9. Defining a tax strategy

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Summary

- Much tax policymaking over the past 20 years has lacked a coherent long-term strategy. It has often been harder to describe government tax strategy than the strategy for the major public services such as health and education and, indeed, the strategy for welfare benefits. Partly as a result, tax changes have tended to be piecemeal, have often lacked transparency and have not formed part of a long-term direction.
- As the Mirrlees Review has pointed out, it is extremely important that the tax system (and the benefit system as well) is seen as just that – a system. It is the overall effect of the system on outcomes such as efficiency, progressivity and the environment that matters. It is perfectly reasonable to have particular taxes that are regressive, or which don't help the environment, so long as the system as a whole meets objectives in these areas.
- The economic and welfare costs associated with a poorly designed tax system may not be obvious, but they are very large. As the tax system does more work as part of the current fiscal tightening, the costs of poor design will only grow.
- Lack of clear objectives and strategy can also contribute to unnecessary complexity in the tax system.
- Still near the start of a parliament, now is a good time for the government to set out its strategy. It should make clear where it sees the shape of the system in the medium term and the purpose and direction of each of the major taxes.
- This government has made an encouraging start in setting out its ambition for an improved tax system and tax policymaking process. But there is further to go in ensuring robust and accountable policymaking, and further review of the ways in which HM Treasury and HMRC work together and of the extent of parliamentary scrutiny may be in order.

9.1 Introduction

The UK government takes in tax just under four pounds in every ten generated in the economy (see, for example, Figure 2.1 in Chapter 2). Inevitably, the way it does that matters for the success of the economy and for the distribution of welfare across citizens. Yet governments have historically been less clear about their tax strategy than they have about many other areas of policy. This makes discussion about the tax system and its effects hard. It makes planning more difficult. And it makes coherent policymaking less likely. There is an evident need for government to set out its view of what it wants from a tax system and hence the direction of tax policy. This is something the previous government signally failed to do. The opportunity is now there for the current government.

In addition, tax policy is arguably subject to less robust policymaking processes within government, and less effective scrutiny in parliament, than is the case for other areas of public policy. This makes the elucidation of a strategy more important, though may also help explain the historic lack of such a strategy.

In fact, the new government has recognised many of these criticisms and has taken initial steps in the right direction. There is much to welcome in the document it published in June on tax policymaking[1] where it set out its desire to increase predictability, to increase stability and to increase simplicity in tax policy and in tax code. It also expressed a desire to increase scrutiny and transparency in the policymaking process, including a very welcome commitment to do more to evaluate the impact of significant changes after implementation. But there is much to do to ensure this happens and to clarify the direction of policy.

In this chapter, we start in Section 9.2 by setting out the case for government having a tax strategy. We argue that the lack of a clearly articulated sense of direction leads to a range of problems for taxpayers. We also identify a number of problems with the current tax system that might be attributed to a lack of overall vision driving policy. In Section 9.3, based on the recently published conclusions of the Mirrlees Review,[2] we illustrate what a long-term strategy might be based on and what its elements might consist of. Section 9.4 provides some illustrations of how getting tax right in the long run can make a big difference to welfare, output and employment levels. This is not an issue of merely academic interest: there is good evidence that the structure of tax policy matters a great deal. Finally, in Section 9.5, we consider briefly the issue of how tax policy is made and scrutinised. Section 9.6 concludes.

9.2 The need for a tax strategy

In previous Green Budgets, and in numerous other publications, IFS researchers have had frequent cause to be critical of tax policy decisions. Indeed, IFS was originally set up, more than 40 years ago, by a group of tax experts despairing of the quality of tax policymaking. The former IFS director, Dick Taverne, put it this way when launching the Meade Report (the predecessor of Mirrlees) in 1978:[3]

> For too long, … tax reforms have been approached ad hoc, without regard to their effects on the evolution of the tax structure as a whole. As a result many parts of our system seem to lack a rational base. Conflicting objectives are pursued at random; and even particular objectives are pursued in contradictory ways.

The same holds true today. There have been useful reforms since the Meade Report was published, but more often the story has been one of drift punctuated by poorly thought-out changes – sins both of commission and omission. At times, there have been clear political calculations associated with poor policymaking. One example of many is the continued unwillingness to revalue properties in England and Scotland for council tax purposes, resulting in a tax base that is already 20 years out of date. This presumably will

[1] HM Treasury and HM Revenue & Customs, *Tax Policy Making: A New* Approach, 2010 (http://www.hm-treasury.gov.uk/d/junebudget_tax_policy_making.pdf).

[2] J. Mirrlees, S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles and J. Poterba, *Tax by Design: The Mirrlees Review – Conclusions and Recommendations for Reform*, Institute for Fiscal Studies, London, 2010 (http://www.ifs.org.uk/mirrleesreview/pamphlet.pdf).

[3] J. E. Meade, *The Structure and Reform of Direct Taxation*, George Allen & Unwin, London, 1978 (http://www.ifs.org.uk/docs/meade.pdf).

have to be rectified at some point. Another example is the now infamous introduction of the 0% starting rate for small companies' corporation tax, which, as predicted, led to a large increase in tax-motivated incorporations and was later scrapped.[4]

Other elements of incoherence have had rather less benign political consequences. The last government introduced and then, at considerable political cost, abolished a lower 10% rate of income tax.[5] It introduced a poorly thought-out reform of capital gains tax (CGT) which it then re-reformed, also at considerable political cost. Much, if not all, of poor tax policy is also poor politics in the long run. Though of course one can see why some poor policy, such as the failure to do a council tax revaluation, is probably good politics.

The pervasive problem has been a reluctance to step back and look at the impact of the tax and benefit system as a whole, both in its effects on people's behaviour and its distributional impact, and to define and follow a clear way forward.

The lack of a clear strategy and objectives can contribute to numerous problems:

- increased uncertainty over the direction of policy, and associated costs in decision-making over investments, savings etc.;
- increased complexity, as policy is made and changed without reference to long-term effects or interactions with other taxes, and different parts of the system fail to work well together;
- increased opportunities for avoidance and evasion;
- lack of transparency over the actual and intended effects of particular changes and of the system as a whole;
- increased costs of compliance, as firms and individuals are less certain of the intention of particular aspects of the system and of reform;
- higher-than-necessary economic and welfare costs from a poorly designed system;
- lack of clarity over the role and purpose of particular parts of the system, and hence further scope for poor policymaking.

Crucially, setting out a clear strategy and high-level vision for the tax system as a whole, alongside a sense of direction for each major tax, would allow consultation over direction and principles. It would also allow future policy changes to be assessed against an overall view of where the tax system is headed. At present, HMRC and the Treasury engage in consultation over specific tax policies, but it is often very hard for respondents to engage in anything other than the minutiae of specific reforms. And not having a clear sense of direction, they make responses in something of a vacuum. If we do not know what a particular tax is intended to achieve or how it is supposed to fit into the system as a whole, then we are bound to have difficulty assessing any particular change to it.

In this context, we do welcome the government's recent consultation on corporate taxes which, as discussed in Chapter 10, does set out a road map. Whilst not perfect or

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[4] Section 9.4 of S. Bond, 'Company taxation', in R. Chote, C. Emmerson, R. Harrison and D. Miles (eds), *The IFS Green Budget: January 2006*, IFS Commentary 100 (http://www.ifs.org.uk/budgets/gb2006/06chap9.pdf).

[5] Though even that still exists for savings income – an incoherent leftover illustrating the way in which policy mistakes can have long-lasting consequences for the shape of the tax system.

comprehensive, it does provide a direction for a range of corporate tax issues and hence a context for policy.[6]

Still being close to the start of a parliament, there is now an ideal opportunity for the government to take this further and set out a broader strategy. And lest we believe that such strategic vision is beyond government, it is worth saying that in many areas of public policy, governments have habitually set out long-term strategies for change – in health and education, for example.

This lack of coherence in long-term tax policymaking matters. The Mirrlees Review has identified seven broad flaws in the current system, flaws that arguably result directly from the failure to set out and follow a strategy for the system as a whole. Others might arrive at a different list, but this one encapsulates some of the most substantial failures of the current system:[7]

1. The current system of income taxes and welfare benefits creates serious disincentives to work for many with relatively low potential earning power. The benefit system, in particular, is far too complex.
2. Many unnecessary complexities and inconsistencies are created by the fact that the various parts of the tax system are poorly joined up.
3. The present treatment of savings and wealth transfers is inconsistent and inequitable. There is no consistent tax base, saving is discouraged for many and different forms of saving are taxed differently.
4. We remain some way short of having a coherent system of environmental taxes to address imperatives around climate change and congestion.
5. The current system of corporate taxes discourages business investment more than necessary and favours debt finance over equity finance. Its lack of integration with other parts of the tax system also leads to distortions over choice of legal form.
6. Current taxation of land and property is inefficient and inequitable. There is a tax on business property – a produced input – but not on land, which is a source of rents. Taxation of housing involves both a transactions tax and a tax based on valuations now 20 years out of date.
7. Distributional goals are pursued in inefficient and inconsistent ways. For example, zero and reduced rates of VAT help people with particular tastes, rather than being targeted at those with low overall resources; and council tax is regressive for no obvious efficiency-improving reason.

Of course, it would be foolish to blame the lack of a long-term strategy for every problem with the tax system. But there can be little doubt that the lack of such a strategy renders coherent policymaking harder, makes mistakes easier and reduces the chances for sensible debate and effective accountability. And doing economic policymaking well is difficult enough without these additional hindrances.

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[6] See HM Treasury, *Corporate Tax Reform: Delivering a More Competitive System*, 2010 (http://www.hm-treasury.gov.uk/corporate_tax_reform.htm).

[7] See pages 8–9 of Mirrlees et al., *Tax by Design: The Mirrlees Review – Conclusions and Recommendations for Reform*, Institute for Fiscal Studies, London, 2010 (http://www.ifs.org.uk/mirrleesreview/pamphlet.pdf).

9.3 The elements of a strategy

It may not have been done before, but the case for this and future governments setting out some direction for tax policy seems to us unarguable. What is bound to be more controversial is the shape of the strategy. To be valuable, a strategy is likely to need an overall, high-level vision and a set of directions for individual elements of the system. The Mirrlees Review set out to provide these elements, and it is worth reviewing here what those elements were. They provide a good illustration of what we mean by setting out a strategy, as well as providing a good starting point for government.

At a high level, the Review suggested that we should aim for a progressive, neutral tax system. That may not sound like a terribly prescriptive vision, and indeed there are different amounts and kinds of progressivity and neutrality at which one might aim. But just taking those three words – progressive, neutral and system – as the core of a vision for tax has the potential to take us a long way in policy terms.

First, consider the system as a whole

As we have already stressed, it is important to consider the tax system as a whole. We mean that in two main senses. First, not all taxes need to address all objectives. Not every tax needs to be 'greened' to tackle climate change, as long as the system as a whole does so. And not all taxes need be progressive as long as the overall system is. In general, one should think of direct personal taxes and benefits as being the part of the system best suited to achieving distributional objectives. Other aspects of the tax system can be focused on achieving efficiency.

Second, the tax system needs to work as a system in the sense that the different forms of taxes fit sensibly together. For example, personal and corporate taxes need to fit together such that the form in which income is received does not imply very different amounts of tax paid. It is simply not possible to consider the appropriate rates and structures for taxes on earnings without taking account of the taxes on savings, profits and consumption.

Second, seek neutrality

Neutrality – meaning treating similar activities similarly – is a powerful starting point for designing a tax system. In general, a system that treats similar economic activities in similar ways for tax purposes will tend to be simpler, avoid unjustifiable discrimination between people and economic activities, and help to minimise economic distortions. Treating different sorts of saving differently results in much effort being put into choosing savings vehicles on the basis of tax treatment rather than on the basis of underlying merits. Treating different forms of corporate finance differently distorts companies' choices over how to raise finance. Taxing different goods and services at different rates distorts the choices that consumers make.

Now, neutrality is not always desirable, and is not always a good in itself. It can be efficient to discriminate between different activities for tax purposes – for example, higher taxes on alcohol and tobacco and on activities that damage the environment are clearly justifiable. Arguments can also be made for taxing pensions more favourably than other forms of saving, for providing tax advantages for research and development (R&D) activity (as we discuss in Chapter 10) and so on.

But deviations such as these should be kept to a minimum, and arguments for further deviations from neutrality should be treated with healthy caution. Defining and policing boundaries between differently-taxed activities is fraught with difficulty: it increases administrative and compliance costs, and creates perverse incentives to dress up one kind of activity as another. Lack of neutrality can also lead to unfairness. If the tax system subsidises goods I prefer to consume but, without good reason, taxes those you prefer, then it may not be treating us fairly.

The key principle for policymaking is that the hurdle for departing from neutrality should be high, requiring a strong and clear justification. This test is only likely to be passed by a handful of headline items such as environmentally harmful activities, 'sin taxes', pensions, R&D, educational investments and childcare. This is a far narrower list than the exceptions that we observe in practice. The tax system discriminates between the employed and self-employed, more and less profitable companies, many different forms of spending, many different forms of saving and different sources of carbon emissions (as discussion in Chapter 11), to name but a few.

It would be hugely valuable if current and future Chancellors were to spell out their view of the degree of importance that should be attached to neutrality and then review current tax policy in that light. Again, we acknowledge the progress of the current government in going at least part of the way towards that in the consultation on corporate taxes published last autumn (see Chapter 10).

Crucially, Chancellors should set a clear marker, or hurdle, for what should be required before future policy creates new non-neutralities. Much of our discussion in Chapter 10 on corporate taxes and Chapter 11 on environmental taxes is, for good reason, focused on the ways in which recent tax changes have either increased, or failed to reduce, the lack of neutrality in the relevant system.

Third, achieve progressivity as efficiently as possible

There are three issues on which a sense of direction under the heading of progressivity[8] would be helpful:

- How does government understand the concept?
- How much of it does the government want?
- What does it see as the best method for achieving it?

The government setting out some view on what it thinks about progressivity would be very valuable. There is a need for a much clearer and better debate. For example, progressivity can be understood in relation to income or spending, lifetime income or a snapshot, the impact of the tax and benefit system across the whole income distribution or just on the poorest or richest. These apparently arcane points matter. As IFS researchers have shown many times (and Chapter 12 mentions), increases in the main rate of VAT appear regressive if measured against a snapshot of the income distribution, but mildly progressive when measured against spending, which might be considered a better indicator of lifetime income. There seem to us to be strong reasons for preferring

[8] We use the word in its classic economic meaning, where a progressive tax takes a higher proportion of a richer person's income than a poorer person's, but we use the term to describe the impact of the tax and benefit system overall. Overall, then, progressivity is a measure of the extent to which the tax and benefit system reduces inequality.

to think about progressivity in this lifetime context, but it would be useful to know the government's view.

The question of how much progressivity to aim for is at the heart of political debate. Reasonable people can and do disagree. There are costs associated with greater progressivity. Some people would be willing to accept a high price for achieving greater equality. Others would not. It is hard to assess policy against the government's own objectives without knowing its view about this.

The third issue is that of how to achieve a given degree of progressivity as efficiently as possible. Here, one can say a great deal without knowing the details of government objectives. Whatever degree of progressivity we plump for, it is important to go about achieving it at least cost.

There is an inevitable trade-off between redistribution and work incentives. One cannot tax the rich, or top up the incomes of the poor, without affecting behaviour. But one can design the system carefully to minimise the efficiency loss associated with achieving progressivity. The reason that any desired level of progression is best achieved through the rate schedule for personal taxes and benefits is that that tends to be the most efficient route to progression. But the rate schedule still needs to be designed to minimise efficiency costs. This can be achieved by designing a rate schedule that reflects knowledge of the shape of the income distribution and the responsiveness of people to taxes and benefits at different income levels. It also implies taking into account decisions over both whether to work (including when to retire) and how much to work, in addition to other responses such as tax avoidance and migration.[9]

There are ways in which we can achieve progressivity more efficiently in the tax system. For example, ending differential VAT rates and compensating through changes in the direct tax and benefit system would achieve this. Reforming the income tax and benefit system to improve work incentives for mothers with school-age children and for those around retirement age – two groups that are particularly responsive to incentives – is another route.

Starting with this high-level view of the desirability of a progressive, neutral tax system – and without taking any stance on the desirable degree of progressivity – the Mirrlees Review arrived at a series of recommendations for the shape of a 'good' tax system. These are set out in the left hand column of Table 9.1. The detailed arguments behind these recommendations are set out in the Review's conclusions, and it should be clear how most of them are coherent with the broad principles we have just enumerated.

Of course, this is by no means the only possible set of desiderata for a system, nor the only possible set of criticisms of the one we have. But, as a starting point, these lists suggest numerous areas where a clearer understanding of policy direction would be helpful.

For example, it would be helpful to know whether the Chancellor believes that an income tax schedule that has a marginal rate of 60% on incomes between £100,000 and £114,950, but of 40% on incomes just below and just above this range, is appropriate, and if so why, or whether this is something he would like to reform.

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[9] See, for example, M. Brewer, E. Saez and A. Shephard, 'Means-testing and tax rates on earnings', in J. Mirrlees, S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles and J. Poterba (eds), *Dimensions of Tax Design: The Mirrlees Review*, Oxford University Press for IFS, 2010 (http://www.ifs.org.uk/mirrleesreview/dimensions/ch2.pdf).

Table 9.1. A good tax system and the current UK tax system

A good tax system	The current UK tax system
Taxes on earnings	
A progressive income tax with a transparent and coherent rate structure	An opaque jumble of different effective rates as a result of tapered allowances and a separate National Insurance system
A single integrated benefit for those with low income and/or high needs	A highly complex array of benefits [though note that the system is due to be much improved following reforms to be put in place by 2013]
A schedule of effective tax rates that reflects evidence on behavioural responses	A rate structure that reduces employment and earnings more than necessary
Indirect taxes	
A largely uniform VAT – with a small number of targeted exceptions on economic efficiency grounds – and with equivalent taxes on financial services and housing	A VAT with extensive zero rating, reduced rating, and exemption – financial services exempt; housing generally not subject to VAT but subject to a council tax not proportional to current property values
No transactions taxes	Stamp duties on transactions of property and of securities
Additional taxes on alcohol and tobacco	Additional taxes on alcohol and tobacco
Environmental taxes	
Consistent price on carbon emissions	Arbitrary and inconsistent prices on emissions from different sources, set at zero for some
Well-targeted tax on road congestion	Ill-targeted tax on fuel consumption
Taxation of savings and wealth	
No tax on the normal return to savings – with some additional incentive for retirement saving	Normal return taxed on many, but not all, forms of savings – additional but poorly designed incentives for retirement saving
Standard income tax schedule applied to income from all sources after an allowance for the normal rate of return on savings – with lower personal tax rates on income from company shares to reflect corporation tax already paid	Income tax, NICs, and CGT together imply different rates of tax on different types of income—wages, profits, capital gains, etc. – some recognition of corporation tax in dividend taxation but not in CGT
A lifetime wealth transfer tax	An ineffective inheritance tax capturing only some assets transferred at or near death
Business taxes	
Single rate of corporation tax with no tax on the normal return on investment	Corporation tax differentiated by company profits and with no allowance for equity financing costs
Equal treatment of income derived from employment, self-employment, and running a small company	Preferential treatment of self-employment and distributed profits
No tax on intermediate inputs – but land value tax at least for business and agricultural land	An input tax on buildings (business rates) – no land value taxes

Note: NICs = National Insurance contributions.
Source: Table 20.1 of Mirrlees et al., *Tax by Design: The Mirrlees Review – Conclusions and Recommendations for Reform* (http://www.ifs.org.uk/mirrleesreview/pamphlet.pdf).

Public debate would be helped immeasurably by a statement setting out the direction of travel on VAT, and whether there is to be any presumption in favour of greater uniformity. This does not simply mean addressing the age-old issue of whether VAT should be levied on goods such as food and children's clothing, or charged at a reduced rate on domestic fuel. Although the economic and equity case for zero-rating these is very weak, and having a reduced rate on domestic fuel is positively detrimental to environmental concerns, it is clear to us why change in these areas has always been seen as politically difficult. Having a future direction of VAT policy would also require thinking carefully about how to tax housing and financial services (both are currently exempt from VAT).

We have already mentioned the absurdity of having a tax on housing based on values as of 20 years ago. Is this to become a tax based on 30-year-old values or is a rational reform part of the agenda? On housing, it would also be nice to see whether this government can provide a clear rationale for stamp duty – something the last government signally failed to do as it increased it very dramatically – or whether it agrees with us that it would form no part of a good tax system.

As Chapter 11 discusses, a clearer explanation by government of the different tax rates applicable to carbon, and the extent to which greater uniformity is an aim of policy, would illuminate the discussion of environmental tax policy. And a clear sense of direction on road pricing must be a priority if only because government targets for greenhouse gas emissions mean that petrol will have to be phased out as a fuel for motor vehicles within the next couple of decades, leaving us with no taxes that could capture the very large congestion externalities created by driving.

The structure of savings taxation has developed piecemeal over many decades, and continued to change in the June 2010 Budget with reforms to CGT and to pension tax relief. The pension tax changes tidied up some of the mess left by proposals from the previous government, proposals which themselves illustrated very well the problem of lack of long-term direction. After years of careful work, much of the pensions tax regime was reformed quite sensibly in April 2006 only for much of that work to be undone in one fell swoop by a single Budget announcement in 2009. We are left with no sense where the savings tax regime will go next. One symptom of the lack of clear direction is the continuing reforms to CGT. What direction will this government take?

And where does the government propose to go on business taxes? As highlighted above, it produced a corporate tax road map last autumn, which does set out that the UK will continue to move towards a more territorial system (i.e. one where the tax base is the profits created from UK-based activity and not the worldwide profits of UK companies), with lower tax rates alongside a broader tax base and a reduced tax burden on the income derived from intellectual property. Each of these directions can be seen as attempts to encourage firms to keep activity in the UK in the face of increased globalisation. (See Chapter 10 for a discussion.) However, there are important issues that are not addressed, such as 'Are we to maintain a corporation tax that discriminates in favour of debt financing and against equity finance and that taxes companies at different rates?'. This is an area where continuing consultation on very specific policy proposals is rendered relatively ineffective by an ongoing lack of clarity about the ultimate objectives.

Table 9.2. Main recommendations of the Mirrlees Review

Taxes on earnings
Merge income tax with employee (and ideally employer) NICs
End the opaque practice of tapering personal allowances and move to a transparent, coherent rate schedule
Introduce a single integrated benefit, getting rid of the very highest effective marginal tax rates (90% and more) faced by some low earners [as is now effectively planned]
Strengthen work incentives for those whose youngest child is of school age and for 55- to 70-year-olds relative to others
Indirect taxes
Remove nearly all the current zero and reduced rates and, where possible, exemptions from VAT. Introduce a comprehensive package compensating the less well-off on average whilst maintaining work incentives.
Retain a destination basis for VAT while ending the zero-rating of exports
Introduce a tax equivalent to VAT on financial services
Replace council tax and stamp duty land tax on housing with a tax proportional to the current value of domestic property, to stand in place of VAT on housing
Environmental taxes
Introduce a consistent price on carbon emissions, through a combination of extended coverage of the EU Emissions Trading Scheme and a consistent tax on other emission sources. This would include a tax on domestic gas consumption.
Replace much of the current tax on petrol and diesel with a national system of congestion charging
Taxation of savings and wealth
Take interest on bank and building society accounts out of tax altogether
Introduce a Rate of Return Allowance for substantial holdings of risky assets (e.g. equities held outside ISAs, unincorporated business assets, and rental property) so that only 'excess' returns are taxed
Tax capital income and capital gains above the Rate of Return Allowance at the same rate schedule as earned income (including employee and employer NICs), with reduced rates for dividends and capital gains on shares to reflect corporation tax already paid
Maintain and simplify the current system of pensions taxation, ending the excessively generous treatment of employer contributions and replacing the tax-free lump sum with an incentive better targeted at the behaviour we want to encourage
At least remove the most obvious avoidance opportunities from inheritance tax and look to introduce a comprehensive lifetime wealth transfer tax
Business taxes
Introduce an Allowance for Corporate Equity into the corporation tax to align treatment of debt and equity and ensure that only 'excess' returns to investment are taxed
Align tax treatment of employment, self-employment, and corporate-source income
Replace business rates and stamp duty land tax on business property with a land value tax for business and agricultural land, subject to confirming practical feasibility

Note: ISAs = Individual Savings Accounts; NICs = National Insurance contributions.
Source: Table 20.2 of Mirrlees et al., *Tax by Design: The Mirrlees Review – Conclusions and Recommendations for Reform* (http://www.ifs.org.uk/mirrleesreview/pamphlet.pdf).

All that said, there is one area where the current government has made real progress: its proposal for a single integrated benefit for working-age adults, the Universal Credit.[10] A strategy was set out and a policy developed. We also note, without passing judgement, that it is the one area of policy in Table 9.1 which is not fully part of the tax system, and where the policy lead has come from DWP rather than from the Treasury and HMRC alone.

The Mirrlees Review goes on to make a range of specific policy proposals, which are summarised in Table 9.2. They are deliberately couched as recommendations for long-term reform, and most are not changes that could be made rapidly. We would not expect any government to agree with all of these, but it would be helpful for all concerned with tax to have a much better idea than we do of what sort of long-term reforms the Chancellor would sign up to.

9.4 The prize

So there seems to be a clear case for a tax strategy. As we have already observed, the lack of clarity over direction contributes towards uncertainty, complexity, high compliance costs and poor policymaking. A poorly designed tax system can also create substantial economic costs. International evidence seems to suggest that design matters more than the total size of the tax take.[11]

This is not surprising, but it is often hard to demonstrate and quantify. Some estimates do exist, however, of the extent to which individual changes in design can impact on employment, welfare or economic output. Here we present just a few of the areas where estimates exist of the potential benefits associated with reform.

- Take the idea that work incentives should be strengthened for families whose youngest child is of school age. Mothers of school-age children are particularly responsive to incentives in the tax and benefit system. One reform that would strengthen their incentives, in a cost-neutral way, would be to make Child Tax Credit more generous (and so means-testing more extensive) for families whose youngest child is aged under 5, and less generous (with less means-testing) for families whose youngest child is aged 5 or over. A best estimate is that such a reform could lead to a net increase in employment of around 52,000 (or roughly 0.2% more workers) and an increase in aggregate annual earnings of around £0.8 billion.[12]
- Or consider strengthening work incentives for those in their later working life, aged 55–70 – a group that is highly responsive to incentives. We could do this by reducing the age at which employee and self-employed National Insurance contributions stop being payable from State Pension Age to age 55, reducing the age at which a higher tax-free personal allowance is available from 65 to 55 and increasing the age of eligibility for Pension Credit to 70, whilst recouping the cost in higher income taxes for younger groups. These relatively limited changes could lead to an increase in

[10] For more details of this reform, see M. Brewer, J. Browne and W. Jin, *Universal Credit: A Preliminary Analysis*, IFS Briefing Note 116 (http://www.ifs.org.uk/publications/5415).

[11] For example, see G. Myles, 'Economic growth and the role of taxation', prepared for the OECD, 2007 (http://people.exeter.ac.uk/gdmyles/papers/pdfs/OECDfin.pdf).

[12] Page 10 of Mirrlees et al., *Tax by Design: The Mirrlees Review – Conclusions and Recommendations for Reform* (http://www.ifs.org.uk/mirrleesreview/pamphlet.pdf).

employment of about 157,000 (or 0.6% of the workforce) and an increase in aggregate annual earnings of just under £2 billion.[13]

- The economic costs of having a narrow VAT base are also large. Considering just the distortion to spending patterns – ignoring the costs of complexity – simulations suggest that, if uniformity were optimal, extending VAT at 17.5% to most zero-rated and reduced-rated items would (in principle) allow the government to make each household as well off as it is now and still have around £3 billion of revenue left over.[14]

- There are also considerable costs associated with the structure of the current corporation tax. It has been estimated that a revenue-neutral reform package introducing an Allowance for Corporate Equity (ACE), effectively allowing equity finance the same treatment currently afforded debt finance, with an offsetting increase in a broad-based tax on consumption would, for the UK, deliver long-run increases of 6.1% in investment, 1.7% in wages, 0.2% in employment and 1.4% in national income.[15] These simulations are subject to wide margins of error, but they confirm (using a rigorous empirical framework) that eliminating the taxation of the normal return to equity-financed corporate investment could result in a significant increase in capital per worker, which in turn could produce worthwhile gains in wages, employment, output, and welfare. Crucially, this does depend on using another part of the tax system to recoup the revenue cost of the ACE. Offsetting the revenue loss by increasing the corporate tax rate would be much less attractive, inducing multinational firms to shift both real activity and taxable profits out of the country.

- It is harder to come up with a single number to put on the costs of the distortions in the current system of savings taxation. However, recent work undertaken as part of the Mirrlees Review suggests that, even on a conservative reading of the economic literature, reducing taxation of the normal return to saving would have significant effects on the quantity and distribution of savings over the life cycle, thereby raising lifetime welfare.[16]

- Even bigger welfare gains are potentially available from a national system of road pricing designed to reflect congestion costs. The government estimates that annual welfare benefits of up to 1% of national income are available from a road pricing scheme that varies charges by place and time of day to reflect actual congestion levels and costs accurately. Introducing such a scheme would be expensive and controversial but the scale of benefits suggested is huge.

Estimating the economic and welfare gains available from better tax policy is fraught with difficulty. The fact that these potential gains are hard to quantify reduces the pressure for better policymaking. The gains from a more uniform VAT system or from a more effective

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[13] Page 10 of the Mirrlees Review's *Conclusions and Recommendations for Reform*.

[14] Page 10 of the Mirrlees Review's *Conclusions and Recommendations for Reform*.

[15] See table B.4 of R. de Mooij and M. Devereux, 'Alternative systems of business tax in Europe: an applied analysis of ACE and CBIT reforms', European Commission, DG Taxation and Customs Union, Taxation Paper 17, 2009. Using a similar approach, D. Radulescu and M. Stimmelmayr, 'ACE versus CBIT: which is better for investment and welfare?', *CESifo Economic Studies*, 2007, 53, 294–328, estimated somewhat larger gains for Germany from a revenue-neutral introduction of an ACE combined with an increase in the rate of VAT.

[16] O. Attanasio and M. Wakefield, 'The effects on consumption and saving of taxing asset returns', in Mirrlees et al. (eds), *Dimensions of Tax Design* (http://www.ifs.org.uk/mirrleesreview/dimensions/ch7.pdf).

corporate tax system, for example, would be felt across the economy. But the effects would be much more obvious on those losing in cash terms in the first instance. Some of the costs of poor tax policy manifest themselves in high compliance costs for businesses that have to distinguish between different sorts of activity for tax purposes. They also show up in opportunities for tax avoidance. These are symptoms of a system creating much wider costs.

9.5 The policymaking process

If we are to think about how we might end up with a more rational tax strategy, we also need to consider the way in which tax policy is made. In Chapter 2, IFS researchers welcome the creation of the Office for Budget Responsibility as a way of helping to ensure that the underlying health of the public finances is transparent and sustainable. Here, we consider briefly some of the institutional barriers that might stand in the way of better and more transparent policymaking in the sphere of taxation. In particular, we ask whether the current split in responsibilities between the Treasury and HMRC is the right one and whether it works effectively to produce good tax policy. We also briefly address the issue of whether there is adequate parliamentary scrutiny of the tax policymaking process.

Since the O'Donnell Review of 2004,[17] responsibility for tax policymaking has been split between HMRC and HM Treasury, with the latter taking lead accountability and responsibility for policymaking and the former being responsible for 'policy maintenance'. Work for the Tax Law Review Committee (TLRC)[18] concluded that 'the experience of the past five years has shown that the current organisation of tax policymaking is not working as effectively as it should to produce clear, effective tax policies and a coherent, competitive tax system' (page 1). In an echo of our earlier discussion, the report goes on to say that 'at times, it can appear that those involved are solely focused on the immediate tax problem they are tackling and the wider implications of a measure are not considered' (page 2).

In common with other commentators, the TLRC Discussion Paper stresses concerns that HM Treasury, where there can be a lack of knowledge and continuity in tax policy, is too much the senior partner in the policymaking process, with inadequate input from those at HMRC who really understand how the system works. The paper suggests that this has led to a number of problems:

- A disconnect between those responsible for tax policy and those operating in the field. There is a perception that tax policy expertise is undervalued in HMRC, which consequently does not contribute as effectively as it could to policymaking, whilst policymakers in the Treasury understand too little of the effects of their decisions. Alt, Preston and Sibieta report an interviewee as saying: '… the reallocation weakened the link between HMT and assessment of what happened in the field. Now the process has a clear divide with policy in HMT, but real-world experience is at HMRC and they don't communicate as well as if they were all in one organization. It

[17] G. O'Donnell, *Financing Britain's Future: Review of the Revenue Departments*, Cm 6163, HM Treasury, 2004 (http://webarchive.nationalarchives.gov.uk/+/hm-treasury.gov.uk/budget/budget_04/associated_documents/bud_bud04_odonnell_index.cfm).

[18] T. Bowler, 'Tax policymaking in the UK', Tax Law Review Committee, Discussion Paper 8, 2010 (http://www.ifs.org.uk/comms/dp8.pdf).

also affects career structures: now, if you are interested in tax policy, you go to HMT. If you start there the chance you will understand what happens in the field or on the ground is low. Policy becomes divorced from an understanding of how it is affecting behaviour in the field'.[19]

- An inadequately-unified approach to the tax system, leading to an increasingly disjointed tax policy and contributing to the complexity and inaccessibility of the tax system. The TLRC paper suggests that 'experience indicates that this previous structure[20] in fact brought greater control over the interaction of changes and a more unified approach to management of the tax system' (page 5) and that HMRC has become narrowly focused on revenue protection and reducing avoidance within the system, rather than helping to create a system that works effectively in itself.
- A lack of clarity of responsibility for policy, which affects stakeholders. Numerous stakeholders have reported concerns that lack of clarity over where policymaking responsibility lies has led to confused consultations and poor policymaking. The Tax Faculty of the Institute of Chartered Accountants in England and Wales (ICAEW) has made this point forcefully to the Treasury Select Committee.[21] Witnesses also highlighted concerns about working relationships between HM Treasury and HMRC in evidence to the Select Committee on Economic Affairs when it reviewed the consultation on CGT and residence and domicile. The Committee's report noted that some witnesses highlighted what they saw as a 'difficulty in lack of coherent communication and understanding between HMT and HMRC'.[22]
- An undervaluing of technical tax knowledge and a lack of experience at HM Treasury causing problems with the effective development of tax policy. In particular, Treasury officials are often seen as clever, but inexperienced in tax, and with little idea about issues faced in implementing tax policy. There is a more general concern about the very high turnover of Treasury officials and the problems that creates both for coherent policymaking and for building relationships.

It is difficult to be certain what division of responsibilities would be optimal, but the persistence of the concerns raised above – similar issues have been raised by numerous stakeholders over a significant period – suggests the need for an extensive and public review.

A separate concern over tax policymaking is created by the relative lack of accountability to parliament. Part of this arises from the particular nature of the Finance Bill. In addition, the Treasury Select Committee is poorly resourced to scrutinise the whole of Treasury activity, in particular complex issues of taxation. The lack of an established policy direction against which to hold the Treasury to account makes this harder. As Sir Alan Budd said in a 2003 Tax Law Review Committee report, 'the truth of the matter is that the House of Commons has neither the time nor the expertise nor, apparently, the inclination

[19] J. Alt, I. Preston and L. Sibieta, 'The political economy of tax policy', in Mirrlees et al. (eds), *Dimensions of Tax Design* (http://www.ifs.org.uk/mirrleesreview/dimensions/ch13.pdf).

[20] That is, the structure before the O'Donnell Review in which tax policymaking was more firmly entrenched in the revenue departments.

[21] At paragraphs 32–34 of Memorandum submitted by Tax Faculty of the Institute of Chartered Accountants in England and Wales, 17 January 2007 (http://www.publications.parliament.uk/pa/cm200607/cmselect/cmtreasy/192/7012413.htm).

[22] At paragraphs 16 and 18 of Select Committee on Economic Affairs, *2nd Report of Session 2007–08: The Finance Bill 2008*, vol. I, Report (quoted in the TLRC Discussion Paper).

to undertake any systematic or effective examination of whatever tax rules the government of the day places before it for its approval'.[23]

The fact that the House of Lords is not involved with Finance Bills reduces scrutiny further. This ban on involvement looks increasingly like an undesirable anachronism.

There are clearly ways of improving the scrutiny of tax policy. The establishment of a tax policy select committee, as recommended by Lord Howe in his 2008 report *Making Taxes Simpler*, is one option.[24] Providing parliament with significantly more expertise and resources than are currently available is another – perhaps modelled in part on the US Congressional Budget Office. Involving the House of Lords would provide a third leg to increased accountability.

This relative lack of parliamentary oversight lies on top of a relative lack of checks and balances within the executive. Spending decisions by other departments are challenged and to some extent overseen by the Treasury. There is nobody playing that role with respect to the Treasury itself. Indeed, Chancellors have historically taken delight in keeping even the Prime Minister uninformed about tax policy decisions until the last possible moment – a practice that may be falling into abeyance in the context of the coalition government, but one that, when implemented, ensures a minimum of challenge and input into some of the most important decisions facing any government.

One innovation of the new government, which followed from recommendations in Lord Howe's report, is the establishment of the Office of Tax Simplification (OTS). The aim of the Office is 'to provide independent advice to the Chancellor on simplifying the UK tax system, with the objective of reducing compliance burdens on both businesses and individual taxpayers. To do this, the Office will:

- 'provide the Government with independent advice on where there are areas of complexity within the UK tax system with the potential for simplification; and
- 'conduct inquiries into complex areas of the tax system, to collect evidence and advise the Government on options for reform.'[25]

In principle, this could be a valuable innovation. In practice, the OTS appears to be rather lightly staffed, and whether it can achieve traction on the real elements of the tax system which are at the root of much complexity remains to be seen.

The making of tax policy is too important for it not to be subject to improved processes within the executive and greater scrutiny from the legislature. There is a clear case for further official review of the ways of working between HMRC and HM Treasury, of the scope for greater challenge and accountability within the executive and of the nature and degree of parliamentary accountability.

9.6 Conclusion

There has been much to welcome in the new government's stated approach to tax policymaking. It has set itself the ambitions to be more open and accountable and to

[23] Page 5 of 'Making tax law', Tax Law Review Committee, Discussion Paper 3, 2003 (http://www.ifs.org.uk/publications/1902).

[24] See *Making Taxes Simpler*, Final Report of a Working Party chaired by Lord Howe of Aberavon, July 2008.

[25] Page 1 of 'Office of Tax Simplification Framework Document' (http://www.hm-treasury.gov.uk/d/ots_framework_document_jul10.pdf).

reduce complexity and the rate of change. The Office of Tax Simplification has the potential to improve both process and outcome of policymaking. And Mr Osborne's promise to publish draft Finance Bills containing as much as possible of what is coming in the next financial year three months before the Budget is another welcome innovation.

But we start from a rather poor position. There has been a long tradition of governments failing to state a strategy in the field of tax policy. Chancellors have taken rather a delight in producing rabbits from hats rather than setting out longer-term directions. This has exacerbated the problems created by the lack of accountability mechanisms for tax policymaking, within both the executive and the legislature. And problems may still remain in the ways that HMRC and HM Treasury work together.

Just as this government has set a direction in welfare policy, and indeed in health and education policy, it would be a great boon to the tax policymaking process if it could go further than it has so far done, and further than its predecessor ever managed, in setting out a direction for tax policy and solving some of the entrenched problems in the tax system. This will require the government to meet all the aspirations it has set out for a better policymaking process, and to show considerable courage in shaping the policy itself.