Editor of the *Financial Times* between 1995 and 1999, and previously served as Economics Correspondent of *The Independent* and a columnist on the *Independent on Sunday*, where he was named Young Financial Journalist of the Year by the Wincott Foundation. He is a governor of the National Institute of Economic and Social Research and a member of the Advisory Board of the UK Centre for the Measurement of Government Activity at the Office for National Statistics.

Malcolm Gammie CBE QC is a barrister at One Essex Court. He has been associated with IFS for almost thirty years, and is currently Research Director of its Tax Law Review Committee. He was a Senior Tax Partner at the City law firm of Linklaters until moving to the Bar in 1997, becoming a QC in 2002. He was named Tax Lawyer of the Year 2008 at the LexisNexis Taxation Awards. A past President of the Chartered Institute of Taxation, he teaches at universities in Australia, the Netherlands, and the UK. He has advised governments of several countries, the European Commission, and the OECD on tax policy issues and was awarded the CBE in 2005 for services to taxation policy.

Paul Johnson is Director of IFS. He started his career at IFS working on tax, welfare, and distributional issues. He went on to spend periods as Head of Economics at the Financial Services Authority, as Chief Economist at the Department for Education, and as a Director in HM Treasury. From 2004 to 2007, he was Deputy Head of the Government Economic Service. He has worked extensively in many areas of public economics and policy, both as a researcher and within government.

Gareth Myles is Professor of Economics at the University of Exeter and a Research Fellow at IFS. He is a Fellow of the Royal Society of Arts and has been a Professorial Fellow at the Australian School of Taxation. He is a managing editor of *Fiscal Studies* and an associate editor of the *Journal of Public Economic Theory*. His main research areas are public economics, labour economics, and microeconomics. His publications include numerous research papers on taxation with imperfect competition, international taxation, and public goods. He has also written the textbooks *Public Economics* (1995) and *Intermediate Public Economics* (2006).

James Poterba is Mitsui Professor of Economics at MIT, President of the National Bureau of Economic Research, and past President of the National Tax Association. He is also a Fellow of the American Academy of Arts and Sciences and of the Econometric Society. His research focuses on how taxation affects the economic decisions of households and firms. He served as a member of the US President's bipartisan Advisory Panel on Federal Tax Reform in 2005, and is a past editor of the *Journal of Public Economics*. He studied economics as an undergraduate at Harvard University and received his doctorate in economics from the University of Oxford.