REFORM

Reality check:
Fixing the UK's tax system

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March 2010

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Executive summary

So far the debate on the deficit crisis has focused on public spending. But tax matters too. Tax policy has been just as short-term and just as subject to political whim as spending policy. The right tax decisions now can both rescue the public finances and help to set the conditions for stronger economic growth in the future.

The main political parties are right to propose policies to increase revenue as part of their plans to ease the deficit. But their plans place too much emphasis on tax rises rather than spending reductions. Most importantly, their plans would cause the maximum economic damage by raising taxes on employment and income rather than consumption, and by increasing the burden on a small group of wealth generators rather than widening the number of taxpayers. The current plans will hinder investment, employment and growth.

Economic opinion is united that a credible plan is needed to eliminate the deficit over a number of years. That plan must involve some additional taxation. In one sense this is simple realism; increasing revenues can reduce the deficit in the short term before the full effects of spending reform take place. But in another it is necessary to remind the electorate that spending has to be paid for. UK political parties have given the impression that ever increasing welfare benefits and public services can be made available to them at little or no cost. The consequence is unsustainable levels of public spending. The link between public spending and taxes needs to be restored.

The great majority of the deficit reduction should come from spending cuts and efficiency due to the poor quality of spending on public services and the benefits system, as set out in previous *Reform* research. A good rule of thumb would be the balance that Canada struck when rescuing their public finances in the 1995 Budget. This would see about one pound of the deficit in every eight dealt with through tax changes. That is a lower proportion of tax rises that each of the major parties is currently offering. Labour propose that one pound in three would be raised in higher taxes; the Conservatives, one pound in five; the Liberal Democrats, one pound in six.

That leaves the question of the right tax policy to deliver the revenue increases. The wrong way is to continue the kaleidoscope of conflicting and unpredictable initiatives into which tax policy has descended in recent years. Each of the major parties has proposed tax policy changes that are little more than gimmicks and have no basis in principle, from freezes in council tax to mansion taxes to a bankers' bonus tax. Basing tax policy on principles will itself go a long way to restore businesses and investors. *Reform* proposes the following as a new set of principles for UK tax policy:

- **Economic efficiency.** This means increasing the tax base rather than damaging increases in tax rates. It means a tax system which is attractive for investors, businesses and individuals, who in a mobile global economy can often choose to locate wherever they wish.
- **Consistency.** Income from different sources should be taxed in an equivalent way and tax should be tied to the individual. An efficient and fair system cannot exist if the tax burden is allocated on an arbitrary basis.
- **Transparency.** The tax system and tax policy process should be free from political whim and consistent with principle. This means an open process of consultation and robust scrutiny of policies.
- **Fairness.** Taxes should be applied in an even handed way and people should pay their fair share, in all parts of the income scale.

Given the weakness of the economy and the need to encourage growth, the tax rises should be levied in the least economically damaging way possible. Unfortunately all three major parties are committed to the most economically damaging tax rises – those on income and employment. Labour has proposed increases on income via the new 50p top rate and withdrawal of the personal allowance for incomes over £100,000, and on employment via an increase in National Insurance contributions. Both Opposition parties have said that they will not repeal the changes in the foreseeable future.

While these changes are yet to come into effect, their proposal is already forcing major companies to consider leaving the UK and dissuading talented people from moving to and investing in the UK. The 50p income tax rate is seen by business leaders as a tipping point for the UK business environment. Taken together with the withdrawal of personal allowances and the restriction on higher rate relief for pensions contributions, the balance of fairness has tilted too far against a small group of wealth generators. Repeal of these measures would be a more important boost to business than a reduction in the corporation tax rate, funded by elimination of reliefs, that the Opposition proposes.

The Opposition has said that it cannot repeal the income tax and NICs increases because of the need to reduce the deficit. That is not true because there is a much better candidate for increasing revenue – indirect taxation on consumption. Eliminating the exemptions on VAT, with protection for the poorest third of households, would make VAT a less complex tax and bring the UK in line with other nations. The UK is one of only four EU countries to apply a zero rate to food and one of only three to apply a zero or reduced rate to children's clothes. Replacing personal allowances with a zero rate threshold of an equivalent amount (£6,475) would also raise extra revenue, while making the income tax system simpler and fairer by capping the benefit at the basic rate.

Taken together, these measures would raise extra revenue of £8.3 billion in 2011-12 and £8.4 billion in 2012-13, compared to the Government's plans which would raise £11.1 billion in 2011-12 and £14.3 billion in 2012-13. These figures only relate to the major tax changes affecting income tax, National Insurance contributions and VAT.

Under the *Reform* package, households with incomes of less than £17,000 would, on average, see a tax reduction (from lower NICs and protection from the broadening of VAT). Households with incomes of over £17,000 would, on average, see a tax increase due to the broadening of VAT and, for higher rate taxpayers, replacement of personal allowances with a zero rate threshold. Individuals earning above £105,000 would see a tax reduction.

1

The UK public finances and the tax/spend balance

As *Reform* has previously argued, substantial increases in taxes will choke off the economic recovery by putting people off work and reducing the UK's competitiveness.[1] Balancing this risk with the need to restore the health of the public finances will determine the shape of fiscal policy in the next Parliament.

Towards a low tax economy

It has been argued that cuts in government spending would take money out of workers' pockets and hold back economic recovery.[2] However, it is important to recognise that tax increases dampen private consumption. Indeed, tax increases can be more harmful than spending cuts (on a pound-for-pound basis), as tax increases reduce the spending that individuals and households undertake while spending cuts reduce spending by government. In cases where individual households have a better understanding of, and information on, their own wants and needs than central government planners, lower taxes would usually lead to greater spending on goods and services that have a real economic benefit.[3]

A low tax economy leaves individuals with more of their money to invest in themselves and their futures. Lower taxes are important as they enable individuals to invest their own resources to develop their careers and add to their own capability.[4] Added to this, increased globalisation has driven a worldwide movement towards lower tax countries, with implications for both business and personal taxes. The UK will need to respond to this trend with competent tax reforms if it is to meet the competitive challenges of the coming years.

The budget deficit

The Treasury estimates the current budget deficit to be £128 billion in 2009-10, with net borrowing at £178 billion. Despite the Labour Government's "Golden rule" – designed to ensure expenditure is kept below the level of revenues over the economic cycle – the UK has been spending more than it has been collecting in taxation practically every year for the last five decades. In only eight of the forty-nine years from 1964-65 to 2013-14 will the government have received more than it has spent. While this problem is not new, since 2001-02 the gap has grown to large levels, reflecting the significant growth in spending since 1998-99.

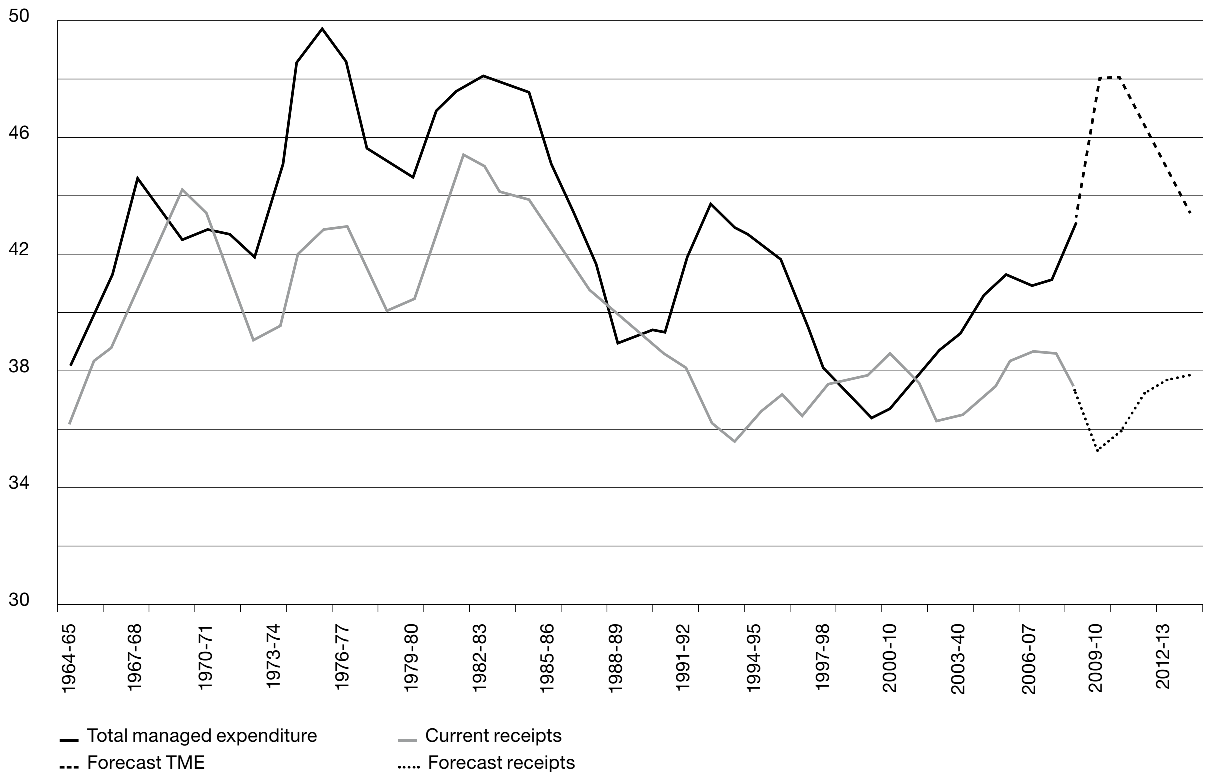
1 Bassett, D. *et al.* (2009), *Back to black: Budget 2009 paper, Reform.*

2 This argument draws on so called Keynesian multipliers, which suggest that, for example, hiring more people in the public sector (even if there is nothing productive for them to do) not only increases employment in this sector but gives these workers wages to spend, which in turn creates downstream economic benefits (for example, shopkeepers taking on extra staff). But this argument assumes that resources are free and have no alternative uses. It is silent on opportunity costs – for example, whether spending government money on propping up unproductive jobs in the public service is the best use of scarce government resources. As the economy moves out of recession the case for Keynesian multipliers also becomes less strong as there is less spare capacity (more real jobs are available) in the economy.

3 Subject to market failures, such as when people excessively discount their future income needs. For further discussion, see Williamson, O. (1975), *Markets and Hierarchies: Analysis and Antitrust Implications.*

4 See Bosanquet, N. *et al.* (2007), *Class of 2007: Inaction sinks the IPOD generation, Reform.*

Figure 1: Government spending and receipts as a percentage of GDP, 1964-65 to 2013-14
Source: HM Treasury (2009), *Public finances databank,* historic data.



While similar to the trend in the US over the last two decades, the UK's fiscal policy is in sharp contrast to many other developed countries. New Zealand and Norway have had almost 15 years where government spending has been less than government revenues.[5] Canada, Australia and Ireland have all had a decade of the same.[6] It is not surprising that the Organisation for Economic Co-operation and Development (OECD) – the think tank for developed nations – has forecast that the UK will have the biggest budget deficit of the advanced world until at least 2017.[7]

Fiscal crisis

The current economic downturn has been reflected in a significant fall in tax revenues in the UK. Total taxes were £21 billion less in 2008-09 than in 2007-08, equivalent to a fall of 2 per cent of GDP.[8] Similar dips in receipts can be seen during previous recessions in 1974-75, 1980-81 and 1991-92. Falls in tax revenue during a recession are a feature of the automatic stabilisers that help to smooth the economy. They reflect a number of factors – increases in unemployment mean that less revenue is collected from income tax, business profits are squeezed reducing corporation tax and people spend less resulting in a fall in consumption tax.

Following the recession of the early 1990s, it took five years for revenues to return to pre-recession levels. The Treasury estimates a similar trend in the current recession, forecasting that receipts will pick up in 2010-11 and continue to rise to once more reach historically high absolute levels within five years of the start of the downturn.[9] These estimates of the return to economic growth and speed of recovery in revenues are likely to be overly optimistic.[10]

5 OECD (2009), Stat Extracts: *General government total outlays* and *General government total tax and non-tax receipts; Reform* calculations.
6 Ibid.
7 OECD (2009), *Economic Outlook No. 86.*
8 HM Treasury (2010), *Public finances databank,* January.
9 HM Treasury (2009), *Pre-Budget Report 2009: Securing the recovery: growth and opportunity.*
10 See for example, Standard & Poor's (2009), *Global Credit Portal Ratings Direct: United Kingdom,* p. 14.

Tax and spending balance

All main political parties are committed to tackling the budget deficit. Alistair Darling has pledged to halve public sector net borrowing – forecast to be £176 billion in 2010-11 – over four years, bringing it down to £96 billion by 2013-14.[11] The 2009 Pre-Budget Report shows that public spending is planned to be £58 billion lower by 2013-14. The rest of the £80 billion reduction in the deficit would come from tax increases of £22 billion.[12]

The Conservative Party has argued that it would start substantially cutting the fiscal deficit more quickly and that the split between tax increases and public spending should be around 20:80.[13] This would mean that a Conservative Government would raise taxes by around £16 billion and cut spending by about £64 billion by 2013-14. The Liberal Democrats have argued that the bulk of the reduction must come on the spending side. Vince Cable has said that the Liberal Democrats have identified £10 billion more in spending cuts than the Government.[14] On this estimate their tax to spending ratio for the fiscal tightening will be around 15:85.

Table 1: Comparison of fiscal plans for the period 2010-11 to 2013-14
Sources: HM Treasury (2009), *Pre-Budget Report 2009: Securing the recovery: growth and opportunity; Reform* calculations.

	Government	Conservative	Liberal Democrat	Reform
Reduction in public sector net borrowing	6.5% (from 12.0% to 5.5%)	6.5% (from 12.0% to 5.5%)	6.5% (from 12.0% to 5.5%)	7.5% (from 12.0% to 4.5%)
Balance between tax rises/spending cuts	30:70	20:80	15:85	12.5:87.5
Increase in tax burden (per cent reduction)	£22.2 billion (1.8%)	£16.0 billion (1.3%)	£12.2 billion (1.0 %)	£12.2 billion (0.9%)
Reduction in total managed expenditure (per cent reduction)	£57.8 billion (4.6%)	£64.3 billion (5.2%)	£67.8 billion (5.5%)	£85.7 billion (6.6%)

A better plan

Reform argues that the Parties' plans are not ambitious enough in terms of the speed and scale of the fiscal tightening. Failure to adequately tighten fiscal policy will damage confidence in the UK's economic policy framework, contribute to higher long-term interest rates and currency instability, and undermine recovery.[15]

Reform proposes that borrowing should be reduced to 4.5 per cent by 2013-14, and below that in later years. *Reform* also argues that it is important that taxes do not rise too high as this would choke off economic recovery. *Reform* estimates that the burden of adjustment should be borne by tax increases and expenditure reductions in a ratio of 12.5:87.5.

Reform's proposal would see £1 raised from tax increases for every £7 saved from cutting spending. This rule of thumb follows the Canadian example of the mid-1990s. The 1995 Budget included CA$7 in spending reductions for every CA$1 increase in tax revenue. As the Minister of Finance at the time, Paul Martin, noted, the fact that the government cut back their own activities rather than putting the burden on taxpayers played a key role in generating support for the process of restoring the public finances.[16] The result was that Canada's budget deficit – which was running at 9.1 per cent of GDP – was cut to zero within three years and public debt – at 70 per cent of GDP – was cut by a third in five years.

11 HM Treasury (2009), *Pre-Budget Report 2009: Securing the recovery: growth and opportunity.*
12 Ibid and *Reform* calculations.
13 See, for example, *UTV News,* "Economy at risk of destruction unless spending slashed, says Tory adviser", 20 January 2010; Eaton, J. (2010), "Leaders' debates 0, football dates 1", *New Statesman,* 28 January.
14 Cable, V. (2010), "The Liberal Democrats are the only party of genuine economic reform", Speech to Demos, 25 January. Mr Cable said: "Deficit reduction has to come from spending cuts primarily though there is a role for taxation... We have so far identified an additional £10 billion in net savings beyond what the government has put forward."
15 Besley, T. *et al.* (2010), "UK economy cries out for credible rescue plan", *The Sunday Times,* 14 February.
16 Martin, P. (1996), "The Canadian Experience in Reducing Budget Deficits and Debt", *Economic Review,* Quarter One, Federal Reserve Bank of Kansas City, pp. 11- 25.

A better tax package

The tables below set out the Government's tax package for income tax, National Insurance Contributions and VAT for 2011-12 and 2012-13 and *Reform's* proposed tax package. Details of these proposals are set out in the report.

Table 2: Government tax plans – Income Tax, National Insurance Contributions and VAT, £ billions
Sources: HM Treasury (2009), *Pre-Budget Report 2009: Securing the recovery: growth and opportunity;* HM Treasury (2009), *Budget 2009: Building Britain's future;* HM Treasury (2008), *Pre-Budget Report 2008: Facing global challenges: Supporting people through difficult times.*

	2011-12	2012-13
Income tax		
50p rate on incomes over £150,000 (April 2010)	£2.5	£2.4
Withdrawal of personal allowance on incomes over £100,000 (April 2010)	£1.5	£1.5
Restrict tax relief on pension contributions (April 2011)	£0.2	£3.1
Freeze higher rate threshold (April 2012)	-	£0.4
	Total £4.2	Total £7.4
National Insurance Contributions[1]		
1% increase employee and employer NICs (April 2011)	£10.0	£10.0
Raise primary NICs threshold to align with personal allowances + £570 (April 2011)	-£3.1	-£3.1
	Total £6.9	Total £6.9
VAT	-	-
Total increase	**£11.1**	**£14.3**

Notes: (1) figures for 2012-13 based on figures for 2011-12 contained in PBR 2008 and PBR 2009. Brackets show the date the measure is due to come into effect.

Table 3: *Reform* tax package – Income Tax, National Insurance Contributions and VAT, £ billions

	2011-12	2012-13
Income tax		
Scrap 50p rate on incomes over £150,000	-£2.5	-£2.4
Convert personal allowances into a tax free threshold[1]	£2.9	£2.9
Scrap gimmick reliefs and benefits	£1.1	£1.1
	Total £1.5	Total £1.6
National Insurance Contributions		
0.5% decrease employee and employer NICs	-£5.5	-£5.5
Raise primary NICs threshold to align with zero rate threshold[2]	-£2.7	-£2.7
	Total -£8.2	Total -£8.2
VAT		
Broaden VAT base with compensation for low income families	£15.0	£15.0
	Total £15.0	Total £15.0
Total increase	**£8.3**	**£8.4**

Notes: (1) based on figures contained in PBR 2009; (2) based on figures contained in PBR 2008. Calculations are set out in later chapters.

2

A broken tax system

The immediate public finances withstanding, the UK tax system needs reform. The link between taxes and government spending has become broken. Politicisation and short-termism has increased complexity, making tax opaque and inconsistent. Scrutiny of tax legislation is poor and the frequency of changes overwhelming. A number of myths about how much and what type of taxes the UK pays have become commonly accepted. A fresh examination is needed.

The limit on taxation has been reached

From low-earners to multi-national companies, the limit on taxation in the UK appears to have been reached. Recent cases where the government has had to reverse or revise its tax policies reflect public frustration over the constant tax tinkering. The new 18 per cent capital gains tax announced in the 2007 Pre-Budget Report was swiftly followed by a caveat for entrepreneurs after lobbying from the small business community, while the abolition of the 10p income tax rate announced in Budget 2007 had to be followed by an increase in personal allowances within a matter of months.

Public backlash over tax increases is not new – Margaret Thatcher's poll tax was abolished by John Major after only a year because of riots – but recent examples have been more frequent and come at a time when public patience over the way tax policy is made has worn thin.

But spending has increased nonetheless

This backlash is not about tax in isolation, but also reflects less satisfaction with public spending. As *The Times* Chief Political Commentator Peter Riddell has written in a commentary on the political economy of tax policy (as part of the Mirrlees Review), "the key issue is not about taxation as such but about whether the public believes that the money is being well spent." Polls show a significant decline in how effective people believe government has been in spending the taxes it collects over the last few years.[17] The 2010 British Social Attitudes Report showed declining support for increasing government expenditure and taxes, with 50 per cent favouring maintaining existing levels, down from 62 per cent in 1997.[18]

However, it is surprising that the shift in attitudes toward spending and taxes has not been greater. The scale of the fiscal deficit might reasonably have been expected to lead to less support for maintaining current levels of expenditure and taxes and more support for reducing spending. Indeed, the British public should not escape responsibility for the UK's large fiscal deficit. Since the end of the First World War, government spending has increased by around 13 percentage points, which is substantially more than the increase in tax burdens.[19] The link between taxation and spending has been broken – with the public appearing to believe that ever increasing welfare benefits and public services can be made available to them at little or no extra cost. As Sir Roger Douglas, former New Zealand Chancellor of the Exchequer, has argued:

> "[Voters] seem to have bought the false notion that we can all be made wealthy through government. Elections have become an opportunity for politicians to promise they will take more money off you, only to give it back to you in another way – a gold card for superannuitants (pensions), a tax credit for working families, or an interest write off for students. If we each pretend that we can be made wealthy through taxing others, then we're destined for poverty. We are increasingly relying on others – be they foreign lenders or domestic taxpayers – to sustain our way of life."[20]

17 Riddell, P. (2008), *The political economy of tax policy: A commentary,* Institute for Fiscal Studies, Prepared for the Report of a Commission on Reforming the Tax System for the 21st Century, Chaired by Sir James Mirrlees.
18 National Centre for Social Research (2010), *British Social Attitudes 26th Report.*
19 Clark, T. and A. Dilnot (2002), *Long-term trends in British taxation and spending,* Briefing note no. 25, Institute for Fiscal Studies.
20 Douglas, R (2009). "A High Growth – Low Tax Welfare State", Speech to the Rotary Club of Orewa, 10 February.

Politicisation

The way tax policy is made does not help foster this link between taxes and public services in the mind of the public. Tax policy in the UK has become increasingly politicised in recent years. Changes are too often made pre-election or at Budget times to provide "eye catching" initiatives. In his 2009 Pre-Budget Report, Alistair Darling dropped his promise to raise the inheritance tax threshold to £350,000 to "make a political point as part of Labour's recently revived class war", as one newspaper put it.[21] The temporary tax on bankers' bonuses has been seen as a political rather than an economic move, with some analysts predicting that the measure could lose the Treasury money in the longer term.[22]

Taxation will always be a political issue. Tax policy involves making judgements on social values and priorities and it should be underpinned by a set of principles, which will vary between political parties. As Peter Riddell notes in a contribution to the Mirrlees Review, "tax decisions cannot be taken out of politics. They are the stuff of the party battle."[23]

However, the primary objective of tax policy should be to raise revenue to fund public services in the most economically efficient and least damaging way. Political whim leads to short-term policies with often highly damaging and costly consequences.

Opaque process

The UK tax system has become a convoluted labyrinth, with taxpayers unable to understand what they should pay and why. Proper public debate around tax policy – in particular the objectives and principles of the tax system – is absent.

The formal process for the scrutiny of tax legislation is also poor. Unlike other areas of policy which are debated and consulted on following the publication of White and Green papers, tax measures are proposed in the annual Finance Bill. There is then a short deadline – usually about five months – for scrutiny in the Commons before the Finance Bill must be enacted (in order to ensure the continued collection of tax revenues).[24]

There has been much criticism from the tax professional community in recent years over the process of forming tax legislation. As the Association of Chartered Certified Accounts (ACCA) has described, MPs lack the time, resources and expertise needed to scrutinise the often vast and complex measures proposed in such a short period of time.[25] The House of Lords fails to have a proper role in scrutinising tax legislation – its role in passing the Finance Bill is purely formal (although the Lords Select Committee on Economic Affairs publishes reports on the Finance Bill). The result is that poor legislation is often passed, followed by the emergence of loopholes and errors, which in turn requires a further law to stem the leaks.[26]

21 *The Daily Telegraph (2009),* "Inheritance tax penalises aspiration", 29 December.
22 Oliver, J. and D. Smith (2009), "Pre-Budget Report: Alistair Darling's jumbo deficit reduction", 13 December, *The Sunday Times.*
23 Riddell, P. (2008), *The political economy of tax policy: A commentary,* Institute for Fiscal Studies, Prepared for the Report of a Commission on Reforming the Tax System for the 21st Century, Chaired by Sir James Mirrlees.
24 House of Commons Library (2009), *The Budget and the Annual Finance Bill,* Standard Note BT/813.
25 ACCA (2009), "Discussion paper: Is there a way out of the tax labyrinth?".
26 Ibid.

Highly complex

Despite a commitment to simplification by practically all governments in the last thirty years, the UK tax system has become more and more complex. The Institute of Chartered Accountants in England and Wales (ICAEW) has noted that with over 11,000 pages the UK tax code is one of the longest and most complex in the world.[27] More than half of all individual taxpayers who submitted tax returns in 2004 used tax professionals to help them and 85 per cent of corporate tax returns were completed with professional advice.[28]

Complexity increases the costs of compliance, both in time and money, and also leads to avoidance. In December 2009, HMRC published for the first time an estimate of the total UK tax gap – the difference between the amount of tax due and the amount collected – as part of the Pre-Budget Report. This estimated that the tax gap is around £40 billion, or 8 per cent of total revenues collected, each year.[29]

Of this, the biggest proportion is from inaccurate returns from individuals and small and medium sized businesses, which indicates both a lack of understanding and gaming of the tax system (for example, small businesses paying other family members for "non-jobs" to capture the benefits of the personal tax allowance). As shown by a comment made by Stephen Fry, a culture has emerged in the UK where it is common for people to have "cheated and fiddled things", such as expenses and taxes.[30]

The Government's Tax Law Rewrite Project has since 1996 endeavoured to rewrite tax legislation in simpler language.[31] There is wide acknowledgement that this body has achieved a great deal in simplifying existing legislation.[32] However, as Lord Howe has noted, it cannot change the substance of the laws, which is often where the complexity lies.[33]

Inconsistent

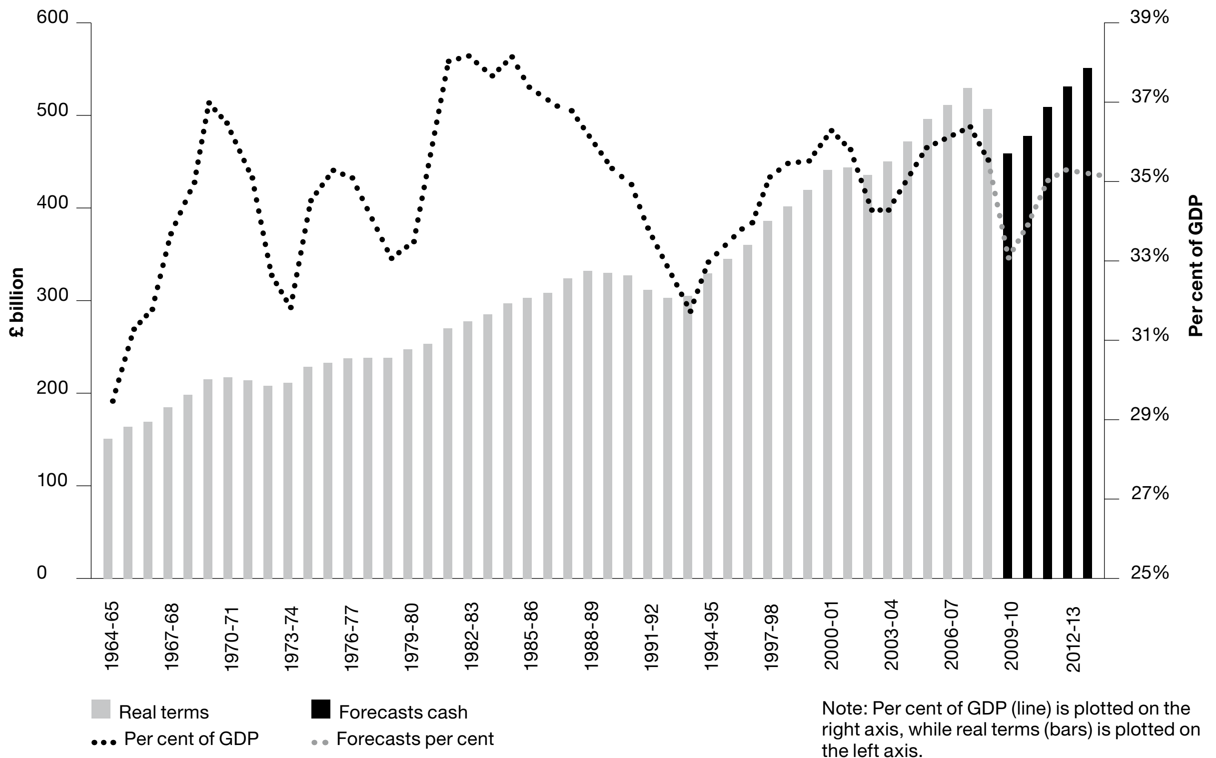
In the 2007 ICAEW Hardman lecture, Mike Truman, Editor of *Taxation Magazine*, said "direct taxes should have only one aim, to tax each pound received as consistently as possible".[34] This principle should ring true throughout the entire tax system, but the current UK system is often arbitrary and inconsistent. On the taxation of income, for example, there are different rates and structures for taxing earned income, interest income, dividend income, inherited income and capital gains. Workers are taxed differently if they are employed, self-employed or freelancers. The multitude of exemptions that perforate the tax system mean that for example, different goods and activities are taxed in different ways. Such inconsistencies create complexity and raise the costs of compliance and avoidance.

Volatile

The economic downturn has led to increased concerns over the volatility of the tax base. In 2009 the Government put "ensuring the tax yield is sustainable and risks managed" as a top strategic objective for HM Treasury.[35] In the thirty years from 1978-79 to 2008-09 total taxation (in real terms) has more than doubled, rising from £237 billion to £508 billion.[36] It has grown fairly consistently year on year for the last four decades. As a proportion of national income, however, tax revenues have been highly erratic ranging from 38 per cent of GDP in 1984-85 to 31.8 per cent of GDP in 1993-94. The range of these swings appears, however, to have been narrowing, particularly since around the mid-1990s, as the line in the graph below illustrates.

27 The Institute of Chartered Accountants in England and Wales (2009), *ICAEW 2009 Pre-Budget Report Submission, TAXREP 57/09.*
28 Evans, C. (2008), *Taxation in the UK: Commentary*, Institute for Fiscal Studies, Prepared for the Report of a Commission on Reforming the Tax System for the 21st Century, Chaired by Sir James Mirrlees.
29 HM Revenue & Customs (2009), *Measuring tax gaps 2009.*
30 BBC Newsnight (2009), "Fry on expenses: it's not important", 11 May.
31 See www.hmrc.gov.uk/rewrite for more details.
32 See for example, Truman, M. (2007), *Hardman Lecture 2007,* Institute of Chartered Accountants in England and Wales.
33 Howe, G. (2008), "Why we must change the way tax law is made", *Financial Times,* 2 July. Lord Howe has been directly involved with the project.
34 Truman, M. (2007), *Hardman Lecture 2007,* Institute of Chartered Accountants in England and Wales.
35 HM Treasury (2009), *HM Treasury Group Departmental Strategic Objectives – 2008-2011,* updated July 2009.
36 HM Treasury, *Public finances databank,* historic data. In nominal terms tax receipts were £58 billion in 1978-9 and £505 billion in 2008-09.

Figure 2: Net taxes and National Insurance Contributions 1964-65 to 2013-14, real terms (2008-09 prices) and per cent of GDP
Source: HM Treasury (2009), *Public finances databank,* historic data.



While revenues from income tax and National Insurance Contributions have risen more or less steadily since the mid-1970s, most of the other main taxes have been less stable. Revenues from corporation tax, stamp duties, capital gains, council tax and business rates have all followed similar trends in the last thirty years, with periods of rapid growth followed by sharp falls.

Corporation tax revenues seem to be the most volatile. In the last 25 years, corporation tax revenues have swung considerably, more than doubling in one four-to-six year period before halving in the next. This pattern is the same when revenues are examined as a percentage of GDP. These swings will reflect factors such as oil price effects, the impact of legislation changes (such as the abolition of Advanced Corporation Tax and rate cuts) and economic downturns. Such volatility makes the government's forecasting of future revenues extremely difficult given corporation tax accounts for around nine per cent of total revenues.

Table 4: Corporation tax revenue volatility
Source: HM Treasury (2009), *Public finances databank,* December; *Reform* calculations.

	Growth in corporation tax revenues, billions	Length of period	Change, billions
1983-84 – 1989-90	£15.0 – £37.6	6 years	+£22.6
1989-90 – 1993-94	£37.6 – £21.5	4 years	-£16.1
1993-94 – 1999-00	£21.5 – £42.9	6 years	+£21.4
1999-00 – 2003-04	£42.9 – £31.9	4 years	-£11.0

Unbalanced?

The impact of the financial crisis and recession on tax revenues has raised a number of debates around the longer-term underlying stability of the UK tax system. These include whether it is too pro-cyclical – resulting in a high degree of volatility – and whether the base is too narrow – being built largely on the housing and finance sectors. Vince Cable, among others, has argued that "tax revenue depended to an unhealthy degree on a 'bubble' economy in financial and housing markets".[37] A "rebalancing" of the economy has been called for.

Certainly, revenues from stamp duties have grown rapidly in the last decade or so as the housing market has boomed. Between 1996 and 2007 real house prices increased by 161 per cent, while revenues from stamp duties more than quadrupled in this period.[38] The biggest fall in tax revenues during this recession has been in stamp duties which nearly halved between 2007-08 and 2008-09. This is likely to reflect a fall in property prices as well as a fall in financial transactions.

However, it should be noted that even at the 2007-08 peak, stamp duties accounted for less than 3 per cent of total tax revenues and only 1 per cent of GDP. The loss of revenues from stamp duties between 2007-08 and 2008-09 amounts to only just over 1 per cent of total tax revenues. Revenues from inheritance tax have also fallen substantially, being over a quarter less in 2008-09 than in the previous year, which could partly reflect a fall in property prices although is likely to be mainly due to the 2007 reform allowing couples to pool their exempt allowances.

Table 5: The effect of the economic downturn on tax revenues
Source: HM Treasury (2010), *Public finances databank,* January.

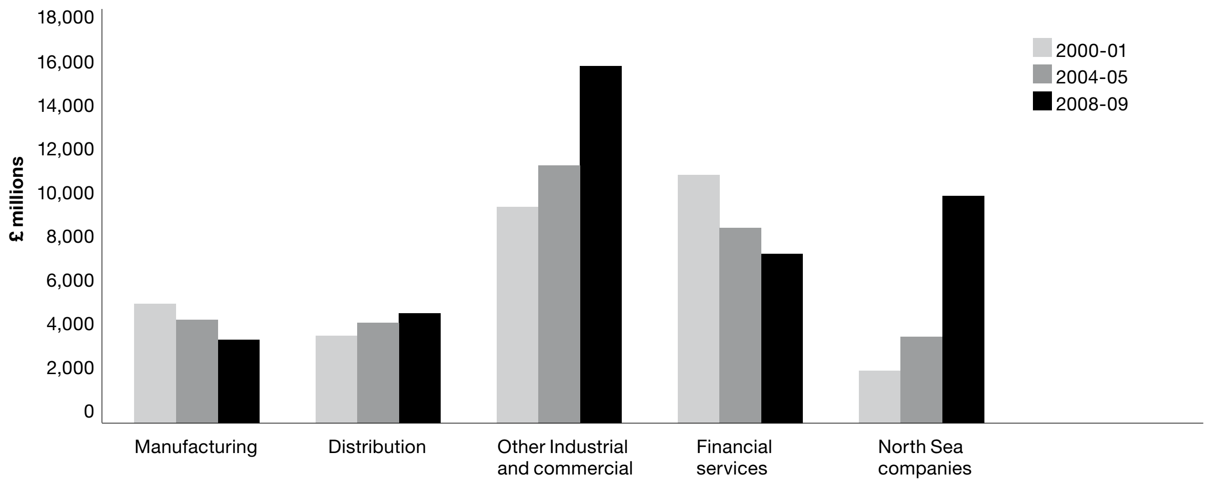
	2007-08, billions (real prices)	2008-09, billions (real prices)	Change, billions	Change, per cent
Income tax	£155.5	£153.4	-£2.1	-1.4
Corporation tax	£47.5	£43.1	-£4.4	-9.3
Stamp duty	£14.4	£8.0	-£6.4	-44.6
Inheritance tax	£4.0	£2.9	-£1.1	-27.4
Capital gains tax	£5.4	£7.9	+£2.5	+45.5
VAT	£82.6	£78.4	-£4.2	-5.1

The financial services industry has been a significant contributor to a number of different taxes – corporation tax on profits, income tax and national insurance on employees' wages, irrecoverable VAT and stamp duties on services and transactions. A study by PricewaterhouseCoopers estimates that the financial services sector contributed £61.4 billion in tax receipts in the year to 31 March 2009.[39] This was over 12 per cent of total tax revenues, despite being nearly 10 per cent lower than in the year to 31 March 2007, largely due to a drop in corporation taxes in the financial crisis.

The estimated loss of revenue from the industry in this two year period is substantial at £6.4 billion, or just over 1 per cent of total government receipts. However, while corporation taxes from the financial services sector have fallen considerably in the last two years, HM Revenue & Customs data shows that this trend started before the current crisis.[40]

37 Cable, V. (2009), *Tackling the fiscal crisis: A recovery plan for the UK, Reform.*
38 Mortgage Guide (2009), *UK House Prices Index Historical Data.* Real house prices fell from £3.29 billion in 1996-97 to £14.47 billion in 2007-08.
39 PricewaterhouseCoopers LLP (2009), *PricewaterhouseCoopers LLP second study of the UK Financial Services Sector for the City of London Corporation.*
40 Additionally, the PwC report estimates that nearly half of the industry's tax contribution comes from employment taxes which the study shows have not fallen in the last two years. This is particularly significant as employment taxes account for such a large proportion of total taxes – income tax and national insurance contributions together make up nearly half of all taxes while corporation tax is less than a tenth.

Figure 3: Corporation tax receipts by industrial sector
Source: HM Revenue & Customs (2009), Table 11.1, May 2009.

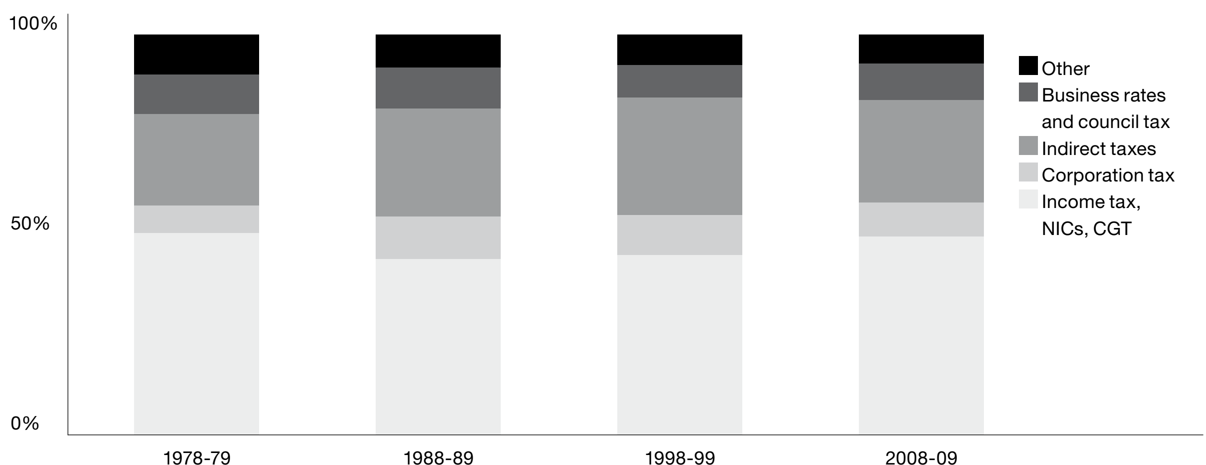


In terms of gross value added, the UK economy seems to be as well balanced today as it has been in past decades. National statistics show that there are seven different sectors which each contribute 7 per cent or more to the economy, including manufacturing, transport and communications, and retail.[41]

As dependent on income as ever

There is a common misperception about the composition of the UK's tax base. The prevailing myth is that, starting in the 1980s, the UK underwent a substantial tax mix switch from direct to indirect taxes. What has actually happened is a shift from taxes on earnings towards taxes on consumption in the 1980s, followed by a reversal of this trend since about 1997. Today, the tax mix is much the same as it was at the end of the 1970s, with income taxes accounting for the largest share – nearly a third – of total taxes.

Figure 4: UK tax mix 1978-79 to 2008-09
Source: HM Treasury (2009), *Public finances databank,* historic data.



Under Chancellor Geoffrey Howe, indirect taxes did go up – his 1979 Budget increased the VAT rate from 8 per cent on standard goods and 12.5 per cent on "luxury" items to a single rate of 15 per cent, while income taxes were substantially cut.[42] This increased revenues from VAT – which contributes double the share to total taxes today as it did in 1978 – but at the same time indirect taxes on specific items (such as tobacco and alcohol) have decreased. The net effect on the overall contribution of consumption taxes has therefore been limited.

41 Office for National Statistics (2009), *Statistical Bulletin: Regional, sub-regional and local gross value added 2009.*
42 The basic rate of income tax was reduced from 33 to 30 per cent and the higher rate was cut from 83 to 60 per cent.

3

Principles for repairing the tax system

Every tax system should be underpinned by a set of principles from which policies flow. The principles for repairing the UK's tax system must take into account the purpose of taxation. A tax system can serve numerous functions, but its primary role is to raise revenue for the government in order to finance public services.

Government objectives for the UK tax system

In 2009 the Government set out various objectives in its performance management framework for HM Treasury.[43] Its top level objectives on taxation were "ensuring that the tax yield is sustainable and risks managed" and "promoting the efficiency and fairness of the tax system".

Table 6: HM Treasury tax policy principles
Source: HM Treasury (2009), *HM Treasury Group Departmental Strategic Objectives – 2008-2011.*

	Outcome relating to tax	Indicator
DSO 1: Maintaining sound public finances	Ensuring that the tax yield is sustainable and risks managed	Tax yield over the economic cycle
DSO 2: Ensuring high and sustainable levels of economic growth, well being and prosperity for all	Promoting the efficiency and fairness of the tax system	Impact of policy measures on taxpayers

The Treasury document goes on to give more detail on these objectives. On the first, it says that the Treasury will deliver a tax base that is "wide" and "sustainable". On the second, it says that policy will minimise costs of collection, impact on the economy and give regard to "fairness" between groups of taxpayers.

Reform tax policy principles

The *Reform* objectives for the tax system are shown in the table and discussed below. These principles are consistency, transparency, economic efficiency and fairness. Many tax policy changes will require trade-offs between these principles – although a good rule of thumb for reconciling these four principles is to pursue a broad base, low rate tax policy (explained below).

Table 7: *Reform* tax policy principles

Government objective	Outcome pertaining to tax	Indicator
Maintaining sound public finances	Ensuring that the tax burden is allocated on a **consistent** basis	Few different rates
Building a strong link between taxes and spending	A **transparent** tax policy process	Scrutiny, well-thought out policies, not *ad hoc*
Encouraging economic growth	Promoting an **economically efficient** system	Broad base low rate
Promoting prosperity for all	Ensuring a **fair** tax system	Applying taxes in an even-handed way and ensuring people pay their fair share

43 HM Treasury (2009), *HM Treasury Group Departmental Strategic Objectives – 2008-2011,* updated July 2009.

Generating additional tax revenue through broadening tax bases is preferable to increasing rates. A broader base would ensure that similar goods and activities are taxed in the same way. This approach would avoid the economic costs associated with higher tax rates – taxes become more damaging as rates increase[44] – and it would allow for lower rates in the longer term. A broad base, low rate approach also tends to result in less political interference as it is harder for governments to introduce tax policies targeted towards particular groups.[45]

Principle 1: Consistency

The tax system should tax every pound as consistently as possible. This has several implications for tax policy.

Even-handedness

The idea of even-handedness is based on the classical definition of "horizontal equity", which suggests that people with equal ability to pay taxes or grounds for receiving assistance should face the same tax burden or should receive the same level of public assistance.[46] This principle remains important and is generally reflected in a concern that the tax system should not treat people on an arbitrary basis and different sources of income should generally be taxed at similar levels. Horizontal equity is a prerequisite for the achievement of vertical equity which is the principle that those with higher ability to pay should pay more than those with lower ability to pay.[47]

Exemptions in tax bases are often counter productive

The prospective benefits of targeted tax subsidies are usually unclear. While tax incentives could increase the overall level of investment, they may be more likely just to move investment from non-subsidised to subsidised areas. There are also problems with governments "picking winners". If government is to encourage or discourage particular behaviours, it is necessary to objectively identify which are the behaviours it should be targeting through the tax system.

The complexity introduced into the tax system through directed incentives is likely to impose a variety of administrative, compliance and economic costs. In addition, selective incentives motivate taxpayers to unproductively divert resources to lobbying government for further incentives.[48]

Exemptions encourage taxes to be used in the wrong ways

Exemptions encourage taxes to be used for the wrong purposes. A clear example of this is when corrective taxes, for example, green taxes, are used for revenue raising purposes, not environmental ones. Additional taxes on foods high in fat or sugar are another example of a corrective tax that is often used on revenue raising and not corrective grounds.

"Green taxes" are becoming increasingly popular and will no doubt grow in future years. In 2008, government revenues from "environmental taxes" accounted for around 7 per cent of total government receipts, with the main source being those on energy. Both the Conservative Party and the Liberal Democrats have pledged "more green taxes".

There are economically rational arguments for these taxes,[49] but in practice the design of such taxes tends to be *ad hoc* and less robust than claimed. The international dimension of many green tax issues suggests that effective policy responses cannot be done by just one country.[50] Green taxes also require emissions to

44 Tax rates should be kept as low as possible as the economic costs of taxes increase more than proportionately with tax rates (taxes become more damaging as rates increase). McLeod, R. *et al.* (2001), *Tax Review 2001 – Issues Paper,* New Zealand Treasury.

45 Public choice theory suggests that a broader base increases efficiency and make it harder to politicise the tax system through targeting particular groups. Buchanan, J. in Nolan, P. (2005), "Targeting Families Assistance".

46 Musgrave, R. (1976), "ET, OT and SBT", *Journal of Public Economics,* 6, p. 4.

47 Horizontal equity is also often a prerequisite for efficiency through ensuring neutral treatment of similar economic resources.

48 McLeod, R. *et al.* (2001), *Tax Review 2001 – Issues Paper,* New Zealand Treasury.

49 These include Pigovian tax arguments that green taxes increase the costs of pollution and encourage polluters to reduce their activities to more socially desirable levels. Market failures occur when the price between a person undertaking an action (such as smoking a cigarette) and other market participants (such as cigarette sellers) will not fully consider the effect of their actions on third parties (such as the additional costs to the NHS). When the private marginal cost of a particular action does not equal the social marginal cost of this action then a market failure (externality) occurs. Externalities may be negative (for example, too much smoking or pollution) or positive (for example, too little savings or economic investment). Arthur Pigou proposed a theoretical solution to externality problems, under which the government levies a uniform per unit tax on, say, emissions set equal to the "marginal damage" imposed on others. Marginal damage is the aggregate amount all users would be willing to pay for reduced emissions, net of cost-effective damage mitigation.

50 It is also useful to note that taxation is one of a number of policy tools for achieving environmental goals. In particular, in certain conditions (especially when the goal is greater certainty over the level of emissions) regulatory responses may be better suited than a tax (which generally provides greater certainty over the change in price of emissions).

be measurable and the damage that they cause to be clearly understood.[51] The uncertainty over these issues leads to a perception that the rise in green taxes is a stealth tax with a climate change justification.

Practical considerations can also mean that corrective taxes may produce counterproductive outcomes. A tax on the consumption of certain food ingredients, for example, would be administratively difficult to introduce (given the range of ingredients contained in most foods) and would add significant additional administration and compliance costs into the tax system. These complexities mean that it is unlikely that the base of activity over which the tax would apply would be clearly linked to the public health issue being addressed (in contrast to an area like smoking, where the link between consumption and damage is clearer).

Tax concessions

Another area where corrective taxes are often promoted is in relation to savings and investment. These activities are seen to create positive externalities and so would tend to be "underprovided" by the market.

However, the arguments in favour of specific tax concessions are generally very weak. For example, the international evidence on subsidies for savings indicates that much of the increase in private savings generated by these schemes is simply a transfer from public to private savings, as the subsidies are paid out of taxpayers' funds, and so reduce funds available to repay public debt. These schemes also incur significant windfall costs – for example, people are paid for undertaking activities they would undertake anyway – and additional deadweight costs of taxation, such as the efficiency costs arising when taxes influence taxpayers' behaviour. Based on experience overseas, a figure of 20 percent should be applied to the cost of projects funded from taxation to reflect these deadweight costs.[52]

Specific tax concessions can also add to the complexity of the tax system, increase administration and compliance costs, and undermine the system's overall fiscal integrity (for instance, once one particular group is provided with a concessionary treatment, it is hard not to introduce concessionary treatment for other groups). Specific tax concessions are thus very difficult to justify on economic grounds.

Harmonising tax rates

The UK tax system currently taxes income differently depending on the source. For example, from April 2010, the following tax rates and bands will be in operation for different forms of income:

Table 8: Differences in the taxation of income
Source: HM Revenue & Customs (2010), *Rates and allowances – Income Tax.*

	UK tax rates, 2010-11
Non-savings income[53]	20 per cent on income up to £37,400
	40 percent on income from £37,400 up to £150,000
	50 per cent on all remaining taxable income
Savings income[54]	10 per cent on income up to £2,440[55]
	20 per cent on income up to £37,400
	40 percent on income up to £150,000
	50 per cent on all remaining taxable income
Dividends and tax credits	10 per cent on income up to £37,400
	32.5 percent on income up to £150,000
	42.5 per cent on all remaining taxable income

51 It is sometimes argued that green taxes may create a "double dividend", both discouraging harmful activity and raising revenue which can be used to offset more damaging taxes elsewhere (such as labour taxes). McLeod, R. *et al.* (2001), *Tax Review 2001 – Issues Paper,* New Zealand Treasury.
52 Buchanan, J. in Nolan, P. (2005), *"Targeting Families Assistance".*
53 The rates shown are those that apply from April this year. The same rates and thresholds currently apply to taxable lump sum payments.
54 These incomes include bank and building society interest, and gains made on life insurance policies (without a 'notional' tax credit).
55 Although if non-savings income is above this level the 10 per cent rate does not apply, so in practice it applies to very few.

The different rates for earned income, interest income and dividend income create complexity. A single set of rates should apply to all incomes. This would make the system simpler and fairer. The current system treats two people with the same incomes (but from different sources) differently. The eventual goal should be to align all rates at two levels, say, 20 per cent and 40 per cent.

Restoring dividend tax credits to correspond to the savings rate (which would in time become the same as the basic rate of tax) would solve this but come at a revenue cost.[56] The special rates attributable to dividend income could then be abolished.

Capital gains are also taxed at a different rate. Capital gains tax is charged when assets that have increased in value are disposed of and is payable when a person's annual gains exceed a threshold, currently £10,100. It is charged at a flat 18 per cent rate with no taper relief following the changes announced in the 2007 Pre-Budget Report.[57] However, the chance to fully simplify the system with these changes was missed as the Government at the same time introduced "entrepreneurs' relief" giving relief on the first £1 million of gains for trading company shares of business assets. There are numerous additional exemptions, notably where the proceeds are for less than £6,000 and for the main home.[58]

The aim of capital gains tax is to ensure that gains on the increased value of capital assets are treated on a par with other forms of income such as dividends and interest which will already have been taxed as they accrue.[59] In recent times, however, rates and exemptions have been structured in such a way as to give favourable treatment to capital in order to "encourage investment". Such distortions over where to put money are neither efficient nor desirable. They also mean that capital gains tax raised only £7.9 billion in 2008-09.[60] Given this, the long term goal should be for capital gains to be taxed in an equivalent way as other forms of income. Relief for inflation may need to be reintroduced at the same time.

Principle 2: Transparency

Politicians have repeatedly used the tax system for political purposes with little or no regard to the economic implications of their decisions. Chancellors famously use pre-election Budget "gimmicks" which are often unsustainable.[61] The result is insufficient scrutiny of tax legislation and an opaque tax policy process.

The current approach

The government is required to present two economic forecasts per year – a spring Budget and an autumn Pre-Budget Report). Most taxes, including all indirect taxes, petroleum revenue tax and taxes on capital are permanent. Income tax and corporation tax must be renewed each year. The re-imposition of annual taxes and most other tax changes announced in the Budget are legislated for in the annual Finance Bill, which is normally published in early January and passed by Parliament in spring. Measures announced in the Budget may take effect before the Finance Bill through the approval of Budget Resolutions.

What a good process should involve

The ICAEW, among others, has argued that prospective changes to the tax system should be announced, and policy options debated in full consultation, before policy decisions are made.[62] As McLeod *et al* have noted, a good tax policy process would achieve the following:[63]

> Resolve key strategic issues early in the policy development process. This includes ensuring an effective link between economic and revenue strategies.

> Ensure a thorough debate on the fundamental intentions of tax policy and their consistency with other Government policies. Once agreed, the intentions should be communicated as soon as practicable to all people involved.

56 The Conservative Tax Reform Commission estimated that this would reduce revenues by about £600 million. Tax Reform Commission (2006), *Tax Matters: Reforming the Tax System,* The Report of the Tax Reform Commission, p. 63.
57 HM Treasury (2007), *2007 Pre-Budget Report and Comprehensive Spending Review: Meeting the aspirations of the British people.*
58 HM Revenue & Customs (2010), *Capital Gains Tax rates and annual tax-free allowances.*
59 Boadway, R. *et al.* (2008), *Taxation of Wealth and Wealth Transfers,* Institute for Fiscal Studies, Prepared for the Report of a Commission on Reforming the Tax System for the 21st Century, Chaired by Sir James Mirrlees.
60 HM Treasury (2010), *Public finances databank,* January.
61 Balls, A. (1999), "Chancellors and their big ideas", *Financial Times,* 10 March: "Throughout Britain's post-war history, Budget day has offered the chancellor of the exchequer an irresistible stage for gimmicks and give-aways." Also see, for example, Grice, A. and D. Coyle (2000), "Brown fires election starting gun with £43bn give-away", *The Independent,* 19 July; Ahmed, K. (2001), "The big Budget give-away", *The Guardian,* 7 March; Walters, S. and G. Owen (2008), "Brown's boomerang budget", *Daily Mail,* 22 November.
62 The Institute of Chartered Accountants in England and Wales (2009), *ICAEW 2009 Pre-Budget Report Submission, TAXREP 57/09.*
63 McLeod, R. *et al.* (2001), *Tax Review 2001 – Issues Paper,* New Zealand Treasury.

> Clarify the roles and responsibilities of all participants in the tax policy process.

> Specify trade-offs relevant to the policy (such as revenue impact, compliance and administrative costs, economic objectives, social objectives and implementation).

> Consult appropriate external people and/or other government departments at all stages of the policy development process, and particularly at the early stages, unless there are specific reasons for excluding them.

> Review the results of tax policy, and the policy process itself, regularly to ensure adherence to the intended direction and potential improvements. Remedial action should be taken as soon as practicable.

> Management of tax policy and the drafting of any subsequent legislation should reflect best practices, including clear accountability, specification and monitoring of performance, the provision of free and frank advice from officials, and optimum use of resources.[64]

Added to this, legislation that is applied retrospectively is extremely damaging. It diminishes the credibility of the UK's tax system and sends out harmful signals about the certainty businesses and individuals can expect from the UK government. Retrospective legislation is a barrier to transparency in the tax system and is also out of line with the principle of fairness – taxpayers should be able to make decisions based on their understanding of the tax consequences without uncertainty about how future changes will affect past actions.[65]

A clearer timeframe

There have been a number of reviews and reports calling for greater parliamentary scrutiny of tax legislation.[66] The Conservative Party has taken up a number of these suggestions, including (following Lord Howe's recommendations)[67] a joint parliamentary select committee with members from both houses to scrutinise tax legislation and a new convention that any changes to tax law with technical content should be proposed no later than the Pre-Budget Report before the Finance Bill in which they are to be included.

These are both sensible ideas and are supported by others.[68] The House of Commons should still maintain the powers to approve legislation, but a joint committee which reviews external evidence would be valuable. This would mean time between the Pre-Budget Report and Budget for committees to scrutinise legislation.

Reducing leakage

Reform's research in *The front line* showed that making real reductions in the big spending departments of government – health, welfare and education – cannot be done without tackling the front line workforce, where the bulk of the costs of public services are absorbed. In response to this report, Mary Maguire, spokeswoman for Unison, said that what was actually needed to reduce the deficit was to "find a way to get the bankers, financial institutions and tax avoiders to pay their fair share of taxation."[69] This is a common argument made in times when fiscal consolidation is needed to avoid more painful spending cuts or tax raises.

Indeed, the financial crisis has prompted an explosion of interest in tax havens and tax avoidance by the "super rich". In February 2009, the Prime Minister pledged to work towards an international clamp down on tax avoidance.[70] In December 2009, HMRC published for the first time an estimate of the total UK tax gap – the difference between the amount of tax due and the amount collected – as part of the Pre-Budget Report. This estimated that the tax gap is £40 billion, or around 8 per cent of total revenues collected, each year.[71] If all of this uncollected revenue could be collected, this would indeed go a significant way to reducing the £128 billion (2009-10) budget deficit. However, the evidence shows that this is highly implausible.

64 Ibid.
65 For more, see Foster, J. D. (1997), "Sound tax policy versus retroactivity", *The Tax Foundation,* 16 August.
66 See, for example, Brazier, A. and V. Ram (2006), *The Fiscal Maze: Parliament, Government and Public Money,* Hansard Society; ACCA (2009), "Discussion paper: Is there a way out of the tax labyrinth?"; Confederation of British Industry (2008), *UK business tax: a compelling case for change.*
67 Working Party chaired by Lord Howe of Aberavon (2008), *Making taxes simpler: The final report of a Working Party chaired by Lord Howe of Aberavon.*
68 See, for example, The Institute of Chartered Accountants in England and Wales (2009), *ICAEW 2009 Pre-Budget Report Submission, TAXREP 57/09.*
69 PublicService.co.uk (2008), "Sack thousands in NHS and police", 8 December.
70 Sparrow, A. (2009), "Gordon Brown planning international agreement on tax avoiders", 4 February.
71 HM Revenue & Customs (2009), *Measuring tax gaps 2009.*

Every country has a tax gap. Comparisons from HMRC show that the amount of uncollected tax in the UK is lower than in the US and Sweden, and higher than in Denmark. It arises from fraud (such as tax credits), error (lack of understanding of the rules), anti-avoidance (artificial structures for the sole purpose of avoiding tax) and the hidden economy (workers not registered or failing to declare all sources of income). However, some tax avoidance and evasion is inevitable. It has been argued that tax loopholes are how "an economy breathes" and reducing tax avoidance and evasion is not a costless exercise.[72]

A huge amount of UK tax legislation relates to anti-avoidance. As Stephen Timms has noted (speaking at a *Reform* seminar), the Treasury is too often reactive – legislation is formed once practice that the Treasury does not like is discovered. Each time another layer is added on to the existing rules, before another loophole is discovered requiring further amendment of the legislation. The aim, and principles, of tax policy get lost along the way.

Principle 3: Economic efficiency

A tax system should aim to raise revenues in the most economically efficient way possible. As set out below, the best way to achieve this is through a low rate, broad base system.

Increasing taxes creates economic costs

Taxes create efficiency losses, or "excess burdens", by distorting taxpayers' behaviour.[73] Excess burdens are costs that are additional to the government revenue generated by taxation (which is a resource transfer) and reflects the extent to which individuals are made worse off through distortions in their decision-making.[74] An economy with long-term, sustainable low taxes will encourage the enterprise, investment and saving needed to increase employment and economic growth.

Higher rates do not equal higher revenues

Higher tax rates do not necessarily translate into higher tax revenues. The Institute for Fiscal Studies illustrated the potential for perverse effects of higher rates on tax revenue in relation to the 45 per cent income tax rate proposed by the Government in the 2008 Pre-Budget Report, noting that "the measure could lose the Government income tax revenue" and suggesting that "the Government could have raised more money by increasing the income tax rate by less".[75] Revenue could also have been increased by broadening the tax base while keeping tax rates unchanged (or indeed even lowered).

The UK must be internationally competitive

In an increasingly global economy, it is easier for businesses and individuals to base themselves in whichever country offers the most appealing economic climate.[76] Although tax is just one factor that influences such migration, the UK's tax regime must be internationally competitive in order to continue to attract businesses and investment. There is a real danger that businesses and wealthy individuals could leave the UK to seek a more favourable economic climate, or decide not to locate to the UK. Ireland has been particularly successful at attracting business since lowering its corporation tax rate from 32 to 12.5 per cent.[77] Major international companies such as WPP, the advertising giant, have relocated their headquarters reflecting the attraction of more lenient tax regimes.[78]

The UK faces a similar threat with individuals. As taxes increase, wealthy individuals have a greater incentive to relocate or simply to devise ever more sophisticated ways of avoiding tax. The economist Art Laffer argued: "The rich have the ability to change the location of their income, the timing of their income, the composition of their income and the volume of their income… If taxes are raised on the rich the government will collect a lot less money."[79]

72 This phrase is attributed to both Barry Bracewell-Milnes and Professor Wheatcroft. The Smith Institute (2008), *Fair tax: towards a modern tax system.*
73 In the case of a reduction in labour supply due to higher taxes, for example, excess burden arises as when "choosing to work less on average, workers will have lower incomes and thus will pay less taxes. Thus a change that would have been revenue-neutral for a fixed level of labour supply will, as a result of the reduction in work, produce a revenue loss. It is this revenue loss that represents the 'excess burden' of taxation (Heady, C. (1993), "Optimal Taxation as a Guide to Tax Policy", Fiscal Studies, Vol. 14, No. 1, pp. 15-41). The excess burden results from the higher taxes required to offset the reduced tax revenue from reductions in labour supply. Any gain in social welfare from redistribution would be reduced by the efficiency costs created by this need to increase tax rates.
74 Hines, J. (1999), "Three Sides of Harberger Triangles", *Journal of Economic Perspectives,* Vol. 13, No. 2, p. 175.
75 Brewer, M. *et al.* (2008), *The distributional effect of the 2008 Pre-Budget Report,* Institute for Fiscal Studies.
76 Edwards, C. and J. Mitchell (2008), *Global Tax Revolution,* Cato Institute.
77 Government of Ireland (1999), *Finance Act, 1999.* The Government of the Republic of Ireland legislated for a gradual reduction of the corporation tax rate over a period of five years, from 32 per cent in 1998 to 12.5 per cent in 2003 and thereafter.
78 *Accountancy Age* (2008), "UK tax regime forces WPP move to Ireland", 29 September.
79 Laffer, A. (2008), *There's nothing about campaigning that has anything to do with governance,* Laffer Associates, 19 November.

Principle 4: Fairness

It is generally accepted that the tax system should collect revenues on a fair basis. There is no one single view on what constitutes a "fair" tax system, but it is often seen as involving some or all of the following features:

> People in the same economic position should bear the same tax burden. This is the principle of even-handedness (discussed above).

> Where possible, the user should pay, so taxes should be allocated in accordance with the level of government expenditure received.

> Taxation should reflect ability to pay.[80]

The benefit principle

The benefit principle argues that taxes should reflect the benefit that individuals receive from publicly-funded goods and services – for example, the use of petrol taxes to recover the costs of funding roads. There are three constraints to using this as a guide to tax policy:

> It is not meaningful to identify the "beneficiaries" of much government expenditure, such as defence.

> Much government expenditure is specifically intended to redistribute income to those in need.

> Much government expenditure cannot be meaningfully allocated on the basis of tax paid, such as education or healthcare.[81]

Ability to pay

"Vertical equity" is the principle that people with higher ability to pay should pay more than those with lower ability to pay.[82] There are also limits in the application of vertical equity to tax design. Progressivity indicates the degree to which income taxes paid and transfers received vary by income. The extent to which progressive taxes are required to achieve vertical equity is disputed, since those who earn more will pay more under both a flat (proportional) tax and a progressive (increasing) scale.

Further, progressivity is defined in terms of the formal structure of the tax-benefit system. However, this provides a misleading view on the actual redistributive effect of the tax system as "this ignores tax incidence effects whereby increased marginal tax rates on higher incomes are offset by even larger salaries or tax avoidance activities, to maintain the real value of after-tax income."[83] Progressive taxation also has an effect on incentives, particularly on labour supply, and so the redistributive effect of taxes will also reflect the difference between the legal and economic incidence of taxes.[84]

Lower rates can be progressive

As lower tax rates incentivise earnings and discourage tax avoidance, they can result in the wealthy paying an increased proportion of total taxes. This was illustrated by Nigel Lawson who, as Chancellor, reduced the top rate of income tax to 40 per cent in 1988. The result of this was that the share of income tax paid by the top one per cent of earners increased from 14 per cent in 1986-87 to 21 per cent a decade later. The top ten per cent of earners' share increased from 39 per cent to 50 per cent.[85]

Increased mobility of highly skilled labour has implications for the extent to which the tax system can be used to achieve redistributive objectives.[86] Extremely progressive taxes on income, profits or wealth will incentivise those who would pay the most taxes to move elsewhere, leaving a larger burden to be shouldered by the poorest.[87] How taxes will be shifted onto others should also be borne in mind. For example, an increase in corporation tax may simply be passed on to consumers as higher prices, employees as lower wages or shareholders as smaller dividends.[88]

80 McLeod, R. *et al.* (2001), *Tax Review 2001 – Issues Paper,* New Zealand Treasury.
81 Ibid.
82 The progressivity of the tax system should also not be judged solely by considering one tax, but should consider the system including tax credits and benefits as a whole.
83 Stephens, R. (1997), "The Interaction and Coordination of Taxation and Expenditure Programmes", in Krever, R. (ed.), *Tax Conversations,* Kluwer Law International, p. 484.
84 Musgrave, R. (1976), "ET, OT and SBT", *Journal of Public Economics,* 6, p. 13.
85 Nelson, F. (2008), "Why Nigel Lawson was the most redistributive Chancellor of the Exchequer", *Spectator Coffee House,* 26 September.
86 McLeod, R. *et al.* (2001), *Tax Review 2001 – Issues Paper,* New Zealand Treasury.
87 Slemrod, J. (2002), "Progressive Taxes", *The Concise Encyclopaedia of Economics,* Library of Economics and Liberty.
88 Ibid.

Lower taxes are important for social mobility

As *Reform*'s previous research has shown, the abolition of the 10 pence starting rate for income tax and the failure to increase the upper rate threshold in line with earnings have created "mobility blocks" which affect increasing numbers of people in the UK. Recent OECD research found that the UK has particularly high marginal effective tax rates falling on single parents and one-earner couples, who can find themselves gaining only 11p for every additional £1 earned.[89] As such, the incentives are dulled for people to cross these thresholds, discouraging people from, for example, moving from part-time to full-time work or progressing to more senior jobs.[90]

The high marginal effective tax rates created by these thresholds and the proliferation of tax credits decrease incentives to work and act as blocks on social mobility. These blocks particularly affect those people at the lower end of the income scale. High marginal rates can increase dependence on benefits and reduce the incentives to increase earnings beyond a low level.

89 Bosanquet, N. *et al.* (2008), *Shifting the unequal state: From public apathy to personal capability, Reform;* Bassett, D. *et al.* (2008), *The hole we are in and how to get out of it, Reform.*
90 Ibid.

4

The Do's

Key reforms that could be implemented in April 2011 and would improve the design and outcomes of the tax system are:

- Broaden the VAT base
- Scrap the 50p income tax rate and reverse the restriction of tax relief on pension contributions
- Reduce National Insurance Contributions
- Replace personal allowances with a tax free threshold
- Keep the bankers' bonus tax as a one-off measure
- Scrap gimmick income tax reliefs and benefits

1. Broaden the VAT base

It is widely expected that the next government will increase the VAT rate from 17.5 per cent to 20 per cent. Indirect taxation is a well-established alternative to taxing the income of individuals or companies. There are strong arguments for a tax on goods and services (a consumption tax) being a preferable way of raising revenue. However, broadening the VAT base by abolishing the zero and reduced rated items, such as food and children's clothes, would be less damaging and more efficient than putting up the rate.

Consumption taxes do not create a disincentive to work

Increasing revenue from VAT is also preferable than increasing the burden of income tax. Higher income taxes create disincentives to work, and high marginal rates can discourage people from working and earning more, as well as causing "mobility blocks". Consumption taxes apply only to the portion of income that is spent and do not create a direct disincentive to work.[91]

Consumption is likely to remain in the UK

Taxing mobile, productive elements of the economy such as labour and capital can cause those elements to move elsewhere, to a more tax-friendly environment. Keeping taxes low is an important element of maintaining the UK's competitiveness to attract, encourage and retain investment and enterprise.[92] Consumption, particularly of goods, will, however, generally remain in the UK economy even if it is taxed – people will always want to buy their goods from the most convenient place, which is usually the shop down the road. This means that consumption taxes are likely to be a relatively reliable source of revenue and less likely to drive labour and capital out of the UK than taxes on income and capital.

Consequently VAT is also a more resilient source of revenue in an economic downturn than, for example, corporation tax.[93] The current recession has seen VAT receipts fall by around 5 per cent, compared to a 45 per cent fall in stamp duties and a 9 per cent drop in corporation tax revenues.

91 Broadening the VAT base may have an income effect but this would likely strengthen incentives to work.
92 Edwards, C. and D. Mitchell (2008), *Global Tax Revolution,* Cato Institute.
93 Houlder, V. (2009), "Further VAT rises likely as Europe sets the pace", *Financial Times,* 20 October.

Consumption taxes have a low economic cost…

Compared with other taxes which are likely to have a substantial impact on behaviour (such as high marginal income tax rates), consumption taxes have less impact on behaviour. This is particularly the case if levied at a low rate on a broad base, so as to minimise the differences between different goods and services. This means that these taxes come at a lower economic cost than other taxes.[94]

And low administration costs

Consumption taxes also have low administrative and compliance costs in comparison to other taxes, and the broader the base the lower these costs will be.[95] VAT is levied on all sales of goods and services (both to private consumers and businesses). Because VAT is collected in stages along the chain of production, rather than all at the retail level, tax evasion is more difficult than with a tax collected at one point.[96]

This also means that if the final sold item is exempt from VAT or subject to a zero or reduced rate, the only revenue lost (assuming the intermediate stages were not also zero or reduced-rated) is the value-added between the penultimate stage of production and the final product.[97]

The current system

VAT raised close to £80 billion in 2008-09, about 15 per cent of total tax revenues.[98] The standard VAT rate is 17.5 per cent. This applies to most goods and services purchased in the UK.[99] A reduced rate of 5 per cent applies to products including domestic power and energy, contraceptives and children's car seats. A zero rate applies to most food, children's clothing, books and residential construction.[100] There are a number of other items, such as financial services and education, which are entirely exempt from VAT under EU rules and are not discussed in this report.

The need for a broader base

Holes in the VAT base distort consumer behaviour and create economic costs. When two products that are broadly the same are treated differently for tax purposes, consumers are encouraged to buy the product with the favourable tax treatment. As well as minimising the differences in taxation between goods or services, broadening the base could also, in the short term, increase revenue, allowing the rate to be reduced further in the longer term. It would also reduce administration and compliance costs.

Holes in the VAT base also lead to costly litigation to determine the tax treatment of different goods. An often cited example is the case of Jaffa Cakes, where the producer won the argument that these products, largely identical in form to biscuits, should be classified as cakes (taxed as basic foodstuffs) and thus be VAT exempt. Biscuits, on the other hand, are classed as a luxury item and incur a 17.5 per cent VAT charge.[101]

The UK is out of kilter with the rest of Europe

The design of the VAT in the UK is out of step with European norms.[102] For example, Britain is one of only four EU countries to apply a zero rate to food (with Ireland, Cyprus and Malta). It is one of only three to apply a zero or reduced rate to children's clothes (with Ireland and Luxemburg). The UK is alone in applying a zero rate on the construction of new homes, although six others apply reduced rates. Only nine member states have reduced rates for gas and electricity.

Indeed, only ten EU member states apply their own zero rates of VAT to particular goods or services and of those most are on one or two items only (such as newspapers and books). Ireland's list contains twelve zero rated items, while the UK has by far and away the most with a list of more than twenty zero rated goods.

94 While any increase in VAT (either increasing rates or broadening the base) will cause a one-off step increase in inflation, this should not affect underlying trend rates of inflation.
95 Crawford, I. *et al.* (2008), *Value-Added Tax and Excises,* Institute for Fiscal Studies, Prepared for the Report of a Commission on Reforming the Tax System for the 21st Century, Chaired by Sir James Mirrlees.
96 Ibid; Mankiw, G. (2009), "The Value Added Tax", *Greg Mankiw's Blog,* 14 October.
97 Crawford, I. *et al.* (2008), *Value-Added Tax and Excises,* Institute for Fiscal Studies, Prepared for the Report of a Commission on Reforming the Tax System for the 21st Century, Chaired by Sir James Mirrlees.
98 HM Treasury, *Public finances databank,* January.
99 VAT is payable within the EU at the rates prescribed by the country from which the goods or service are purchased. An EU resident (in the UK or elsewhere) purchasing from a UK company will pay VAT at the UK rate; a UK resident purchasing from Spain will pay VAT at the Spanish rate, for example.
100 Crawford, I. *et al.* (2008), *Value-Added Tax and Excises,* Institute for Fiscal Studies, Prepared for the Report of a Commission on Reforming the Tax System for the 21st Century, Chaired by Sir James Mirrlees.
101 See "VFOOD6260 – Excepted items: Confectionery: The bounds of confectionery, sweets, chocolates, chocolate biscuits, cakes and biscuits: The borderline between cakes and biscuits", at www.hmrc.gov.uk.
102 All European Union VAT rates data from: European Commission Taxation and Customs Union (2006), *VAT Rates Applied in the Member States of the European Community.*

Inefficiency and lost revenue

The zero-rating and reduced rating of VAT on products ranging from children's clothing to contraceptives results in substantial lost revenue. HMRC estimates that at least £31 billion of additional revenue would have been raised last year without these exemptions.[103] The economic costs created by these exemptions means that the UK's "C-efficiency" rate, which measures the efficiency of consumption tax systems,[104] is one of the lowest (worst) in the OECD.[105]

Table 9: Broadening the VAT base (estimated lost revenue 2008-09)
Source: HMRC (2009), *Estimated costs of the principal tax expenditure and structural reliefs, 2008-09*

Zero-rated items	£ million
Food	11,450
Construction of new dwellings*	5,700
Domestic passenger transport	2,600
International passenger transport *	150
Books, newspapers and magazines	1,500
Children's clothing	1,200
Water and sewerage services	1,350
Drugs and supplies on prescription	1,450
Supplies to charities *	200
Ships and aircraft above a certain size	650
Vehicles and other supplies to disabled people	350
Reduced rate items	
Domestic fuel and power	3,950
Certain residential conversions and renovations	150
Energy-saving materials	50
Women's sanitary products	50
Estimated total	**30,800**

*These figures are particularly tentative and subject to a wide margin of error.

Politicians in the UK have been unwilling to broaden the VAT base for the wrong reasons. As the Institute for Fiscal Studies has argued: "The policy rationale for the zero-rating of food and children's clothing is extremely weak… The survival of zero-rating of food and children's clothing appears simply to reflect politicians' doubts of their ability to explain why a package involving its removal need not have a regressive impact."[106] The variation in rates is also inconsistent and arbitrary: why, for example, should children's clothing be zero-rated but children's car seats be rated at five per cent?

103 HM Revenue and Customs (2009), *Estimated costs of the principal tax expenditure and structural reliefs.*
104 The C-efficiency rate is the ratio of actual VAT revenue to the potential total revenue if all private consumption was subject to VAT at the standard rate. This would be 100 per cent if VAT is levied at a uniform rate on all consumption; the UK rate is 49 per cent.
105 OECD (2008), *Consumption Tax Trends 2008.*
106 Crawford, I. *et al.* (2008), *Value-Added Tax and Excises,* Institute for Fiscal Studies, Prepared for the Report of a Commission on Reforming the Tax System for the 21st Century, Chaired by Sir James Mirrlees.

Distributional effect of broadening the base

A concern over the base broadening of VAT is that it is a regressive tax. Many commentators believe that taxing consumption hurts poorer families most, since a greater proportion of their income is spent on consumer goods and services than that of the rich.[107] This argument suggests that broadening the base to include items such as food and children's clothes would hit the poor particularly hard.

There are a number of arguments to suggest that VAT is (or can be) less regressive than believed, and that zero and reduced rating is undesirable:

Since the rich save a greater proportion of their income than the poor, it *appears* as though they are effectively "escaping" VAT on that portion of their income. But this saved money will generally be spent later (aside from bequests), so VAT is not escaped over the lifecycle. As a proportion of household spending, therefore, the poor do not seem to spend more, or not much more, than the rich on items on which VAT is charged.[108]

The zero and reduced VAT rates are a poor way to target help on poor families, in fact benefiting the rich more than the poor since a wealthy individual or family will, in absolute terms, spend more than a poorer one. Using preferential rates introduces complexity into the system and, since they are not particularly effective at helping those on low incomes, it is better to use the existing redistributive mechanisms in the welfare system for this purpose.[109]

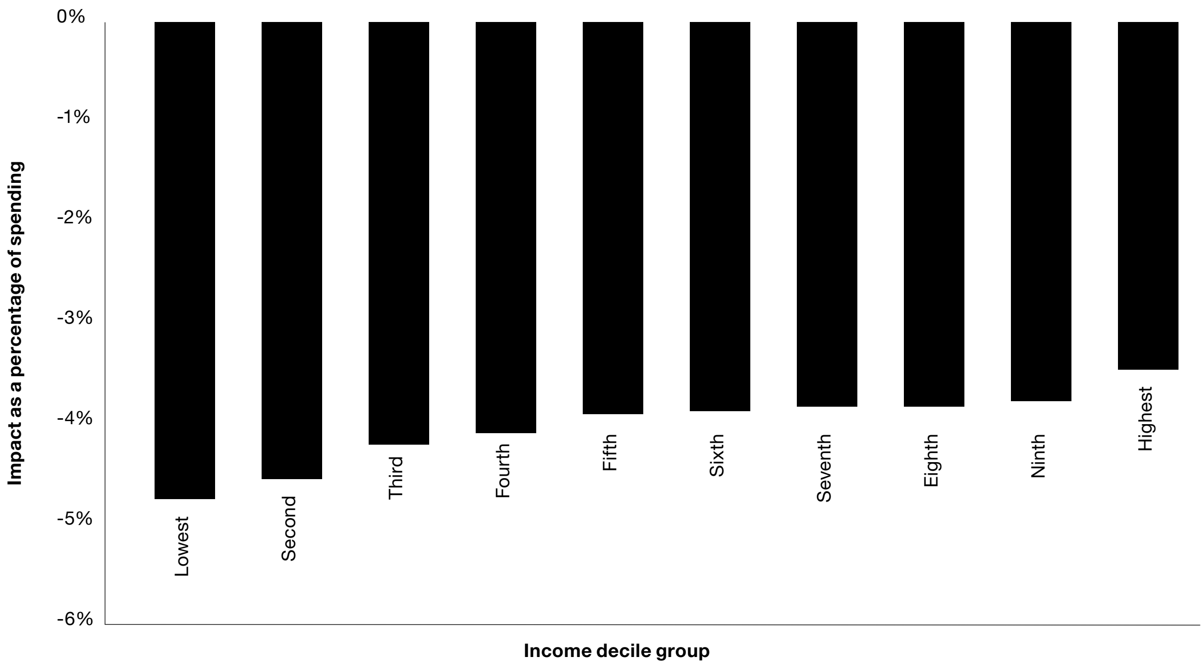
Offsetting the increase

The OECD similarly concludes in a worldwide study of consumption taxes, "It is generally better to use the benefit system to offset any undesirable effects of tax changes on the poor."[110] Rather than inefficiently trying to use the VAT system to help the poorest, an increase in benefits could offset the regressive effects of increasing the efficiency of VAT by broadening the base.[111] In New Zealand, the introduction of the Goods and Services Tax (GST) was offset with a one-off benefit adjustment for pensioners that reflected the effect on consumer prices.[112] Low-paid workers also received relief through income tax credits, targeted in particular at families with dependent children, as evidence showed that the tax was more regressive for these families.[113]

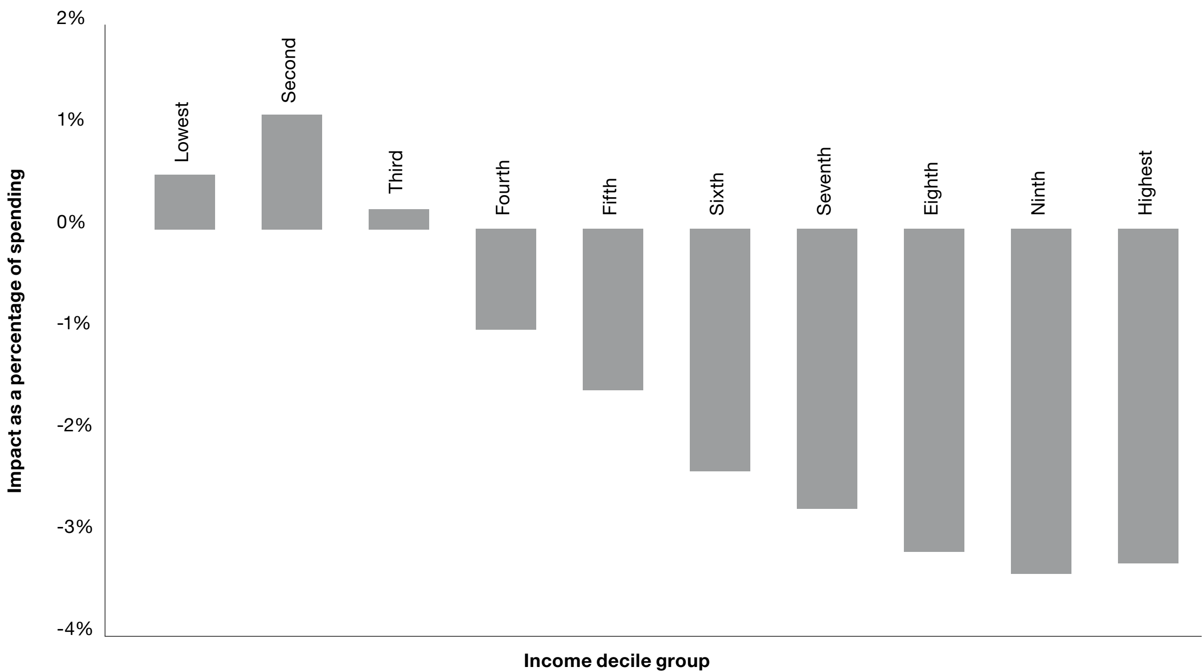
107 See for example, Murphy, R. (2009), "The Conservatives, planning a 20% VAT rate (or more)", Tax Research UK, 10 August; Wintour, P. (2009), "Gordon Brown blocked Alistair Darling's plan to increase VAT", *The Guardian,* 10 December.
108 Crossley, T. *et al.* (2009), "Value added tax", in Institute for Fiscal Studies (2009), *The IFS Green Budget 2009;* Office for National Statistics (2008), *The effects of taxes and benefits on household income 2007/08,* p. 4.
109 Chote, R. (2008), "Issues in personal tax design" in Wales, C. (ed.), *Fair tax: towards a modern tax system,* The Smith Institute.
110 OECD (2007), *Consumption Taxes: The Way of the Future?*
111 Crawford, I. *et al.* (2008), *Value-Added Tax and Excises,* Institute for Fiscal Studies, Prepared for the Report of a Commission on Reforming the Tax System for the 21st Century, Chaired by Sir James Mirrlees.
112 Dickson, I. and D. White, (2008), *Value-Added Tax and Excises: Commentary,* Institute for Fiscal Studies, Prepared for the Report of a Commission on Reforming the Tax System for the 21st Century, Chaired by Sir James Mirrlees.
113 Data gathered from household income and expenditure surveys suggested that the presence of dependent children within a family type magnified the effect of taxing food and other necessities, while the impact on pensioners was less than for a typical household due to their relatively lower food consumption.

Figure 5: The distributional effect of broadening the VAT base with *Reform's* proposal
Sources: Office for National Statistics (2009), *Family spending: A report on the 2008 Living Costs and Food Survey;* Office for National Statistics (2009), *The effects of taxes and benefits on household income, 2007/08; Reform* calculations.[114]

Before compensation



After compensation



114 Losses calculated from applying a 17.5 per cent VAT rate on household expenditure on food, mortgage payments, passenger transport, books, newspapers and magazines, drugs and prescriptions and children's clothes; and by applying a 12.5 per cent rate on electricity and gas (the difference between the current 5 per cent reduced rate and the standard rate).

Reform has calculated that the government could scrap the zero and reduced rates of VAT while compensating the poorest and still raise approximately £15 billion of extra revenue. This is based on increasing all cash benefits by 7.5 per cent and would mean that the poorest 30 per cent of households would, on average, be better off while all other deciles would lose, progressively by a higher amount the richer the household.

As the charts above show, on average, before compensation poorer households lose the most. A bigger proportion of their spending goes on food and gas and electricity than for richer households, although richer households spend more proportionately on mortgage payments which evens out the impact somewhat.

The *Reform* calculations are estimates. The precise impact of any change in VAT is difficult to calculate as behavioural changes would have an effect and altogether there are currently over eighty zero and reduced rated items.[115] The figures are based on household spending on the main zero and reduced rated items, including food, domestic gas and electricity, mortgage payments, books, papers and magazines, transport, drugs and prescriptions and children's clothes.

Administration and compliance

While it is difficult to quantify the gains from having a broad-based VAT with a uniform rate, the New Zealand experience suggests that there can be significant administrative cost savings. GST, unlike the UK VAT, does not require hundreds of pages of classifications of goods, services, providers, interpretations and rulings. Further, GST has been a "low maintenance tax", requiring the time of only one and a half professional policy staff out of a total Inland Revenue tax policy team of 45 for ongoing administration.[116] It is difficult to accurately quantify the benefit in compliance costs, but independent analysis suggests that "the wider base of the New Zealand tax … could be expected to reduce compliance costs compared with the United Kingdom".[117]

Housing industry

After VAT on food, the second biggest loss in VAT revenue comes from the zero rate on the construction of new properties. This is estimated to cost the Treasury £5.7 billion a year. The construction industry and others will argue that removing the zero rate on new builds will be damaging given the current fragility of the housing market – presuming the cost would be borne by house buyers in the form of higher prices. Indeed, the industry has been lobbying for a further break in the form of a 5 per cent rate on repairs and home improvements to help stabilise the market.[118] However, there are several counter-arguments to consider.

The UK is alone among OECD countries in zero-rating the construction and sale of residential properties.[119] The housing industry is also alone in having such generous tax breaks. Other industries would no doubt welcome a similar incentive for their customers. Manufacturing, for example, has been gradually declining in the UK. It does not seem fair or rational for one specific industry to receive this kind of tax break.

The housing industry also gets a second major tax break. The capital gains tax exemption on the principal home means that for many new builds no tax will be paid at all on the construction or sale of the properties. Even for those homes with a value of £125,000 or more, the only tax that will be paid is stamp duty land tax at no more than 4 per cent.

The UK's housing and construction industries are going through an unstable period as they try to recover from the bursting of the bubble. However, the extent of the housing crash in the UK has called people to question the boom period of this industry. Levels of personal debt in the UK have been seen to be unsustainable and well above those in other developed countries.[120] Moving to a more neutral tax treatment of housing would be central to ensuring that investments in housing stock reflect the underlying value of the assets and may help to prevent people from taking on unsustainable levels of debt.

115 See "VAT notices" on www.hmrc.gov.uk.
116 Dickson, I. and D. White (2008), *Value-Added Tax and Excises: Commentary,* Institute for Fiscal Studies, Prepared for the Report of a Commission on Reforming the Tax System for the 21st Century, Chaired by Sir James Mirrlees.
117 Sandford, C. and J. Hasseldine (1992), *The Compliance Costs of Business Taxes in New Zealand.*
118 www.cutthevat.co.uk.
119 Crawford, I. *et al.* (2008), *Value-Added Tax and Excises,* Institute for Fiscal Studies, Prepared for the Report of a Commission on Reforming the Tax System for the 21st Century, Chaired by Sir James Mirrlees.
120 Total UK personal debt at the end of December 2009 stood at £1,460 billion – equivalent to £9,000 per household excluding mortgages and £57,937 including mortgages. Credit Action (2010), *Debt statistics: Total UK personal debt February 2010.*

The other options

Broadening the VAT base has the rare advantage of being a revenue-raising measure which is also good for the tax system. Removing the zero and reduced rates on particular items would make VAT a less distortionary tax, as well as being simpler and less costly to comply with. To raise a similar amount of revenue (around £30 billion) the standard rate of VAT would need to increase to around 23.5 per cent. Alternatively employer and employee rates of National Insurance Contributions would need to increase by around 3 per cent.[121] Increasing the VAT or income tax rates would be more damaging than broadening the base as higher rates have a greater distortionary impact on behaviour.

The political implications

A useful comparison is New Zealand's GST, which was introduced in the 1980s with the "twin pillars" of a uniform rate and a very broad base, including food, children's clothing, medical care, education services, publications and energy.[122] Realising the political challenges of implementing such a tax, New Zealand policymakers developed arguments for taxing food and other necessities and ran large-scale public engagement, consultation and education campaigns. The argument was broadly accepted that taxing food, though appearing regressive, in fact makes additional revenue available for redistribution to the poor (since the rich spend more on food in absolute terms). This allowed the Government to implement the GST with a comprehensive base and a single rate.[123]

The New Zealand example demonstrates that the argument for a broad VAT base and uniform rate can be won if made in a rational, consultative way by a credible government. Acceptance of the GST by business, in particular, was aided by extensive consultation, and the draft legislation was substantially rewritten as a result.[124] It has also been observed that the acceptance and success of the GST was in large part due to the emphasis put on horizontal equity (people in similar circumstances being taxed equally) since this underpinned a key notion of fairness.[125]

2. Scrap the 50p income tax rate and reverse the restriction of tax relief on pension contributions

On the Treasury's Budget 2009 estimates, scrapping the 50p income tax rate would lose about £2.5 billion in tax revenues from 2011-12 onwards. Other estimates have put this revenue at less and the Treasury has said that it has revised down its forecasts.[126] The Conservatives have said that reversing this new rate will not be a priority in the first Parliament of a Conservative Government.

How the current top rate compares

In Geoffrey Howe's first Budget in 1979 he cut the basic rate of income tax from 33 to 30 per cent and cut the top rate from 83 to 60 per cent. In 1988 the Conservative Party reached their long-term aim of cutting the basic rate to 25 per cent, while at the same time cutting the top rate to 40 per cent. In 1997, this was a competitive higher rate and was lower than or equal to the top rates in 17 other OECD countries (out of a total 30). The proposed 50 per cent top rate on incomes over £150,000 due to come into force in April 2010 will give the UK the second highest top rate in the OECD (joint with Belgium and Austria, and just behind the Netherlands' 52 per cent rate).[127]

121 The IFS estimates that around £5 billion would be raised by increasing the standard rate of VAT by 1 per cent, and a similar amount by increasing the employers' and employees' rates of National Insurance by 0.5 per cent each, both above and below the upper earnings limit.
122 Dickson, I. and D. White (2008), *Value-Added Tax and Excises: Commentary,* Institute for Fiscal Studies, Prepared for the Report of a Commission on Reforming the Tax System for the 21st Century, Chaired by Sir James Mirrlees. This paper suggests that ending all current zero and reduced rates while increasing all means-tested benefits and tax credits by 15 per cent would leave the poorest 30 per cent of the population better off, on average, and still raise an additional £11 billion for the exchequer.
123 Ibid.
124 Dickson, I. and D. White (2008), *Value-Added Tax and Excises: Commentary,* Institute for Fiscal Studies, Prepared for the Report of a Commission on Reforming the Tax System for the 21st Century, Chaired by Sir James Mirrlees.
125 Stephens, R. (2007), "The Economic and Equity Effects of GST in New Zealand", in Krever, R. and D. White (eds.), *GST in Retrospect and Prospect.*
126 See for example, Adam, S. (2009), *Reactions to Budget 2009: Direct Taxes and Benefits,* Institute for Fiscal Studies.
127 OECD (2008), "Personal income tax rates: table I.1", OECD tax database.

A major cause of complexity

Together with the phasing out of the personal allowance for taxpayers with incomes over £100,000, the 50p tax rate will add considerable complexity to the tax system and corresponding tax calculations, as the tax professional community has highlighted.[128] It will also result in high effective marginal tax rates. Those earning between £100,000 and £112,950 will face a marginal tax rate of 60 per cent, while someone earning £115,000 will face a marginal tax rate of 40 per cent. There is no economic rationale for this pattern of marginal tax rates which will have a distortionary impact.

Table 10: Impact of 50p rate and withdrawal of personal allowance
Source: HM Treasury (2009), *Budget 2009: Building Britain's future; Reform* calculations.

Gross income	Effective marginal tax rate
£6,475	0 per cent
£30,000	20 per cent
£50,000	40 per cent
£110,000	60 per cent
£120,000	40 per cent
£155,000	50 per cent

It also widens the gap between tax paid on capital gains and the higher income tax rate only a year after the Government introduced the 18 per cent flat rate capital gains tax, which was welcomed for narrowing the discrepancy between these rates.

Targeting people who contribute a lot already

The Chancellor said that the change would affect only the wealthiest 2 per cent of the population. Looking at the current burden, the richest 1 per cent of taxpayers provide nearly a quarter of total income tax revenues and the richest 10 per cent provide over half. The UK relies on this group to fund a large proportion of public services.

Table 11: Share of income tax for percentile groups, 2009-10
Source: HM Revenue and Customs (2009), *Table 2.4: Shares of total income (before and after tax) and income tax for percentile groups.*

Top 1 per cent of income taxpayers	Top 10 per cent of income taxpayers	Top 25 per cent of income taxpayers
24.1 per cent	53.3 per cent	71.0 per cent

128 House of Commons Library (2009), *Income tax: the new 50p rate,* Standard Note BT/249.

Unlikely to raise much revenue

While Alistair Darling said that the aim of the measure was to help plug the hole in public finances, it is likely to raise a relatively small amount of extra revenue. The Treasury initially estimated that it would raise an additional £1.13 billion in 2010 and £2.48 billion in 2011.[129] In January 2010, Lord Myners stated that the Treasury had revised its behavioural assumptions in their modelling and lowered the estimates of revenue collected.[130]

Leading to damaging behaviours

As set out in Chapter 3, higher tax rates can reduce revenues as people and companies will engage in avoidance behaviours and incentives to work can be damaged.[131] In the US, a "millionaires" tax bracket was introduced in the state of Maryland in 2008 – within a year one third of the millionaires had disappeared from Maryland's tax roll.[132] While emigration is an extreme reaction, people can do a number of things to avoid paying extra tax, including forgoing salary, converting more income into capital and retiring earlier.[133]

This measure itself may not be enough to drive the 350,000 UK residents who earn over £150,000 out of the UK.[134] But on top of other recent changes to hit the wealthiest, including the charge for non-domiciled taxpayers, the tax on bankers' bonuses and the restriction of higher rate relief on pensions, these changes make the UK a less attractive place for highly mobile individuals. Indeed, there has been evidence of high net worth individuals emigrating following these changes.[135] These people are needed to help create wealth and economic growth as the UK tries to move out of recession. These damaging tax changes are coming at exactly the wrong time.

These measures reverse the move towards a flatter, more economically efficient, tax system that has occurred in the last thirty years. As set out in the previous section on VAT, raising revenue requires a broad base, not increasing tax rates on a small minority.

Reversing the restriction of tax relief on pension contributions

In Budget 2009, the Chancellor also announced the restriction of higher rate tax relief on pension contributions for those on incomes above £150,000 from 2011-12, raising an estimated £3.6 billion annually.[136] Under the plans relief will be tapered away so that those on incomes over £180,000 will receive relief at only the basic rate.

Together with the 50p rate, these measures represent a shift in the balance of fairness in the tax system. They are short-termist, politically motivated measures designed to plug the public finances hole by taking money away from high earners. Severing the link between income tax rates and pensions relief creates inconsistency in the tax system and increases the compliance burden. It also makes the environment for savings more complex and reduces the confidence consumers need to save for their futures.[137] It is contradictory to the Government's ambitions to increase savings and to the recommendations of the Turner Commission for successful private savings to enable a decrease in state benefits.[138]

Reform's proposed scrapping of the 50p rate will further weaken the rationale for this measure, as it will reduce demand for pension contributions as a form of salary sacrifice.

129 HM Treasury (2009), *Budget 2009: Building Britain's future,* p. 153; HM Treasury (2008), *Pre-Budget Report 2008: Facing global challenges: Supporting people through difficult times,* p. 10. The Budget 2009 estimates were in addition to the yield published at PBR 2008 for the 45 per cent additional rate commencing from 2011-12.

130 Jagger, S. and R. Watson (2010), "Treasury loses as top earners dodge 50p tax", *The Times,* 2 February.

131 Wanniski, J. (1978), "Taxes, revenues and the 'Laffer Curve'", *The Public Interest,* No. 50.

132 De Rugy, V. (2008), "Who Wants to Tax a Millionaire?", *Reason Online.*

133 House of Commons Library (2009), *Income tax: the new 50p rate,* Standard Note BT/249.

134 Brewer, M. and J. Browne (2009), *Can more revenue be raised by increasing income tax rates for the very rich?,* Briefing note BN84, Institute for Fiscal Studies.

135 See, for example, Hanney, B. (2010), "Non-doms flight takes off", *Accountancy Magazine,* February.

136 HM Treasury (2009), *Budget 2009: Building Britain's future.* Budget 2009 estimated the measure would raise £200 million in 2011-12 rising to £3.1 billion in 2012-13 due to lagged effects of self-assessment. Pre-Budget Report 2009 updated the income definition, adding an additional £500 million to the 2012-13 yield. For further explanation of the proposals see Deloitte's Budget 2009 website at www.ukbudget.com.

137 NAPF (2010),*"Chancellor must adopt a Budget for pensions",* 25 February.

138 Pensions Commission (2005), *A New Pension Settlement for the Twenty-First Century: The Second Report of the Pensions Commission.*

What a drag

Personal income tax burdens may increase even when income tax rates and thresholds remain unchanged. Increases in workers' incomes as an economy grows mean that more people will move into higher income tax brackets without any changes being made. The 2009 Pre-Budget Report proposed a freeze of the higher rate income tax threshold in 2012-13, which would impact individuals on incomes of £43,875 and raise £0.4 billion.[139] Accountancy firm Grant Thornton estimated that this would drag 70,000 people into the higher rate bracket in that year.[140] This measure is an increase in taxation by stealth – average earnings rose by 1.2 per cent in the year to December 2009.[141] It should not be implemented and the higher rate threshold should be adjusted to offset fiscal drag.

3. Reduce National Insurance Contributions

The Government has announced increases to employee and employer national insurance contributions to take effect from April 2011. Increasing NICs will make work less rewarding and reduce incentives to participate in work or increase work effort. It will also increase the cost of employing workers at a time of high unemployment.

As well as personal taxes, National Insurance Contributions are levied on income from work. The rates and thresholds for these contributions (in the 2009-10 tax year) are 11 per cent on earnings between £110 and £844 per week and 1 per cent on earnings above £844 per week. There are also other features of national insurance, with, for example, rates differing for earners who have contracted-out of national insurance.

National insurance (both employee and employer) raises £85 billion for the Exchequer, around 18 per cent of total tax revenues. National Insurance Contributions fall relatively more heavily on the lower paid than on the rich and more heavily on employees than on the self-employed. The current system is complicated and calculated in different ways to income tax.

A job killer

The Government has announced that National Insurance Contribution rates facing employees and employers will each increase by 1 percentage point from April 2011.[142] This will be a harmful tax increase. By increasing the wedge between gross wages (wages before taxes and national insurance) and income in the hand, these increases will make work less rewarding and reduce incentives to participate in work or increase work effort. They will also increase the cost of employing workers and so will reduce employers' demand for staff at the worst possible time. The recent CIPD/KPMG labour market outlook survey found that one in eight employers surveyed expected to recruit fewer staff, while 6 per cent planned to make more redundancies, due to the increase in National Insurance Contributions.[143]

Increase in the primary threshold

To offset this increase in contribution rates for some lower income individuals the Government has proposed lifting the primary threshold for National Insurance Contributions to around £135 per week (from the current level of £110 per week). This increase is made up of two changes. In the 2008 Pre-Budget Report it was announced that the NICs primary threshold would be aligned with the personal allowance in 2011-12. This was estimated to have a fiscal cost of £1.61 billion in 2011-12.[144]

In the 2009 Pre-Budget Report the Government said that the NICs primary threshold would be increased by a further £570 a year to ensure that individuals under £20,000 per annum would not face any increase in contributions following the rate rises. This was estimated to cost an additional £1.48 billion in 2011-12 and £1.5 billion in 2012-13.

139 HM Treasury (2008), *Pre-Budget Report 2008: Facing global challenges: Supporting people through difficult times.*
140 Budworth, D. and M. Atherton (2009), "Doubling of rise in National Insurance will affect 20 million people", *The Times*, 10 December.
141 Refers to regular pay excluding bonuses. Office for National Statistics (2010), *Statistical Bulletin: Labour market statistics: February 2010.*
142 For employees the basic rate will rise from 11 to 12 per cent and the higher rate from 1 to 2 per cent. For employers the rate will increase from 12.8 to 13.8 per cent.
143 CIPD/KPMG (2010), *Quarterly Labour Market Outlook: Winter 2009-10.*
144 This estimate seems, however, lower than could be expected as, based on the current level of the personal allowance of £6,475, this would imply an increase in the weekly level of the primary threshold of around £15 per week, which would have a cost closer to £2.7 billion (static estimate). Any increase in the personal allowance would increase the cost of increasing the NICs threshold, so basing this analysis on the current level of the allowance understates the cost of the NICs threshold change.

Reversing the proposed tax rise

Reform proposes that the increase in rates should be reversed and a decrease of 0.5 per cent on the employee class 1 rates (from 11 to 10.5 per cent and 1.0 to 0.5 per cent) and the employers' class 1 rate (from 12.8 to 12.3 per cent) should be implemented from April 2011. The primary threshold should be raised, aligning it with the proposed zero tax rate threshold of £6,475 (set out in the next section of this chapter).[145]

Altogether, *Reform's* National Insurance Contribution proposals would be a tax cut on employment of £8.2 billion, compared to the Government's planned tax rise of £6.9 billion. In contrast to the Government's proposals, these measures would improve incentives for work at a time when the UK economy needs a kick start to come out of recession.[146] The changes would also reduce the costs facing employers of taking and keeping on staff and so would improve demand for labour and help stimulate economic recovery. Rather than killing jobs, the *Reform* proposal would help stimulate job growth.

Longer-term simplification

There have been strong calls for simplification of the interaction between income tax and employee National Insurance Contributions by tax and industry experts. The HMRC Measurement Project (established to measure and reduce the administrative burden of the tax system) also echoed this view. There are some measures that could simplify the interface between income tax and employee national insurance contributions in the short terms. These include aligning the charging rules to reduce complexity.

4. Replace personal allowances with a tax free threshold

Personal allowances reduce the thresholds at which income tax rates apply. Personal allowances reduce taxable incomes and so provide higher benefits to higher rate taxpayers, as the reduction received is at the higher rate rather than the basic rate. Efforts have been made to reduce the benefit of personal allowances for higher rate taxpayers by introducing clawback of these allowances. The current levels of personal allowances and clawback (in the 2010-11 tax year) are:

- Personal allowance: £6,475.
- Income limit for personal allowance: £100,000 – thereafter phased out by £1 for every £2 of income above the threshold.
- Personal allowance for people aged 65-74: £9,490.
- Married couples allowance aged 75 and over: £6,965.
- Income limit for age-related allowances: £22,900.
- Blind person's allowance: £1,890.

The clawback of the personal allowance on incomes above £100,000 will create high and erratic marginal tax rates and further complexity. *Reform* proposes that personal allowances are scrapped and replaced with a tax free threshold.

Allowances versus a tax free threshold: what are the differences?

Although a personal tax allowance and a tax free threshold may appear to be two very similar ways to provide relief to individuals at the bottom of the income tax scale, the effects of these policies often differ from what is commonly assumed.

A key difference between an allowance and a tax free threshold is that an allowance reduces taxable income and then calculates tax paid. A tax free threshold does not reduce taxable income but reduces the tax rate that applies to some of this income. In practice this difference means that a tax allowance provides more support the higher the marginal tax rate of the taxpayer. To illustrate, assuming the operation of a 50p tax rate:

- An individual on £160,000 would pay £3,237.50 more with a tax free threshold than with a personal allowance.
- An individual on £36,475 would pay exactly the same amount.

145 As the 1 per cent increase will no longer take place, the additional £570 increase in the primary threshold will not be required.
146 This change would both improve marginal tax rates (improving the financial reward from additional work) and encourage greater work to compensate for the change in income (income effect).

Table 12: Impact of removal of personal allowances and introduction of zero-rate threshold
Source: HM Revenue & Customs (2010), *Rates and allowances – Income Tax; Reform* calculations.

	Current system	*Reform* proposal	Current system	*Reform* proposal
Income	£36,475	£36,475	£60,000	£60,000
Personal allowance	£6,475	-	£6,475	-
Taxable income	£30,000	£36,475	£53,525	£60,000
Taxed at 0%	-	£6,475 = £0	£6,475 = £0	£6,475 = £0
Taxed at 20%	£30,000 = £6,000	£30,000 = £6,000	£37,400 = £7,480	£30,925 = £6,185
Taxed at 40%	-	-	£16,125 = £6,450	£22,600 = £9,040
Total tax	£6,000	£6,000	£13,930	£15,225

Implications for taking people out of the tax system

This difference in the operation of personal allowances and tax free thresholds has important consequences for the ability to take people out of the tax system. In particular, as the benefits of tax free thresholds are capped at the level of the basic rate of tax, higher rate taxpayers receive the same benefit from tax free thresholds as basic rate taxpayers. This means that relief can be provided to basic rate taxpayers in a more efficient and cost effective way.

Removing personal allowances and introducing a tax free threshold of an equivalent amount (£6,475) would mean that no basic rate taxpayers would be any worse off and that the revenue collected through the tax system (before accounting for behavioural changes) would increase by £2.8 billion. This additional revenue could fund deficit reduction and the removal of more damaging taxes, such as the 50p personal tax rate and the taxes on bankers' bonuses.

Reform calculations have shown that increasing the level of the basic personal allowance from £6,475 to £7,000 would increase the cost of the personal allowances by around £3.3 billion per annum. In contrast, removing personal allowances and introducing a tax free threshold of £7,000 would be largely revenue neutral (at a additional cost of around £0.2 billion).

Personal allowances and tax avoidance and evasion

There is evidence that the personal allowances are skewing the income distribution. *Reform* analysis shows that there are close to 800,000 individuals with total earned taxable incomes of below £1, and just under 10 million individuals with tax records and total earned taxable incomes of between £1 and £6,475. Given that there is a total of 40,695,011 individuals with tax records in the UK, this means that close to one quarter of all these people earn less than the personal allowance threshold of £6,475.

There is little economic explanation for the income distribution having such a large mode at around this income level. This suggests evidence of tax planning with, for example, families who are able to manipulate their taxable incomes effectively making multiple use of personal allowances by paying out income from their businesses to different family members.

The potential use of personal allowances for income splitting purposes can be shown by the difference in the measured poverty incidence and living standards of children in self employed families. While poverty and living standard measures often poorly match, most data sources show that children in self employed families are more likely to be identified as living in poverty (which is a measure of income) than children in employed families. However, living standards data (which measure the extent to which children forego consumption of certain items because of their costs) show that children in self employed families generally have higher living standards.[147] This highlights that incomes in self employed families are relatively fungible and that low incomes do not necessary mean low living standards.

147 Brewer, M., C. O'Dea, G. Paull and L. Sibieta (2009), *The living standards of families with children reporting low incomes, Research Report No 577,* Department for Work and Pensions, p. 85.

Removal of age related personal allowances

The different personal allowances in operation are a major source of complexity in the tax system. There is little reason for treating taxpayers differently through the tax system simply because of their age. Pensioner households are, for example, less likely to be in poverty than other households and pensioners tend to have relatively high rates of asset ownership. More people in their 60s, 70s and even 80s are interested in working full time, part time or flexibly.[148] Yet government policy is predicated on the idea that all people around retirement age are poor and are unable or unwilling to work

The scrapping of the age-related personal allowances would generate around an additional £2.3 billion (static estimate) in tax revenue (excluding the additional tax paid on people with incomes between the basic and the age related allowances).[149] As pensioners would largely not benefit from the reduction in NICs and would face an increase in costs due to the broadening of the VAT base, the value of the Pension Credit could be increased to ensure that no pensioners in need would be any worse off. Based on 3.33 million claimants of the Pension Credit,[150] increasing this programme by around £13 per week would more than offset the increase in tax liability for low income pensioners from the removal of age-related personal allowances. This proposal would be approximately cost neutral.

5. Keep the bankers' bonus tax as a one-off measure

In the 2009 Pre-Budget Report, the Government announced a temporary tax of 50 per cent on bankers' bonuses over £25,000 in 2009-10. Alistair Darling said that "Their [the banks'] priority should be to rebuild their financial strength and increase their lending" and that the measure was designed to "claw money back for the taxpayer".[151] In other words, the tax was aimed at encouraging a long-term move away from high bonuses based on risky transactions, as well as appeasing taxpayers who have bailed out the banks. The Treasury estimated that it would raise £550 million.[152]

It is understandable that there is public anger at the fact that taxpayers funds have been used to save institutions which paid over vast sums of money in bonuses to a minority of rich people. However, attempts by government to micro-regulate bankers' pay packages will not make a similar crisis less likely or help to repair the public finances.

As Nicholas Boys Smith has argued in an essay for *Reform*, the real problem was with the nature of the banks' profits and their belief that they could measure risk more precisely and certainly than they could. High bonuses based on short-term gains were a symptom, not a cause, of the risky operations of some banks. Additionally, many of the biggest banks (including AIG-FC, Lehmans and HBOS) had significant employee share ownership schemes, so bankers did have incentives in the long term profitability and stability of the banks.[153]

As well as failing to have a long-term impact on the way banks' remuneration systems work, the temporary tax on bankers' bonuses is also unlikely to work in limiting the size of bankers' remuneration in the immediate term. Wage policies implemented in the 1970s showed that employers will find loopholes in wage legislation far more quickly than most governments can close them down.[154] It is telling that France has been the only other country to follow suit, while other governments have taken more rational steps. In Germany, where the government left the market to act, eleven financial institutions have agreed to self-regulation to limit excessive bonus payments this year. In the US, a proposal has been made for a premium tax levied on the banks not their employees, which would stay in place until the government funding has been "repaid".[155]

148 Standard Life (2009), *The Death of Retirement.*
149 HMRC Survey of Personal Incomes (Public Use Tape) Data for 2006-07 indicate that there were 3.72 million individuals with tax records aged 65 to 74 and 2.83 million people aged 75 and over. Of this there were 2.88 million people aged 65 to 74 and 2.06 million people aged over 75 with total incomes above the appropriate age related scales. Applying a 20 per cent tax rate to the difference between the age-related allowances and the basic personal allowance in 2006-07, indicates that pensioners aged 65 to 74 would lose at most £8.63 a week and pensioners aged 75 and over would lose at most £9.17 a week.
150 Cawston, T *et al.* (2009), *The end of entitlement, Reform,* p. 25.
151 Darling, A. (2009), "Pre-Budget Report statement to the House of Commons", 9 December.
152 HM Treasury (2009), *Pre-Budget Report 2009: Securing the recovery: growth and opportunity.*
153 Boys Smith, N. (2009), *A dangerous consensus: Where we are going wrong on banks and bonuses*, *Reform*.
154 Ibid.
155 Wearden, G. (2009), "France poised to join UK in taxing bankers' bonuses", The Guardian, 10 December; Thomas, A. (2009), "A Bonus Deal in Germany", *The Wall Street Journal Online,* 11 December.

The bankers' bonus tax is an example of the worst kind of tax legislation. It is a hastily implemented measure based on short-termism and political motives. The incorrect idea that a few greedy, overpaid bankers are responsible for the UK's ballooning budget deficit is a convenient fiction for the government and the public. But the UK has long been living beyond its means. The £550 million the Government estimates that the tax will raise will not dent the deficit and there is a risk that the tax will become permanent. The long-term impacts on banks' operations and balance sheets are unknown – indeed, no such analysis, if it was done by Government, has been made public – but could be highly damaging, for example, encouraging financial institutions to increasingly relocate out of the UK. The next government should ensure that it resists the temptation to maintain this temporary tax.

6. Scrap gimmick income tax reliefs and employee benefits

As well as the complicated system of rates, bands and allowances, the personal income tax system is complicated by the presence of a large number of tax reliefs. According to HMRC allowance tables, the UK tax system offers more than 400 tax expenditure reliefs, structural reliefs and allowances to its taxpayers, many of which have little value in a modern tax system.[156] The system of employee benefits is particularly convoluted, with there being 155 sections in the Income Tax (Earnings and Pensions) Act 2003 that apply to the taxation of benefits other than shares.[157]

Many taxpayers are unaware of the existence of most of these reliefs which add complexity and lose HM Treasury revenue. Many are based on outdated working practices and are *ad hoc*, rather than consistent. Most of these should be abolished including:

> Relocation relief. The cap has remained constant for 13 years and it seems unlikely that it now serves any role in encouraging labour mobility. It should be the role of employers to account for the tax on compensation for moving costs. This could increase government revenues by £300 million.[158]

> Relief for professional subscriptions. Abolishing this relief could increase government revenues by £90 million.[159]

> A working at home tax exemption of £2 a week or more – a "green tax break" aimed at reducing the environmental impact of travelling to work – and the cycle to work scheme – where employees can hire a cycle and cycle safety equipment from employers as a tax free benefit. Both of these schemes are poorly targeted, add complexity to the tax system and are unlikely to provide any material environmental benefit. It should be the role of employers to account for the tax on these benefits.

The Conservative Tax Reform Commission estimated that the abolition of all employee reliefs and exemptions would increase government revenues by around £1.1 billion.[160] It would also broaden the tax base and reduce HMRC administration costs.

156 HM Revenue & Customs (2009), *Table 1.5 – Estimated costs of the principal tax expenditure and structural reliefs*; *Table B.1 – Cost of minor tax allowances and reliefs*; *Table B2 – Tax allowances and reliefs in force in 2007-08 or 2008-09 – Cost not known.*
157 Tax Reform Commission (2006), *Tax Matters: Reforming the Tax System,* The Report of the Tax Reform Commission, p. 65.
158 Ibid.
159 Ibid.
160 Ibid.

5
The Don'ts

The following proposals being considered by the Opposition should not be done in the next Parliament:

- Do not recognise marriage in the tax system
- Do not make an early cut to the main rate of corporation tax
- Do not make an early increase in the inheritance tax threshold

1. Recognising marriage in the tax system will be money poorly spent

David Cameron has said that the Conservatives would end the couple penalty in the tax credit system and recognise marriage and civil partnerships in the tax system in the next Parliament.[161] These pledges have been motivated by desires to both arrest the decline in the proportion of households of this type and to improve child outcomes (through encouraging a caregiver to remain in the home).

A transferrable tax allowance has been costed at between £600 million and £3.2 billion depending on the design.[162] This would not be money well spent as it would not achieve its objective of halting the decline in marriage in the UK. It is also inconsistent with the direction of travel across the world which has seen governments taking much more neutral approaches with tax systems.

Costs of family breakdown

It is possible to overstate the extent and costs of family breakdown. Most families experience generally positive outcomes, children brought up in nuclear families do not always do better than children brought up by sole parents and divorce may help avoid negative family outcomes (such as in high conflict situations). Yet on average, two-parent families fare better than sole parent ones and these differences in outcomes matter for social policy.[163]

Marriage penalties

Marriage penalties occur when two parents (or spouses) have a higher total income (net of income transfers and living costs) when separated than as a partnered unit. It is argued by some that these penalties mean that some people may be discouraged from entering into or remaining in a marriage.[164]

However, as well as these financial incentives, people's decisions regarding work effort and family structure are influenced by many other factors, including social norms.[165]

Moreover, the mere presence of a problem should not be used to justify poorly thought-out policy. Proposals for recognising marriage in the UK tax code lack a rigorous assessment of their full economic benefits and costs. A concern over family breakdown does not justify failing to consider the real costs and benefits associated with pro-family tax policies.

Marriage penalties – a product of progressivity

In many countries over the last few decades tax policy reform (towards a broad-based and low-rate tax system) has significantly reduced the strength of such arguments for recognising marriage in the tax system. The shift towards a broad-based and low-rate tax system has reduced the disparities in the tax burden faced by couples with one and couples with two incomes.[166]

161 The Conservative Party (2010), *Conservatives Draft Manifesto 2010: Chapter 2: Mending our broken society.*
162 The Centre for Social Justice (2010), *Green Paper on the Family.*
163 Nolan, P. (2008), *The value of family: fiscal, benefits of marriage and reducing family breakdown in New Zealand,* report to Family First New Zealand Inc., NZIER.
164 The Centre for Social Justice (2010), *Green Paper on the Family.*
165 Nolan, P. (2008), *The value of family: fiscal benefits of marriage and reducing family breakdown in New Zealand,* report to Family First New Zealand Inc., NZIER.
166 Yet over time these disparities may increase when wage inflation lifts people into higher tax brackets (fiscal drag). Fiscal drag can be illustrated by comparing unchanged personal income tax thresholds with personal income tax thresholds indexed for inflation.

Recognising marriage would make the UK out of step with the OECD

It has been claimed that Britain is one of the "very few countries in the Western world" that does not recognise marriage in the tax system.[167] Most countries, however, do not recognise marriage in the personal income tax system.[168] Where marriage is recognised this tends to be through the provision of credits or reliefs for income from activities such as the sale of the family home, and many countries make no recognition of marriage in their tax system at all (including Sweden, Finland, New Zealand, Greece, Hungary, Mexico and Turkey).

Further, over the last 25 years the number of countries recognising marriage in the tax system has been decreasing. Countries throughout the OECD have broadened personal tax bases through moving from household to separate taxation and removing or consolidating complex systems of tax deductions and rebates for single-income households and households with dependents. This broadening of tax bases has helped fund the flattening of personal income tax scales.[169]

Moves towards flatter personal income tax scales have meant that the need for recognising marriage through the tax system has reduced as the dispersion between primary and secondary earners' separate marginal tax rates has narrowed.

Money poorly spent

It has been shown that policies that recognise marriage through the tax system fail to improve outcomes, such as increasing the marriage rate or lowering the costs of family breakdown. Money could be spent more effectively on other policies, for example, programmes and services to reduce unwed pregnancy among teen mothers or to help prepare couples for, and support them during, marriage.[170]

Further, recognising marriage through the tax system would be inconsistent with other policy objectives, such as increasing labour supply and reducing child poverty.[171] For instance, sole parents, a household type with a high incidence of poverty, would not receive any assistance from policies that recognise marriage in the tax system.

Fairness

Tax relief for married families in the personal income tax system performs poorly against vertical equity criteria. High-income single-earner couples would be the main beneficiaries of the policy since it would allow this group of people greater access to low rates designed for low-income earners. If the concern is that marriage is only the domain of the middle classes, why introduce a new form of middle class welfare?

It is sometimes argued that a goal of recognising marriage in the tax system would be to ensure that a single income couple and a two income couple with the same household income would pay the same amount of tax. However, with the growing variations in household structures it has become increasingly difficult to define a progressive tax scale that treats all households equally (or reflects their different cost functions).[172]

167 The Conservative Party (2010), *Conservatives Draft Manifesto 2010: Chapter 2 Mending our Broken Society.*

168 New Zealand Inland Revenue Department (2008), *Income splitting for families with children: a government tax policy discussion document.* The report identified that 17 OECD countries (including Australia, Canada, New Zealand and the United Kingdom) use pure individual taxation. Only four OECD countries (France, Luxembourg, Portugal and Switzerland) use pure joint taxation of earnings. In the Czech Republic, Iceland, the Netherlands, Norway, Poland and Spain the individual is used as the tax unit but joint taxation is also possible (only capital income of married couples is taxed jointly in Iceland, while in the Netherlands certain parts of income, such as from owner-occupied housing and from savings, can be taxed jointly). In Germany and Ireland, spouses are normally assessed jointly but they have the option of being separately assessed. In the United States, married couples can file their earnings either separately or jointly.

169 OECD (2009), *Employment Outlook 2009,* p. 141.Relatively few countries (8 of 24 OECD countries) had systems where separate taxation was available in 1970. By 1990 separate taxation had become more widespread (particularly throughout Europe) and by 1999 relatively few (11 of 29 OECD countries) countries had systems where joint taxation was available.

170 Nolan, P. (2008), *The value of family: fiscal, benefits of marriage and reducing family breakdown in New Zealand,* report to Family First New Zealand Inc., NZIER.

171 Brewer, M., J. Browne, and R. Joyce (2009), *Analysis of tax and benefit changes affecting families with children for Gingerbread,* Institute for Fiscal Studies.

172 For example, adjusting tax liability on the basis of equivalence scales (which adjust household incomes according to their cost functions) would create serious difficulties. Aside from the impracticality of such an approach, there is considerable variation in the weightings used in equivalence scales and there is no one scale that would be appropriate in every circumstance. There are also difficulties in reconciling household equivalence scales with an income tax administration based on individual tax returns. It is also sometimes argued that it is unfair that transfers in the marketplace (such as for childcare services) are recognised for assistance (such as childcare subsidies), but transfers in the home (such as between a working and a non-working spouse) are not. Yet difficulties would arise in measuring and attributing a dollar value to transfers within households and the benefits from domestic production.

Efficiency

Approaches to recognising income through the tax system could also act as a barrier to female participation and hours of work in the labour market. Approaches to recognising marriage could lower the marginal tax rates facing men in partnered households, while increasing tax rates facing women. Empirical analysis indicates that females tend to be more sensitive to financial disincentives to work than males.[173] As such it is likely that there would be a net reduction in labour supply from recognising marriage in the income tax system.

Administration and compliance

It would be necessary for HMRC to ensure that taxpayers who claim that they share their household incomes are actually eligible couples. This would require rules as to what constitutes an eligible relationship and these rules would need to be monitored and enforced. Rules would also have to be designed to determine the treatment of couples that begin or end their relationship during an income tax year. Complying with the tax system with a married couple tax allowance would be more difficult and costly.

2. Certainty is more important to business than low headline rates

The UK must ensure that its tax system adds to the attractiveness of the UK as a place to do business and invest. In the medium and longer-term this may mean reducing corporation tax rates, but this should not be a priority for the next Parliament.

The debate around corporation tax in recent years has focused on the competitiveness of the UK's headline rates. However, a review of the evidence suggests that this misses the more critical issues regarding the taxation of businesses. Firstly, competitive employment taxes are particularly important to businesses as workforces are responsive to changes in taxation. Secondly, the actual taxes businesses face reflect the interaction of headline rates with other features of the tax system, such as allowances. Thirdly, a "race to the bottom" with downward pressure on company taxes may have reached its peak and in large economies company taxes are just one of a number of economic considerations affecting businesses.

UK headline rates

Since the mid-1980s corporation tax has accounted for around 9 per cent of tax revenues in the UK.[174] Currently companies in the UK pay corporation tax on chargeable profits at three rates (2009-10 tax year):

- a rate of 21 per cent on chargeable profits up to £300,000;
- an upper marginal rate of 29.75 per cent on chargeable profits between £300,000 and £1.5 million, causing the average tax rate to rise to 28 per cent when profits reach £1.5 million;
- a main rate of 28 per cent on all chargeable profits over £1.5 million.[175]

Towards lower taxation

Increased globalisation and mobility of labour and capital has driven a worldwide movement towards lower taxation, in personal and business taxes. The average corporation tax rate in the OECD has fallen by over a third in the last twenty years, as countries have cut rates drastically.[176] Ireland has reduced its main rate from 43 per cent to 12.5 per cent; Sweden's rate has dropped from 53 per cent to 26.3 per cent; Denmark's has fallen from 40 per cent to 25 per cent.[177]

In contrast to this trend, in the UK the main rate of corporation tax has remained relatively stable. As the table below shows, in 1990 the UK had one of the lowest corporation rates in the OECD – with a rate of 34 per cent being the fourth lowest. However, in the last twenty years it decreased by only 6 percentage points leaving the UK currently ranked in 18th place in the OECD.

173 See, for example, Eissa, N. and H. Hoynes (2004), "Taxes and the Labor Market Participation of Married Couples: The Earned Income Tax Credit", *Journal of Public Economics,* 88, pp. 1931-1958.
174 HM Treasury (2009), *Public finances databank,* historic data.
175 HM Revenue & Customs (2010), *Corporation Tax rates.*
176 OECD (2009), *Tax Database: Table 11.1 Corporate Income Tax Rate, 1981 – 2009.*
177 Ibid.

Table 13: OECD corporate income tax rates
Source: Organisation for Economic Co-operation and Development (2009),
Tax Database: Table 11.1 Corporate Income Tax Rate, 1981 – 2009.

	1990	2000	2009
Ireland	43.00	24.00	12.50
Iceland	-	30.00	15.00
Poland	-	30.00	19.00
Slovak Republic	-	29.00	19.00
Czech Republic	-	31.00	20.00
Hungary	40.00	18.00	20.00
Turkey	-	33.00	20.00
Switzerland	30.60	24.90	20.17
Korea	-	30.80	24.20
Austria	30.00	34.00	25.00
Denmark	40.00	32.00	25.00
Greece	46.00	40.00	25.00
Netherlands	35.00	35.00	25.50
Finland	44.50	29.00	26.00
Sweden	53.00	28.00	26.30
Portugal	40.20	35.20	26.50
Italy	46.40	37.00	27.50
Mexico	36.00	35.00	28.00
Norway	50.80	28.00	28.00
United Kingdom	34.00	30.00	28.00
Luxemburg	-	37.50	28.59
Australia	39.00	34.00	30.00
New Zealand	33.00	33.00	30.00
Spain	35.00	35.00	30.00
Germany	54.50	53.00	30.18
Canada	41.45	42.57	31.32
Belgium	41.00	40.20	33.99
France	42.00	37.76	34.43
United States	38.65	39.34	39.10
Japan	50.00	40.90	39.50
OECD average	41.05	33.54	26.29

There is a growing body of thought that argues that the UK's failure to cut rates in line with the dominant trend in developed countries is damaging the attractiveness of the UK as a place to do business.[178] Ireland has been successful at attracting business since lowering its corporation tax rate from 32 to 12.5 per cent.[179] A number of major international companies such as WPP, Kraft and Yahoo have relocated their UK or European headquarters, partly reflecting the attraction of more lenient tax regimes.[180] Some economic theory suggests that this trend could continue and deepen, with a much stronger "race-to-the-bottom" type of corporate tax competition.[181] The UK could find itself falling even further down the table.

For these reasons and following the Forsyth tax review in 2006, the Conservatives have pledged to reduce the main rate of corporation tax from 28p to 25p.[182] It is estimated that reducing the main rate by 3p would cost the Treasury £1.2 billion in 2010-11, rising to around £2.5 billion each year once revenues pick up as the economy recovers.[183] The Conservatives have said that under their plans, this cut would be funded by reducing corporation tax reliefs and allowances.[184]

While competitive headline corporation tax rates are important, there are several reasons to suggest cutting the main rate of corporation tax should not be a priority for the next government.

Race to the bottom myth

Evidence suggests that the notion of a "race-to-the-bottom" in corporation tax competition has been overstated. A 2007 report by the OECD concludes that while "there is some evidence that increasing mobility has had some impact on corporate tax rates", the relentless race-to-the-bottom type of corporate tax competition predicted by some economic theories has so far "not been observed in OECD countries."[185] There are a number of possible reasons why this has not occurred.

Companies care more about tax on employees

One reason is that it is individuals who are most mobile, not companies. There is some evidence of businesses relocating from the UK for tax reasons (as discussed above), but there seems to be a greater number of rich individuals moving for such purposes (see chapter 4). As such, removing damaging high rates on income taxes, as discussed in chapter 4, should be the priority. Businesses will also support more competitive taxes on employment because they need to attract mobile and talented workers. Further, research has found that EU countries do not face strong incentives to engage in corporate tax competition, particularly if tax reduction is financed by an increase in consumption and labour income taxes.[186]

The UK is competitive for its size

Additionally, there is a strong correlation between size of country (by GDP) and the level of its corporate tax rate.[187] As the table above shows, the UK still has a very competitive tax rate compared to similar-sized economies. Within the G7 nations, Britain has the second lowest corporation tax rate, more than ten percentage points lower than the American and Japanese main rates.

178 See, for example, Tax Reform Commission (2006), *Tax Matters: Reforming the Tax System,* The Report of the Tax Reform Commission; Baron, R. and C. Taylor (2009), *Tax – Making the UK Competitive, Institute of Directors.*
179 Government of Ireland (1999), *Finance Act, 1999*
180 *Accountancy Age* (2008), "UK tax regime forces WPP move to Ireland", 29 September; *BBC News Online (2007),* "Kraft plans to move European HQ", 4 January; *Bloomberg News* (2008), "Yahoo will move European headquarters to Switzerland", 13 March.
181 OECD (2007), *Fundamental Reform of Corporate Income Tax.*
182 The Conservatives have also pledged to decrease the small companies rate from 21p to 20p. The Conservative Party (2010), *A new economic model: Eight benchmarks for Britain.*
183 These figures appear to be based on HM Treasury's estimates of the static costs of a 1p reduction in the main rate of corporation tax. However, the volatility and complexity of corporation tax and reliefs means that such estimates are highly speculative. HM Treasury (2009), *Tax ready reckoner and tax reliefs,* December.
184 The Conservative Party (2010), *A new economic model: Eight benchmarks for Britain.*
185 OECD (2007), *Fundamental Reform of Corporate Income Tax* p. 36.
186 Ibid, p. 37.
187 Ibid, p. 22.

Limits to base broadening

A further reason to suggest that the race-to-the-bottom has not yet occurred as vigorously as anticipated is simply because most countries need the revenues. Data up until 2006 shows that while the reduction in statutory corporation tax rates amongst OECD countries has continued, these reductions have occurred at a slower rate than in the 1980s.[188] This might indicate that many OECD nations cannot afford to continue engaging in the corporation tax competition of the past. Companies are also always likely to use tax structuring to derive profits from lower tax countries, meaning unless the UK cuts its rates down to the 12.5 per cent rate of Ireland, a small cut is unlikely to have a great effect on incentives to retain profits.

Finally, the race-to-the-bottom is unsustainable because countries have decreasing scope to offset reductions in statutory rates by expanding their corporation tax bases. The corporation tax base was broadened significantly in past decades, especially during the 1980s, and while this trend has continued in recent years, it has been at a much a slower pace.[189] The slowing down of corporation tax reductions has therefore been paralleled by the slowing down of base broadening, implying that the ability of governments to maintain, or even increase, revenues while reducing statutory rates is becoming weaker over time.

Certainty is more important

The evidence set out above suggests that the real issue with the UK's corporation tax regime is not overly high headline rates. Rather, it is the lack of certainty caused by constant changes and poor transparency that most discourages investment and expansion. This point was made in a recent review of London's global competitiveness, in which a panel of financial services Chief Executives cited deterioration in the tax environment as an important factor in the UK's declining competitiveness. While the £30,000 tax levy on non-domiciled individuals and the higher rate income tax increase were factors referenced by interviewees as dimming the UK's tax reputation, the report concluded that the issue with these changes was not the actual cost to individual taxpayers of the changes, but instead:

> "the move from a long period when most people thought these policies were not going to change, to a sudden change, the direction of which is clearly unhelpful from a competitiveness perspective and which is perceived (whatever assurances were ultimately given to the contrary) to have the potential to be the first of a series of moves rather than a one-off event."[190]

It is the unpredictability of UK tax policy and the lack of consultation with stakeholders, rather than the headline tax rates themselves, which is most damaging to the country's reputation as a good place to do business.

Additionally, changes in headline rates can have unintended, negative consequences. A reduction in the main corporation tax rate would not necessarily be good for all businesses. It could significantly decrease the value of losses being carried forward to offset against future profits meaning a bigger tax bill for some firms. The complexity of the corporation tax system means that any proposed changes cannot be viewed in isolation.

Simplification

Comparisons of different tax jurisdictions cannot just be made on the basis of headline rates. Effective rates are more important in terms of what companies actually pay, but the complexity of the interaction of numerous different parts of the legislation, together with the myriad of reliefs and allowances available, means that comparing effective rates across countries is extremely difficult. The corporation tax regime in the UK would benefit from simplification.

The corporate world is extremely good at lobbying. The evidence of this are the numerous calls for tax breaks to "incentivise" the growth of industries. Recent examples include lobbying from the offshore industry,[191] the manufacturing industry[192] and the bioscience industry [193] for tax breaks.

188 Ibid, p. 36-7.
189 Ibid, p. 37.
190 The Review of the Competitiveness of London's Financial Centre (2008), *London: Winning In A Changing World,* p. 19.
191 Perry, D. (2009), "Treasury is putting jobs at risk, say North Sea bosses", *The Press and Journal,* 20 October.
192 Marsh, P. (2009), "Tax credit plan for industry wins Mandelson's ear", *Financial Times*, 1 December.
193 Reuters UK (2009), "UK biosciences industry calls for tax incentives", 22 January.

Politicians fall all too easily for these pleas from business. David Cameron has recently spoken of encouraging entrepreneurship, as has Lord Mandelson.[194] But using the tax system towards this end is questionable. The most effective way to encourage entrepreneurship is through a stable, transparent tax system, not the introduction of *ad hoc* tax breaks for specific industries that add layers of complexity to the system.

Business surveys have confirmed that the UK tax system is considered too complex and that targeted tax breaks are inefficient and contribute to that complexity. 78 per cent of business executives interviewed by the 2006 Conservative Tax Reform Commission believed that the level of complexity in the tax system had increased in recent years, and 23 per cent of small and medium sized enterprises acknowledged that there were tax reliefs or exemptions which they could have claimed, but did not because of the complexity of the system.[195]

3. Raising the inheritance tax threshold is not a priority

Inheritance tax is currently levied on death estates (which includes assets held in trust and gifts made within seven years of death) valued at over £325,000 (or £650,000 joint allowance for couples) at the rate of 40 per cent. The Conservatives have pledged that they would raise the threshold to £1 million at an estimated cost of £3.1 billion a year.[196] The true cost may be less than this given the fall in revenues following the 2007 reforms allowing the combining of couples' allowances – total revenues were £2.9 billion in 2008-09, compared to £3.9 billion in 2007-08.

Inheritance tax is an unpopular tax. There is a belief among many that parents should be able to pass on their wealth to their children without incurring "double taxation" on wealth that has already incurred income or capital gains tax. It raises only a relatively small amount of revenue, £2.9 billion in 2008-09,[197] and it mostly falls on moderately-wealthy families, as the wealthiest are better able to avoid the tax.[198] Most other countries have moved, or are moving, away from death taxes.[199]

However, the strong argument for inheritance tax is that is promotes equality and social mobility and that it taxes wealth received by a donee who has made no effort to accumulate the wealth (and thus it is not actually double taxation).

While inheritance tax thresholds should rise in line with asset prices, rather than the current approach of inflation increases, given the size of the public budget deficit raising the threshold should not be a priority for the next government.

However, as with most UK taxes, there is a plethora of reliefs and exemptions in relation to inheritance tax that make it complex and often arbitrary. In the medium term, there is scope for reforming the system. A donee-based system, which taxes each heir's inheritance individually rather than the estate as a whole, is one proposal worth considering. It would remove the perception of double taxation and would mean smaller estates would avoid the need to sell assets solely to pay inheritance tax.[200]

194 Cameron, D. (2009), Speech to the CBI Annual Conference, London, 23 November: "We will be unashamedly pro-enterprise and pro-wealth creation"; Mandelson, P. (2010), "Going for Growth", Speech to The Work Foundation, 6 January: "First and foremost we need to foster a new climate for enterprise in Britain".
195 Tax Reform Commission (2006), *Tax Matters: Reforming the Tax System,* The Report of the Tax Reform Commission.
196 *BBC News Online* (2007), "Tories would cut inheritance tax", 1 October.
197 HM Treasury (2010), *Public finances databank,* January.
198 Boadway, R. *et al.* (2008), *Taxation of Wealth and Wealth Transfers,* Institute for Fiscal Studies, Prepared for the Report of a Commission on Reforming the Tax System for the 21st Century, Chaired by Sir James Mirrlees.
199 Ibid.
200 Ibid. The example of Ireland, which introduced a donee-based system in 1976, shows that such a system can work in practice and address many of the perceived problems with a traditional donor-based system.

6

Conclusions: a better system

Reform's recommendations outlined in the previous chapters would improve the state of the UK's tax system. Firstly, a new set of principles should be established. Secondly, measures should be taken to align the current system with these principles.

A new set of principles

A new set of principles is needed to give confidence and structure to the future of tax policy. The primary objective of tax policy should be to raise revenue to fund government activity at the minimum cost. The proposed principles to underpin this objective are *consistency*, *transparency*, *economic efficiency* and *fairness.*

> **Consistency** means that income from different sources should be taxed at the same rate and that tax should be tied to the individual. An efficient and fair system cannot exist if the tax burden is allocated on an arbitrary basis.

> **Transparency** means a tax system and a tax policy process free from political whim and consistent with principle. It means an open process of consultation and robust scrutiny of policies.

> **Economic efficiency** means a greater focus on increasing the tax base rather than damaging increases in tax rates. It means a tax system which is attractive for investors, businesses and individuals, who in a mobile global economy can often choose to locate wherever they wish.

> **Fairness** means that taxes should be applied in an even handed way and that people should pay their fair share.

Policy recommendations

Flowing out of these new principles, *Reform's* policy recommendations are set out below. These measures should be implemented from April 2011. They would raise £8.3 billion in 2011-12 and £8.4 billion in 2012-13 and improve the outcomes of the tax system.

Do's:

Broaden the VAT base.
All zero and reduced rates should be scrapped. Increasing revenue from VAT is preferable to increasing the burden of income tax and one uniform rate is more efficient and less distortionary. To compensate the poorest households for this change, *Reform* proposes increasing cash benefits by 7.5 per cent so that the poorest three decile groups would be better off. Additional revenue of £15 billion would be raised.

Scrap the 50p income tax rate and reverse restriction on pensions relief.
These measures are short-termist and politically motivated and will tip the balance of fairness in the tax system. They will add considerable complexity and result in high effective marginal tax rates, reducing incentives to increase work effort. The freeze on the higher rate threshold should also be abandoned to avoid dragging an extra 70,000 people into the 40p bracket. Reversing these policies would lose the Treasury up to £2.5 billion.

Reduce National Insurance Contributions.
The Government's planned increases in NICs will make work less rewarding and reduce incentives to participate in work or increase work effort. They will also increase the cost of employing workers at a time of high unemployment. Reducing employee and employer NICs by 0.5 per cent while raising the primary threshold to £6,475 to align it with *Reform's* proposed income tax zero rate band would be a tax cut of £8.2 billion, compared to the Government's tax rise of £6.9 billion.

Replace personal allowances with a zero rate threshold.
Personal allowances reduce taxable income and so provide higher benefits to higher rate taxpayers. A zero rate threshold would cap the benefit received to the basic rate for all taxpayers, meaning relief can be provided to basic rate payers in a more efficient and cost effective way. Including compensation for pensioners, this would raise additional revenue of £2.9 billion keeping the current threshold of £6,475.

Keep the bankers' bonus tax as a one-off measure.
This is unlikely to change the long-term "risky" activities of banks and along with other measures targeted at the rich – including the 50p rate, withdrawal of personal allowances over £100,000 and the non-doms changes – could be damaging in driving financial institutions and workers out of the UK. This is meant to be a one-off measure so would be cost neutral.

Scrap gimmick income tax reliefs and employee benefits.
The system of employee benefits is highly convoluted. Many of the reliefs are based on outdated working practices and are ad hoc, rather than consistent. Most of these benefits could be abolished at an estimated saving of around £1.1 billion.

Don'ts:

Recognise marriage in the tax system.
This will not achieve the objective of halting the decline in marriage in the UK so will not be money well spent. It is also inconsistent with the direction of travel of tax systems across the world, which are taking a more neutral approach. A transferrable tax allowance has been costed at between £600 million and £3.2 billion depending on the design.

Introduce an early cut in the main rate of corporation tax.
Surveys shows that certainty and transparency is more important to businesses than low headline rates. The UK's corporation tax rates are competitive compared to other large economies and the changes to personal taxes discussed above are likely to be more damaging to the UK's attractiveness as a place for business and workers. It is estimated that a reduction in the main rate from 28p to 25p would cost £1.2 billion in 2011 and £2.5 billion annually thereafter.

Introduce an early rise in the inheritance tax threshold.
While inheritance tax thresholds should rise in line with asset prices, given the size of the budget deficit this should not be a priority for the next Parliament. It is estimated that increasing the threshold to £1 million would cost £3.1 million.

A fair way of raising revenues

These measures would see the increase in tax revenues raised in a fair and economically efficient way.

The changes to VAT, including the compensating increase in cash benefits, would mean that on average only households on incomes above £17,000 would face any increase in their VAT bill.

The changes to personal income taxes and National Insurance Contributions would mean that no individuals below pension age on incomes of less than £37,400 would pay more income tax. Lower income pensioners would be compensated for this increase in income tax liability with a more generous pension credit.

The income tax changes would mean top rate taxpayers on incomes up to £105,000 would face higher tax burdens, with the maximum increase of £944 per annum for individuals with incomes around £44,000. Taxpayers on incomes above £105,000 would experience a reduction in their income tax liability.

A better tax system

Reform's proposals would cut taxes on employment at a time when the economic recovery depends on business growth and increased work effort and reduce complexity in personal taxes. They would raise taxes on consumption by modernising the UK's VAT system and removing inefficiencies. They would restore the link between sound principles and tax policy making, improving stability and confidence.

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Appendix: Party proposals

Table 14: Conservative Party tax proposals
Sources: The Conservative Party (2010), *A new economic model: Eight benchmarks for Britain*; www.conservatives.com/Policy/Economy.

Proposal	Detail	Funded	Cost/revenue	*Reform* comment
Raise inheritance tax threshold	Raise threshold from £325,000 to £1 million		Up to £3.1 billion annually	Not immediate priority
Recognising marriage	End the couple penalty in the tax credit system and provide a transferrable tax allowance		Between £600 million and £3.2 billion, depending on the design	Inconsistent with modern tax systems and will not achieve its objective
"Freeze" council tax for two years	Councils that keep their council tax rises to 2.5 per cent or below would receive additional funding from central government to pay for a 2.5 per cent cut in council tax bills	Funded by reducing wasteful spending on advertising and consultancy in central government	Conservative estimate: £500 million in 2010-11 and £1 billion in 2011-12. Government estimate: £470 million more over the two years. 2010-11 council tax revenues: estimated at £25.8 billion	Adding to complexity and breaking the link between service delivery and taxes
Abolish National Insurance Contributions on new jobs	Any new business started in the first two years of a Conservative Government will pay no Employer National Insurance on the first ten employees it hires during its first year.	Paid for from the changes to the company tax regime.	Just over £250 million a year	Short term gimmick that adds to complexity
Raise stamp duty threshold to £250,000 for first time buyers	Would take nine out of ten first-time buyers out of stamp duty	Funded by a flat-rate annual charge on non-domiciles (regardless of the length of time they have been in the UK)	Treasury estimate: cost of £200 million annually	No economic rationale
Cut main corporation tax rate from 28p to 25p and cut small companies' rate from 21p to 20p		Paid for by reducing complex reliefs and allowances	Treasury ready reckoner: £1.2 billion and £22 million in 2010-11; £2.5 billion and £420 million 2011-12	Not immediate priority
Increase the proportion of taxes collected from green taxation	Revenues would go into a families fund to reduce taxes on families		No detail	Green taxes should be based on environmental not revenue raising grounds

Table 15: Liberal Democrat tax proposals
Sources: Liberal Democrats (2010), *Your Money Policy Briefing;* Liberal Democrats (2009), *Liberal Democrat Tax Plans;* Liberal Democrats (2009), *Creating a Banking Levy: A Fair Deal for the Taxpayer.*

Proposal	Detail	Funded	Cost/revenue	*Reform* comment
No tax paid on first £10,000 of income	Aim to take 4 million people out of income tax	Funded by the sum of the measures below	The Liberal Democrats estimate this to cost £16.5 billion	Expensive and poorly targeted approach to reliving the tax burdens of low income families
A "mansion tax"	A 1% levy on homes worth over £2 million		Estimated would raise £1.7 billion	Arbitrary and applying to a very narrow tax base – will affect only an estimated 70,000 to 80,000 households
Restrict tax relief on pension contributions to the basic rate for all individuals			Estimated would raise £4.6 billion	Adding further complexity to the environment for savers
Close gap between capital and income taxes	Align capital gains tax rates with income tax rates and reduce the annual exemption from £10,000 to £2,000		Estimated would raise £4.1 billion	Not immediate priority
Green taxes	Specific taxes on air travel have been proposed		Estimated would raise £2.6 billion	Green taxes should be based on environmental not revenue raising goals. Air travel accounts for only 3 per cent of all carbon emissions
A 10% temporary tax on bank profits	Payable by all banks incorporated in the UK		Estimated would raise £2 billion annually	Complex and does not address the real problems with banks

Table 16: Key Labour Party tax proposals
Sources: HM Treasury (2008), *Pre-Budget Report 2009: Facing global challenges;* HM Treasury (2009), *Pre-Budget Report 2009: Securing the recovery.*

Proposal	Detail	Funded	Cost/revenue	*Reform* comment
50p top tax rate	50p tax rate on incomes above £150,000		Estimated would raise £2.4 billion a year (2012-13)	Adding to complexity and reinforcing perception of UK as hostile tax jurisdiction
Personal allowance clawback	Withdraw personal allowances on incomes over £100,000		Estimated would raise £1.5 billion a year (2012-13)	Adding to complexity and reinforcing perception of UK as hostile tax jurisdiction
Pension relief clawback	Restrict tax relief on pension contributions on incomes over £130,000		Estimated would raise £3.1 billion a year (2012-13)	Adding to complexity and reinforcing perception of UK as hostile tax jurisdiction
Increase NICs	1% increase in employee and employer NICs		Estimated would raise £10 billion a year (2012-13)	Would damage job growth and employment
Raise primary NICs threshold	Raise primary NICs threshold to align with personal tax thresholds + £570		Estimated would cost £3.1 billion a year (2012-13)	Would fail to address much of the damage caused by the NICs rate increase
Freeze higher rate income tax threshold	Freeze 40p threshold at £43,875		Estimated would raise £0.4 billion a year (2012-13)	Would be a tax by stealth and damage the integrity of the tax system
Increase in fuel duties	Above inflation rises in fuel duties		Estimated would raise £2.8 billion a year (2012-13)	Example of a corrective tax being used for revenue raising purposes

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