



The Coalition Government's Record on Tax

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Executive summary

- As part of its deficit reduction programme, the coalition government has made tax changes whose direct impact is to reduce borrowing by £16.4 billion in 2015–16: the net effect of £64.3 billion of tax rises and £48.0 billion of tax cuts. Despite these tax-raising reforms, government revenues as a share of national income are forecast to be no higher in 2015–16 than they were in 2009–10, since growth in individuals' earnings and companies' taxable profits has been unusually slow.
- The biggest tax increases were implemented early in the parliament: a rise in the main rate of VAT from 17.5% to 20%, a sharp reduction in the amount that can be saved in tax-privileged pensions, and a 1 percentage point increase in employer, employee and self-employed rates of National Insurance contributions (NICs) that had already been pencilled in by the previous Labour government.
- The government has also managed to find scope for three big tax cuts with a combined cost of £19.5 billion in 2015–16. Increasing the income tax personal allowance to £10,600 has cost £8.0 billion (net of reductions to the higher-rate threshold), reducing the main rate of corporation tax from 28% to 20% has cost £7.6 billion, and real-terms cuts to fuel duties have cost £3.9 billion.
- For the most part, the reforms introduced by the coalition have involved changes to rates and thresholds with little attempt to address the fundamental structural deficiencies of the tax system. VAT has been increased but its base not broadened. Fuel duties have been cut but their increasing unsuitability for tackling congestion has not been addressed. Corporation tax has been cut but its base continues to distort investment and financing decisions. Income tax and NICs rates and thresholds have been changed but the two taxes have not been integrated. Business rates have been cut but made more unstable and continue to discourage property-intensive production. Council tax has been cut but allowed to get ever more out of date. Inheritance tax has been increased but its loopholes untouched. Capital gains tax has been increased but with no clear strategy for dealing with the tension between minimising disincentives to save and minimising avoidance opportunities.

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- There have been some welcome structural reforms, but even there the job is incomplete. Stamp duty land tax no longer has big jumps in liabilities at price thresholds for housing, but still does have them for non-domestic properties, and the more fundamental problems with the tax remain. The use of the discredited retail prices index to adjust the system for inflation has been ended for direct taxes, but not for indirect taxes, and an increasing number of thresholds are not updated at all.
- The coalition has made some admirable improvements to the institutions of tax policy, enhancing transparency and allowing better scrutiny. But the way in which it has announced tax policy has not always been so admirable. While in some areas the government followed a clear plan, as with the corporate tax road map, other areas – such as fuel duties and business rates – have seen a stream of ad hoc, often temporary, announcements overtaking each other without a clear statement of principles or long-run intentions.
- The next government will face two immediate challenges: what role (if any) tax changes should play in reducing the still-large budget deficit, and how to manage the devolution of tax-setting powers to different parts of the UK. There are also longer-term challenges. Incomes have become more concentrated in the hands of a small number of people, which may lead governments to want to tax them more heavily but also means that tax revenues are already perilously reliant on this group. And the international mobility of tax bases continues to grow. Long-standing weaknesses in the tax system also remain to be addressed, and the next government would do well to set out a strategy for doing so.

1. Introduction

The coalition government has overseen a large fiscal consolidation since coming to office, with government borrowing forecast to fall from 10.2% of national income in 2009–10 to 4.0% in 2015–16. The emphasis of this deficit reduction has been on spending cuts, which have accounted for 82% of the consolidation to date. The overall direct impact of tax changes implemented by the coalition has also been to reduce borrowing, by £16.4 billion in 2015–16: the net effect of £64.3 billion of tax rises and £48.0 billion of tax cuts.²

In this briefing note, we assess the coalition government's reforms to the tax system. Although it implemented some large tax rises early in the parliament – an increase in the main rate of VAT and in all rates of National Insurance contributions (NICs) – the government has also managed to find scope for significant tax cuts. Just three of these – increases in the income tax personal allowance (net of reductions in the higher-rate threshold), cuts to the main rate of corporation tax, and real-terms cuts to fuel duties – have a combined cost of £19.5 billion in 2015–16. But the coalition's changes to the tax system go far beyond that, with a large number of smaller measures constituting the bulk of its activity.

² The role of tax changes in reducing the government's budget deficit is set out more fully in C. Emmerson and G. Tetlow, 'Public finances under the coalition', in C. Emmerson, P. Johnson and R. Joyce (eds), *The IFS Green Budget: February 2015*, 2015, <http://www.ifs.org.uk/publications/7530>.

The overall effect of tax (and benefit) reforms on the distribution of incomes and work incentives is discussed in a separate IFS briefing note.³ It shows that tax and benefit reforms have taken money from lower-income households and above all from the highest-income tenth, with upper-middle-income households little affected on average (and indeed gaining from tax reforms in isolation); work incentives have been strengthened principally by cuts to means-tested benefits, though tax changes also contribute. The focus of this briefing note is rather on the design of the individual reforms and on what they imply for the coherence of the tax system as a whole. Our analysis is limited to (direct and indirect) personal taxes: we do not discuss corporation tax or the bank levy, which are covered in a separate briefing note.⁴

The rest of this note proceeds as follows. Section 2 briefly outlines how government revenues have evolved over the coalition's time in office and the contribution that tax reforms have made to that. Section 3 discusses changes to the indexation of direct tax thresholds, while Sections 4 to 7 assess in turn the coalition's reforms to taxes on earnings, savings, spending and property. Section 8 discusses the government's approach to tax evasion and avoidance, while Section 9 looks at changes in the way that tax policy is made. Section 10 sets out some of the challenges that the next government will face and Section 11 concludes.

2. Revenues under the coalition government

Government revenue is forecast to be £670.3 billion in 2015–16. That equates to 35.5% of national income, similar to its share in 2009–10. Since, as noted above, the net effect of coalition policy has been to increase taxes, this implies in the absence of reforms revenue would have fallen substantially as a share of national income over this parliament. Ordinarily, we might expect receipts to grow as a share of national income over time because many thresholds in the tax system – most notably in income tax, capital gains tax, stamp duty land tax and inheritance tax – either are not indexed at all or increase in line with inflation, which is typically lower than growth in the underlying tax base (e.g. incomes or transacted house prices). Estimates based on past data suggest that one might expect this 'fiscal drag' to push receipts up by about 0.1% of national income each year: in other words, tax revenues should rise as a percentage of national income.⁵ Yet as the cross in Figure 2.1 shows, without the tax changes implemented by the coalition we estimate tax revenues would have fallen to 34.6% of national income.⁶

The period from 2009–10 to 2015–16 has of course been far from normal. The economy has recovered slowly from the 2008 financial crisis and associated recession, with real GDP only surpassing its pre-crisis peak in 2013–14. In such times, the relationship between tax revenue and national income described above is likely to be quite different.

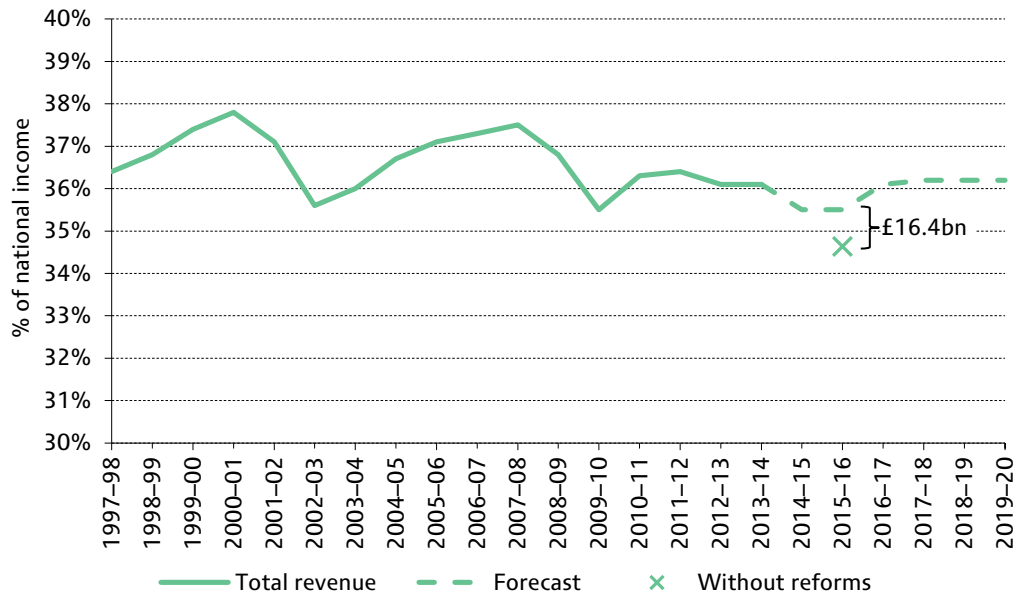
³ J. Browne and W. Elming, 'The effect of the coalition's tax and benefit changes on household incomes and work incentives', IFS Briefing Note BN159, 2015, <http://www.ifs.org.uk/publications/7534>.

⁴ H. Miller and T. Pope, 'Corporation tax changes and challenges', IFS Briefing Note BN163, 2015, <http://www.ifs.org.uk/uploads/publications/bns/BN163.pdf>.

⁵ Source: paragraph 2.19 of T. Helgadottir, G. Chamberlin, P. Dhami, S. Farrington and J. Robins, 'Cyclically adjusting the public finances', OBR Working Paper 3, 2012, <http://budgetresponsibility.independent.gov.uk/wordpress/docs/Working-paper-No3.pdf>.

⁶ This is a purely arithmetical calculation: in practice, of course, the path of the economy and of revenues would have been different if no tax changes had been implemented.

Figure 2.1. Total government revenue over time



Source: Office for Budget Responsibility, Public Finances Databank, March 2015, available at <http://budgetresponsibility.org.uk/data/>; Table 2.1.

The slow growth in underlying revenue over the past five years has been primarily driven by taxes on labour income and on corporate profits.⁷

Although employment held up surprisingly well given the depth and duration of the recession – and has now recovered to its pre-crisis level – average weekly earnings of those in work have risen less quickly than inflation as measured by the consumer prices index (CPI): by the third quarter of 2014, average weekly earnings were around the same in real terms as they were over 10 years earlier in 2004Q2. Growth that is employment-driven rather than earnings-driven is likely to lead to slower growth in tax revenue, as a given amount of aggregate labour income will attract a larger number of tax-free personal allowances if there are more people in work, and less of the income will be taxable at higher rates if earnings are lower. In previous work, IFS researchers have shown that the fact that the composition of aggregate earnings has been less ‘tax-rich’ than originally expected can account for about £6.5 billion of the shortfall in income tax and NICs revenues relative to that expected in June 2010.⁸ In addition, the self-employed now make up a greater share of the total workforce and, because the self-employed are taxed at lower rates than employees, this will tend to further reduce tax revenues.

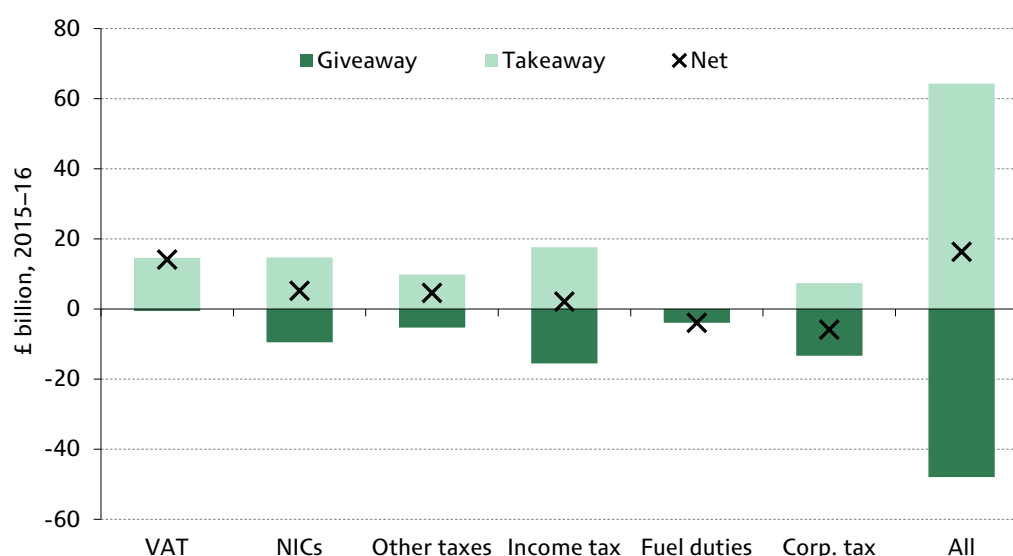
Corporation tax revenues were particularly badly hit by the recession and have been very slow to recover, with real receipts forecast to remain significantly below their pre-crisis peak even by 2019–20. This in part reflects the effect of accumulated losses, especially in the financial sector, which will act to offset tax liabilities over the next few years.⁹

⁷ For a more detailed discussion, see R. Crawford, C. Emmerson, and G. Tetlow, ‘Public finances: a dicey decade ahead’, in C. Emmerson, P. Johnson and R. Joyce (eds), *The IFS Green Budget: February 2015*, 2015, <http://www.ifs.org.uk/publications/7530>.

⁸ See R. Crawford, C. Emmerson, and G. Tetlow, ‘Public finances: a dicey decade ahead’, in C. Emmerson, P. Johnson and R. Joyce (eds), *The IFS Green Budget: February 2015*, 2015, <http://www.ifs.org.uk/publications/7530>.

⁹ For further discussion, see H. Miller and T. Pope, ‘Corporation tax changes and challenges’, IFS Briefing Note BN163, 2015, <http://www.ifs.org.uk/uploads/publications/bns/BN163.pdf>.

Figure 2.2. Estimated revenue effects in 2015–16 of tax changes implemented by the coalition



Source: Authors' calculations using Office for Budget Responsibility's Policy Measures Database (downloaded from <http://budgetresponsibility.org.uk/data/> on 31 January 2015) and various HM Treasury Budget, Autumn Statement and Pre-Budget Report documents.

With this backdrop in place, we now turn to look at the revenue effect of policy measures. The overall direct impact of tax changes implemented by the coalition has been to reduce borrowing, by £16.4 billion in 2015–16: the net effect of £64.3 billion of tax rises and £48.0 billion of tax cuts. Figure 2.2 shows the gross giveaway and takeaway for a number of different taxes. Income tax has seen both the biggest gross giveaway (£15.5 billion) and the biggest gross takeaway (£17.6 billion), but they broadly offset each other in revenue terms, with the net effect being a £2.1 billion tax rise. The biggest net revenue-raiser has been VAT, while it is corporation tax revenues that have been reduced most by the coalition's reforms.

Table 2.1 sets out the revenue effects of some of the larger individual reforms. These show that the coalition's biggest single tax increase was the rise in the main rate of VAT from 17.5% to 20% (raising £14.0 billion), followed by the 1 percentage point increase in all employer, employee and self-employed rates of NICs (raising £11.8 billion). Perhaps surprisingly, the income tax giveaway from the higher personal allowance is more than matched by additional revenues from measures that increase income tax: these include reducing limits on tax-privileged pension saving (£5.0 billion) and a large number of smaller reforms (many of them anti-evasion and anti-avoidance measures). There have been net tax cuts in both fuel duties and onshore corporation tax, though taxation of North Sea oil and gas has been increased.

One tax cut not included in these figures is that to council tax, which is determined by local authorities (though influenced by central government). The average band D rate set by local authorities in England has fallen by 12% in real terms between 2010–11 and 2015–16, with central government part-funding this through increases in grants to local authorities that chose to freeze council tax rates in cash terms (see Section 7). Relative to continuing the average rate of increase from 2007–08 to 2010–11, this amounts to a total giveaway across Great Britain of £2.8 billion in 2015–16. Thus, while coalition (central)

government tax changes increase revenue by £16.4 billion, the net tax increase experienced by households is only £13.6 billion.

Table 2.1. Estimated revenue effects in 2015–16 of tax changes implemented by the coalition government

	£ million
Income tax	+2,100
<i>of which:</i>	
<i>Changes to the personal allowance and higher-rate threshold (and to NICs UEL and UPL^a)</i>	-8,000
<i>Reduction in the additional rate from 50% to 45%</i>	-100
<i>0% starting rate for savings income and band widened</i>	-300
<i>Transferable allowance for some married couples</i>	-500
<i>Reduction in pension contribution limits</i>	+5,000
<i>Reduction in age-related allowances</i>	+1,000
<i>Other</i>	+5,000
National Insurance contributions	+5,200
<i>of which:</i>	
<i>Increase in rates</i>	+11,800
<i>Increase in earnings thresholds</i>	-7,400
<i>Switch to CPI uprating of thresholds</i>	+1,000
<i>Introduction of employment allowance</i>	-1,400
<i>Other</i>	+1,200
VAT	+14,100
<i>of which:</i>	
<i>Increase in main rate</i>	+14,000
<i>Other</i>	+100
Stamp duty land tax	-300
<i>of which:</i>	
<i>Introduction of higher rates on properties over £1m</i>	+500
<i>Abolition of 'slab' structure</i>	-800
Corporation tax	-5,900
<i>of which:</i>	
<i>Reduction in main rate from 28% to 20%</i>	-7,600
<i>Reduction in small profits rate from 21% to 20%</i>	-1,400
<i>Changes to capital allowances</i>	+700
<i>Introduction of patent box</i>	-700
<i>Changes to North Sea oil and gas taxation</i>	+2,000
<i>Other</i>	+1,100
Bank levy	+2,900
Fuel duties	-3,900
Business rates	-1,600
Capital gains tax	+1,100
Other taxes	+2,400
Total	+16,400

^a UEL is upper earnings limit. UPL is upper profits limit.

Source: Authors' calculations using Office for Budget Responsibility's Policy Measures Database (downloaded from <http://budgetresponsibility.org.uk/data/> on 31 January 2015) and various HM Treasury Budget, Autumn Statement and Pre-Budget Report documents.

3. Indexation of tax thresholds

The government's public finance forecasts assume that most tax thresholds will be uprated each April to keep pace with inflation, and that is what normally happens. Both the government and we measure 'reforms' relative to that 'no change' baseline of inflation uprating. In Budget 2011, the government announced that the inflation measure used to uprate direct tax thresholds would change from the retail prices index (RPI) to the consumer prices index (CPI). In some cases, this switch would happen immediately; in others, by the end of the parliament.

CPI inflation tends to be lower than RPI inflation, so this switch raises revenue, with lower tax thresholds meaning that more income falls into higher tax brackets.¹⁰ It is forecast to raise £1.1 billion a year in 2015–16, but since uprating will be lower every year into the future, the revenue effect will get ever larger: the longer the horizon examined, the more significant this reform appears.

The RPI is a discredited measure of inflation, stripped of its National Statistic status in 2013 because of its flaws, and moving away from it is welcome. However, the reform has not been carried out in a consistent manner:

- Indirect taxes and business rates continue to be uprated with RPI inflation by default. It is hard to think of a reason to uprate direct and indirect taxes differently, or indeed to use the RPI for uprating anything. Switching to the CPI for indirect taxes would mean lower excise duties and therefore reduce revenue; switching to the CPI for business rates would increase revenue.¹¹
- Some thresholds are by default not uprated at all. These include thresholds for stamp duty land tax (SDLT) and the £40,000 annual limit and £1.25 million lifetime limit on what can be saved in a tax-favoured private pension. And it is striking that thresholds introduced into the system recently are among those not uprated at all: they include the £100,000 threshold at which the income tax personal allowance is withdrawn and the £150,000 threshold at which the additional (45%) rate of income tax becomes payable. These thresholds therefore fall over time in real terms, often leading to rapid 'fiscal drag' as even nominal growth in the tax base extends the reach of higher rates of tax. In some cases (such as the pension saving limits), governments have simply allowed this; in other cases (such as SDLT), governments have responded with sudden sharp increases in thresholds (e.g. doubling them) every few years. It would be better if the thresholds were suitably indexed every year instead, so that they evolved more gradually and predictably.

What is needed is a more coherent approach to the indexation of tax (and benefit) parameters more generally. The government could decide that cash values in the tax system should be indexed to inflation, in which case it should apply a suitable measure

¹⁰ This is not the case for all thresholds: for example, the main rate of employee NICs falls from 12% to 2% at the upper earnings limit (UEL), so increasing this threshold at a slower rate actually costs the government money. Most direct tax thresholds are associated with increasing rates, however, so the overall effect is to increase revenue.

¹¹ Business rates are limited by legislation to rise no faster than RPI inflation. The government could still choose to uprate them by CPI inflation instead unless the CPI increased faster than the RPI, in which case a change to primary legislation would be needed.

across the board.¹² Or it could take the view that each tax should be indexed to something appropriate to its base – income tax thresholds in line with average incomes, SDLT in line with property prices, etc. – which would minimise fiscal drag. But while even a partial move away from using the RPI is welcome, the current mishmash of indexation rules across the tax and benefit system is also indefensible. The next government should set out its thinking on uprating policy systematically.

4. Taxes on earned income

The UK has two taxes on individuals' earnings: income tax and National Insurance contributions. We first examine the changes the coalition has made to income tax and then turn to consider NICs.

The coalition government has made three main changes to the income tax schedule:

- The personal allowance has been increased to £10,600 in 2015–16, £2,835 higher than the £7,765 it would have been if the 2010–11 allowance had simply been increased in line with RPI inflation (used by default for uprating at the time).
- The higher-rate threshold will be £42,385 rather than £52,765, a reduction of £10,380.¹³
- The additional rate that applies to incomes above £150,000 has been reduced from 50% to 45%.

The effect of these changes on the income tax schedule for earned income is shown in Figure 4.1, along with the gain or loss (in terms of income tax liability) at each level of income. Before discussing these three reforms, it is worth noting that the strangest feature of this schedule has not been reformed: the effective 60% rate that applies in a band of income above £100,000, where the gradual withdrawal of the personal allowance creates an extra 20p of income tax liability, on top of 40p higher-rate tax, for each extra £1 of income.¹⁴ Indeed, the increase in the personal allowance means that this 60% band is now wider, reaching up to £121,200 rather than £115,530. It is hard to see why the marginal income tax rate should increase from 40% to 60% and then drop back down to 40% before the 45% additional rate kicks in, and the main reason this anomaly attracts so little attention is probably that it is described in such an obscure way – as a withdrawn personal allowance rather than a 60% rate – that few people understand it.

The £2,835 increase in the income tax personal allowance is perhaps the coalition's most prominent tax reform. It represents an income tax reduction of £567 per year for each basic-rate taxpayer, and takes 2.6 million individuals out of income tax altogether (these individuals gain between zero and £567). For those who do not have enough unearned income to pay income tax, this £567 is an additional incentive to work.¹⁵

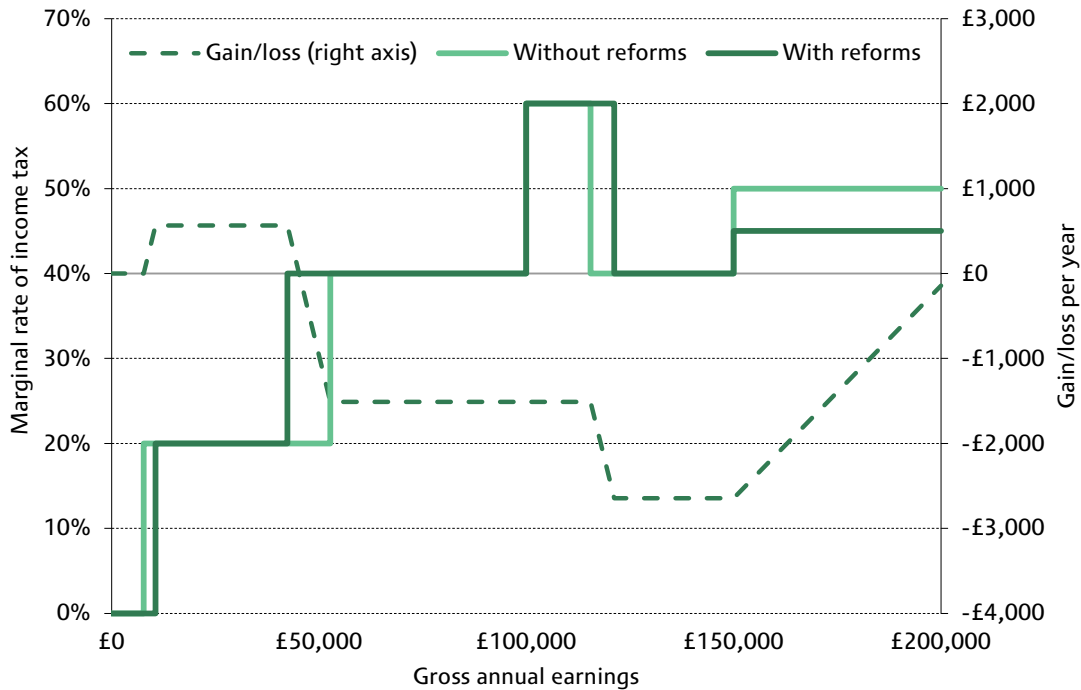
¹² For a discussion of the merits of different inflation measures, see P. Johnson, *UK Consumer Price Statistics: A Review*, UK Statistics Authority, 2015, <http://www.statisticsauthority.gov.uk/reports---correspondence/current-reviews/range-of-prices-statistics.html>.

¹³ This change also applies to the NICs upper earnings limit and upper profits limit, which are aligned with the income tax higher-rate threshold.

¹⁴ The personal allowance is reduced by 50p for each £1 of income above £100,000. This extra 50p of taxable income, taxed at the 40% higher rate, adds 20p to tax liability on top of the 40p tax on the £1 itself.

¹⁵ It is also possible that some basic-rate taxpayers who receive a tax cut may not need to work as much. Such 'income effects' apply to all tax changes – people who receive tax cuts may be able to afford to work less, and

Figure 4.1. Income tax schedule for earned income, 2015–16



Note: Assumes individual is aged under 65 and all taxable income is earnings.

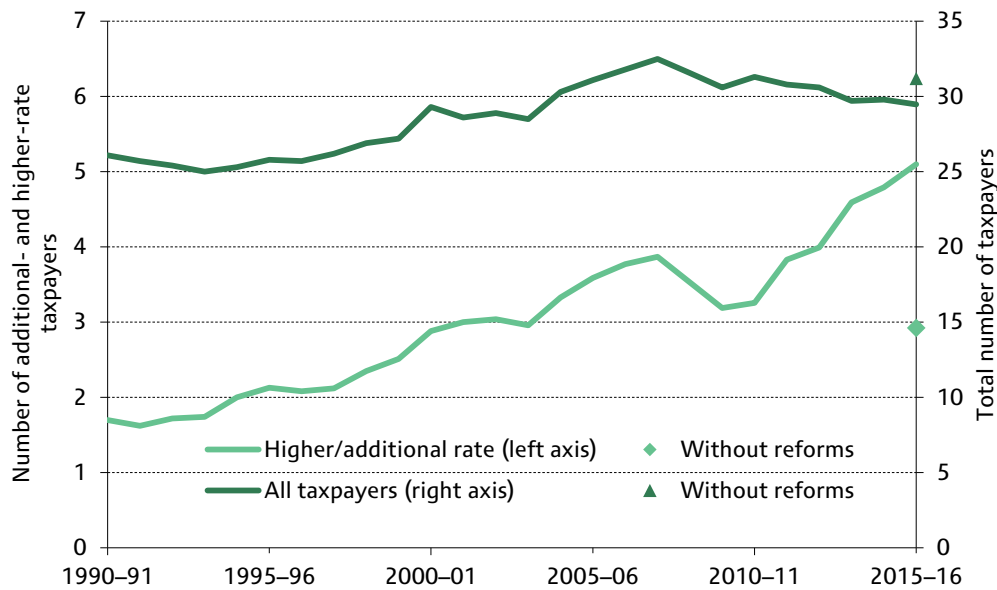
At the same time, big reductions in the higher-rate threshold (including some that were planned by the previous Labour government but which the coalition chose to implement) have more than offset higher-rate taxpayers' gains from the increased personal allowance: most higher-rate taxpayers will pay £471 per year more than if these reforms had not happened.¹⁶ The decision to reduce the higher-rate threshold by more than £10,000 has led to an increase of over 2 million in the number of individuals subject to the higher or additional rate of income tax. Figure 4.2 shows that the number of people facing higher rates of income tax is forecast to rise from 3.3 million in 2010–11 to 5.1 million by 2015–16. Had the higher-rate threshold instead risen in line with RPI inflation, we estimate this number would have fallen slightly to 2.9 million. At the 2014 Conservative Party conference, the Prime Minister said that he thought the trend of rising numbers of higher-rate taxpayers undesirable and proposed to increase the higher-rate threshold to £50,000 by the end of the next parliament, but that is not official government policy.¹⁷ If the higher-rate threshold is uprated as normal, and taking the Office for Budget Responsibility (OBR)'s forecasts for growth in incomes, previous IFS research

people who see tax increases may feel a need to work more – and we do not discuss them further in this briefing note.

¹⁶ As Figure 4.1 shows, the extra *income tax* paid by most higher-rate taxpayers is £1,509 per year. The overall loss to higher-rate taxpayers is less than this because the NICs upper earnings limit (and upper profits limit for the self-employed) is aligned with the income tax higher-rate threshold, so reductions in the higher-rate threshold that result in more income being taxed at 40% rather than 20% also result in more earnings being subject to employee NICs at 2% instead of 12%. Taking this change in the UEL into account, higher-rate taxpayers will normally pay £471 more. If we exclude the (small) changes to the personal allowance and (bigger) changes to the higher-rate threshold that were announced by Labour but implemented by the coalition, basic-rate taxpayers gain £593 per year rather than £567 and higher-rate taxpayers gain £38 per year rather than losing £471.

¹⁷ See <http://press.conservatives.com/post/98882674910/david-cameron-speech-to-conservative-party>.

Figure 4.2. Total number of income taxpayers and number paying higher or additional rates



Note: Data points for 2008-09 are linear interpolations and those from 2013-14 onwards are forecasts. Source: HM Revenue & Customs, table 2.1, <https://www.gov.uk/government/statistics/number-of-individual-income-taxpayers-by-marginal-rate-gender-and-age>; authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on updated data from the 2012-13 Family Resources Survey.

estimated that fiscal drag will increase this number by a further 1.2 million by 2020-21 and by 2.8 million by 2025-26.¹⁸

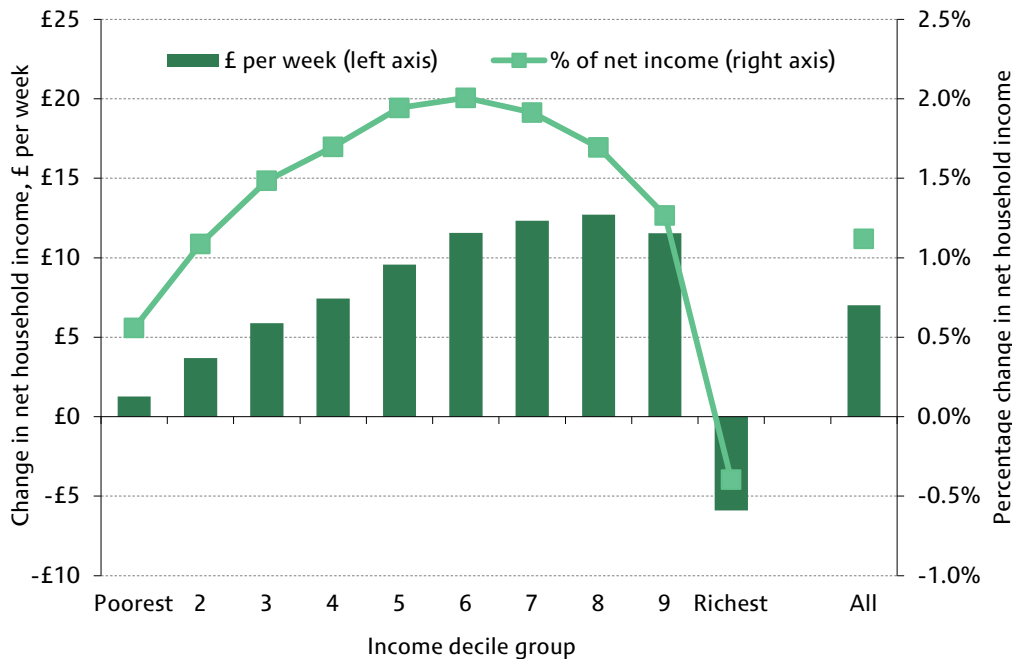
Taken together, the changes to the personal allowance and higher-rate threshold (and NICs upper earnings limit) implemented by the coalition have a net cost of £8.0 billion in 2015-16, according to official estimates.

A casual glance at the dashed line in Figure 4.1 might suggest that the changes to the personal allowance and the higher-rate threshold have benefited those on low incomes and hurt those on high incomes. That impression is only partly correct. It is true that basic-rate taxpayers gain from the reforms while higher-rate taxpayers lose. But the population is overwhelmingly concentrated on the left-hand side of the chart: only 10% of the adult population will pay higher- or additional-rate tax in 2015-16, whereas around 44% will not have an income high enough to pay income tax at all.¹⁹ So the number losing is relatively small; the principal comparison is between those basic-rate taxpayers who have seen their annual income tax liabilities fall by £567 per year and those whose incomes are too low to have gained from a higher personal allowance. Furthermore, Figure 4.1 shows only the effect on income tax liabilities: among basic-rate taxpayers, the £567 income tax cut will be worth less to those with lower incomes whose housing benefit or council tax support is reduced in response to their higher after-tax incomes. Finally, note that Figure 4.1 shows the effect on individuals. If instead we

¹⁸ See R. Crawford, C. Emmerson and G. Tetlow, 'Public finances: a dicey decade ahead', in C. Emmerson, P. Johnson and R. Joyce (eds), *The IFS Green Budget: February 2015*, 2015, <http://www.ifs.org.uk/publications/7530>.

¹⁹ Number of taxpayers and higher-rate taxpayers as per Figure 4.2; adult population defined as those aged 16 or over and taken from table A1-1 of Office for National Statistics, *2012-Based Principal Population Projections*, <http://www.ons.gov.uk/ons/rel/npp/national-population-projections/2012-based-projections/rft-table-a1-1-principal-projection---uk-summary.xls>.

Figure 4.3. Distributional impact of changes to the personal allowance and higher-rate threshold



Note: Reform modelled includes changes in the personal allowance for under-65s (but not age-related allowances), the higher-rate threshold and the NICs upper earnings limit and upper profits limit. The 'all' bar in this chart implies an exchequer cost of £9.8 billion in 2015–16 for these reforms, substantially higher than the official estimate of £8.0 billion; there are several possible reasons for this. Income decile groups are derived by dividing all households into 10 equal-sized groups according to income adjusted for household size using the McClements equivalence scale.

Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on updated data from the 2012–13 Family Resources Survey.

consider family income, the picture changes because two-earner couples – who tend to have higher family incomes – benefit twice over from the giveaway.

These factors are reflected in Figure 4.3, which shows gains and losses in terms of net household incomes across the population from changes to the personal allowance and the higher-rate threshold. Only the highest-income tenth lose on average; the biggest gains in cash terms are felt elsewhere in the top half of the income distribution, while as a percentage of income the gains are largest in the middle of the distribution.

The outgoing Labour government introduced an additional rate of income tax, levied at a rate of 50% on income in excess of £150,000 per year, in April 2010. Budget 2012 announced that the rate would be reduced to 45% from April 2013. HM Revenue & Customs (HMRC) estimates that only 313,000 individuals will pay the additional rate in 2014–15, just 0.6% of the adult population, but they provide 28% of all income tax revenue.

If nobody changed their UK taxable income in response to this reform, it would cost £3.8 billion. That is an unrealistic assumption – with a lower tax rate, people will not go to as great lengths to reduce their taxable incomes – but it is difficult to tell how much high-income individuals respond to such changes in tax rates. HMRC's central estimate – signed off by the Office for Budget Responsibility as reasonable – is that the cut in the additional rate will cost just £100 million in 2015–16 once one allows for behavioural

response by the affected individuals, though there is considerable uncertainty around that estimate.²⁰

Other income tax reforms have reintroduced an element of family taxation into the system. The first is the use of income tax to withdraw child benefit from families containing an individual with an income of more than £50,000, discussed in a separate IFS briefing note.²¹ The second is the introduction of a transferable income tax allowance for some married couples. From April 2015, up to 10% (£1,060) of the income tax personal allowance will be transferable between adults who are married or in a civil partnership, so long as the higher-income adult is a basic-rate taxpayer. The government estimates that the cost of this measure will rise to about £800 million by 2018–19 as take-up is expected to rise.

Both of these reforms complicate the tax system. A transferable personal allowance for married couples capped at £1,060 and then withdrawn using a cliff-edge at the higher-rate threshold is not the simplest to understand. Individuals experiencing the withdrawal of child benefit now face a marginal rate of income tax that depends on the number of children they have. There are simpler ways of providing more support to working low- and middle-income married couples (for example, a higher work allowance for married couples in universal credit) and of withdrawing support for children from high-income households (integrating child benefit with the child tax credit, subject to a family-level means test). Both measures also seem to have been implemented without a clearly articulated view of what roles individuals' and couples' circumstances should each play in the tax and benefit system. There is a much wider, principled debate about the role of joint versus individual assessment that has not been had.

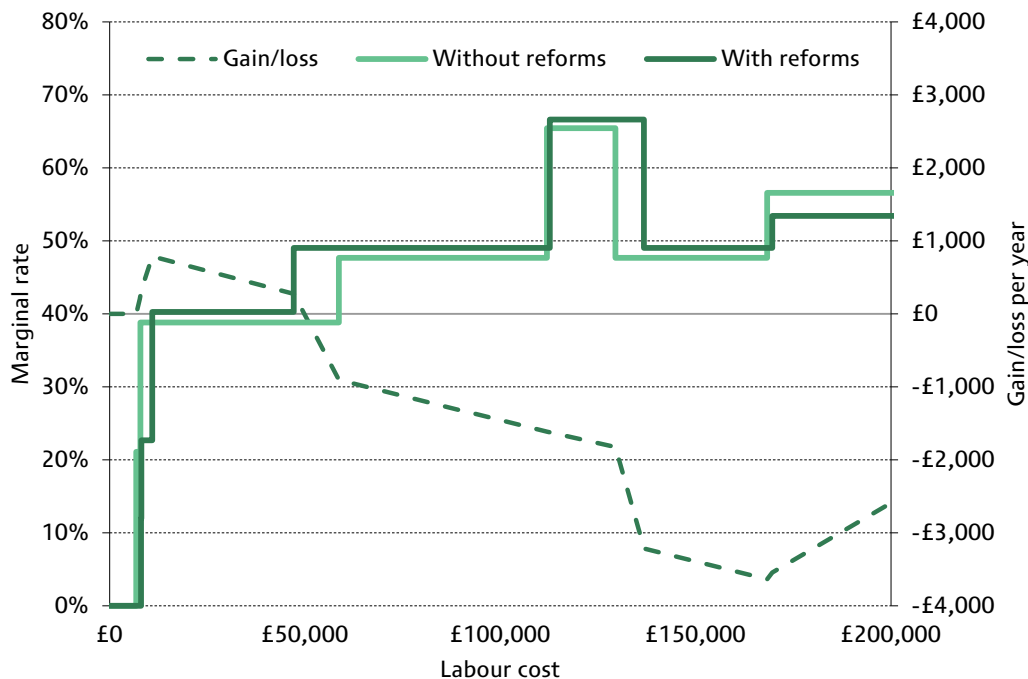
Despite the increase in the personal allowance, the reduction in the additional rate and the introduction of a transferable allowance, the net effect of the coalition's income tax reforms is in fact to increase revenues by £2.1 billion in 2015–16. The biggest income tax increase is a reduction in the limits on tax-privileged pension saving (discussed in Section 5.2), which raises £5 billion on its own. But there are also a number of smaller tax increases (such as increases to company car tax, reductions in the age-related allowance and the introduction of an overall cap on tax reliefs) and a raft of anti-avoidance and anti-evasion measures (such as measures to tax 'disguised remuneration' as labour income and an agreement with the Swiss government to tackle offshore evasion). We discuss the coalition's approach to combating avoidance and evasion in Section 8.

As well as income tax, the UK has a second tax on earnings: National Insurance contributions. In April 2011 the rates of NICs paid by employees, employers and the self-employed all increased by 1 percentage point, raising £11.8 billion. These increases had been announced, but not implemented, by the previous Labour government; the coalition chose to go ahead with them. At the same time, the thresholds at which NICs become payable were increased. The increase in thresholds for employees and the self-employed (costing £3.6 billion) had also been planned by Labour; the increase in the threshold for employers (costing £3.9 billion) was a new announcement. These threshold increases reduced the impact of the NICs rate rise on low earners. However, the NICs thresholds

²⁰ See HM Revenue & Customs, 'The Exchequer effect of the 50 per cent additional rate of income tax', 2012, <http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hmrc.gov.uk/budget2012/excheq-income-tax-2042.pdf>.

²¹ A. Hood and D. Phillips, 'Benefit spending and reforms: the coalition government's record', IFS Briefing Note BN160, 2015, <http://election2015.ifs.org.uk/uploads/publications/bns/BN160.pdf>.

Figure 4.4. Combined income tax and NICs schedule for earned income, 2015–16



Note: Assumes individual is aged under 65 and all taxable income is earnings.

have not increased in line with the income tax personal allowance. It is hard to think of a good economic reason for wanting to increase the income tax allowance but not the NICs thresholds. The emphasis on income tax and neglect of NICs highlights the absurdity of continuing to have two similar but separate taxes given that National Insurance is not a true social insurance scheme.

Figure 4.4 shows the effect of the coalition's reforms on the combined income tax and NICs schedule, with overall marginal rates and gains/losses shown at each level of labour cost (that is, gross earnings plus employer NICs).²² The gains to individuals from a higher income tax personal allowance are partially offset by losses from the rise in NICs rates, with the latter measure also increasing the losses for individuals above the higher-rate threshold.

Real Time Information

One of the biggest changes the coalition government has made to income tax and NICs is one that does not affect anyone's tax liabilities. The introduction of Real Time Information (RTI) reporting in 2013 was a major change to the PAYE system for administering income tax and NICs. Previously, employers notified HMRC after the end of the tax year how much they had paid each employee, and how much they had deducted in income tax and NICs, during the year. Under RTI, employers must notify HMRC on or before the day they make each wage payment.

²² The coalition has also made two other notable changes to NICs not shown in Figure 4.4. First, it has introduced an 'employment allowance' that reduces the employer NICs liabilities of all firms by £2,000, primarily benefiting small employers at a cost of £1.4 billion in 2015–16. Second, the coalition has entirely abolished employer NICs for those aged 21 or under earning less than the UEL (£815 per week in 2015–16), benefiting young workers and their employers at a cost of £0.5 billion.

The intention was twofold: first, so that HMRC, getting the information earlier, would be able to operate the tax system better – to deal more easily with people starting or leaving jobs, for example, and to make any necessary adjustments to tax payments smoothly during the year rather than having to deal with under- and over-payments after the end of the tax year; and second, so that the RTI data could be passed on to the Department for Work and Pensions and used to determine benefit entitlements under the new universal credit system, which depend on people's actual earnings each month.

In practice, neither of these aims has yet been fully met. HMRC has not yet developed systems to make the most of the RTI data it receives. And the use of RTI data for universal credit purposes has been limited by the fact that the introduction of universal credit is several years behind schedule, with the roll-out having only just begun. In the longer term, however, there are potential benefits from RTI.

In the shorter term, the biggest concern has been the difficulties for small firms of complying with RTI in full. In response to these concerns, in March 2013 the government announced a one-year relaxation of the 'on or before' reporting requirement for employers with up to 49 employees, allowing them to report monthly instead. It later extended the temporary relaxation to April 2016 for existing employers with up to nine employees. It remains to be seen whether that relaxation will be allowed to expire and if so what the consequences will be.

A survey of employers carried out for HMRC in late 2013, soon after RTI was rolled out, found that it was working well: of the 1,750 employers interviewed, 70% said they found RTI 'fairly easy' or 'very easy' to deal with overall; 72% rated the burden under RTI lower than or the same as under the previous system and even more expected that to be true in the long term.²³ The National Audit Office concluded that HMRC had 'learned the lessons' from problematic past reforms to PAYE and that implementation of RTI had been 'much more successful'.²⁴ Reports in the specialist press and some statements from professional bodies have been less positive, with many highlighting problems experienced with the system.²⁵ Yet it is difficult to tell how far vocal complaints reflect the wider experience of RTI. There have certainly been some problems, notably with large numbers of incorrect automated notices being sent to employers; the government responded by temporarily suspending automatic penalties for late filing and payment. Despite the intention of RTI being to facilitate in-year adjustments, the first year of RTI also ended with more, rather than fewer, over- and under-payment notices being sent to employers for reconciliation after the end of the year – and thousands of the notices were themselves incorrect. But it is perhaps understandable that there should be some problems in the first year of implementation, and there is certainly no sign of the scale of problems associated with a previous reform to PAYE in 2009. With RTI yet to complete its second full year of

²³ K. Bunt, A. Fearn and A. Thomas, *PAYE Real Time Information: Main Migration Research*, HMRC Research Report 304, January 2014, <https://www.gov.uk/government/publications/payee-real-time-information-main-migration-research>.

²⁴ Comptroller and Auditor General, *Report on HM Revenue and Customs 2013–14 Accounts*, 2014, <http://www.nao.org.uk/report/her-majestys-revenue-customs-2013-14-accounts-2/>; Comptroller and Auditor General, 'Increasing the effectiveness of tax collection: a stocktake of progress since 2010', 2015, <http://www.nao.org.uk/report/increasing-the-effectiveness-of-tax-collection-a-stocktake-of-progress-since-2010/>.

²⁵ See, for example, <http://www.accountingweb.co.uk/article/rti-working-spite-mistakes-says-tax-chief/554683>, <https://www.accountancylive.com/rti-boon-or-burden>, <http://ukcampaign4change.com/2014/10/14/real-time-information-the-good-and-bad/> and http://www.att.org.uk/technical/newsdesk/PR_tax_assoc_call_inclusive_review_RTI_problems.

operation, and some temporary transitional arrangements still in place, it is perhaps still early to judge how effective it will ultimately prove to be.

5. Taxation of savings and wealth

5.1 Interest-bearing accounts and Individual Savings Accounts

The coalition has reduced the taxation of some forms of saving. It has substantially increased the amount that can be saved tax-free in Individual Savings Accounts (ISAs), benefiting those who are rich enough to want to put more than the previous limit into an ISA each year, and it has abolished the distinction between cash and equity ISAs. This costs only £80 million in 2015–16 but the cost will rise over time – to £560 million in 2018–19, for example – as interest rates are expected to rise and as the stock of additional funds held in ISAs and attracting preferential tax treatment grows. And from April 2015, the starting rate of income tax that applies to ordinary savings income (such as bank interest) will be cut from 10% to zero and will apply to a £5,000 band of income instead of £2,960, benefiting mostly middle-income households (and disproportionately pensioners) at an annual cost of £310 million. Allowing more cash saving to be tax-free has economic efficiency advantages: the government should not discourage people from spending their money tomorrow rather than today. The case for allowing more shares to be held in ISAs is less clear-cut as equity returns partly reflect luck, skill in picking shares, and so on, which there is more reason to tax.

5.2 Pensions

While the coalition is allowing more money to be saved tax-free in bank accounts and ISAs, it has reduced the amount that can be saved tax-free in private pensions. This is a much bigger change in revenue terms, raising £5.0 billion in 2015–16 and increasing amounts thereafter. The coalition has reduced the amount that can be contributed in any single year from £255,000 to £40,000 and the total amount that can be accumulated in a private pension from £1.8 million to £1.25 million. This is less incoherent than the plan inherited from the previous Labour government (and current Labour Party policy), which was to give income tax relief at the basic rate (20%), rather than the additional rate (then 50%), for additional-rate taxpayers.²⁶ However, there are much better ways the government could have raised revenue from the taxation of private pensions. Rather than limit the amount that can be saved in a pension, it would have been better to reduce the unjustifiably large and ill-designed subsidies that pension saving currently attracts (even among those who already have large pension pots): the 25% of a pension fund that can be withdrawn free of income tax and especially the complete absence of employer or employee NICs on employer pension contributions.²⁷ The case for reconsidering these subsidies looks even stronger now that the government is removing many of the restrictions on how accumulated funds in defined contribution pensions can be used.

²⁶ Some of the flaws with the previous Labour government's policy are set out in <http://www.ifs.org.uk/publications/4773>.

²⁷ These options are discussed in 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*, Oxford University Press for the Institute for Fiscal Studies, Oxford, 2011, <http://www.ifs.org.uk/publications/5353> and in C. Emmerson, 'Taxation of private pensions', in C. Emmerson, P. Johnson and H. Miller (eds), *The IFS Green Budget: February 2014*, <http://www.ifs.org.uk/publications/7072>.

5.3 Capital gains tax

The coalition's first Budget reintroduced a higher rate of capital gains tax (CGT): instead of a flat rate of 18%, higher- and additional-rate income taxpayers now face a rate of 28%. This is forecast to raise almost £1 billion in 2015–16.

Increasing CGT rates discourages saving and investment. But it was never clear why CGT should have no higher rate when income tax did. The reintroduction of a higher rate is a move towards alignment of CGT with income tax, which reduces the scope to avoid tax by converting income into capital gains. Yet the government has also expanded entrepreneurs' relief, applying a reduced (10%) CGT rate on up to £10 million, rather than £2 million, of lifetime capital gains on owner-managers' businesses – precisely the area where there is most scope to convert income into capital gains.

This government's reforms are the latest turn in a decades-old trend for CGT policy to go round in circles, with rates yo-yoing (and preferential treatment periodically introduced and abolished for certain asset classes, or long-held assets) in response to the tension between wanting to minimise disincentives to save and wanting to minimise avoidance opportunities. This tension is pervasive in savings taxation. Successive governments' responses have been ad hoc rather than based on clear principles, and the result is that the current system of savings taxation is a mess. Saving in many forms is discouraged, to an extent that varies absurdly with inflation; among other things, the system distorts people's choices as to which assets to invest in, whether to work via a company, and (for owner-managers of businesses) the balance between taking salary, dividends or capital gains. The Mirrlees Review proposed a solution: to exempt from taxation a 'normal' (risk-free) rate of return to amounts saved, but to tax returns in excess of this (whether income or capital gains) at full labour income tax (including employee and employer NICs) rates.²⁸ The coalition may agree or disagree with that approach, but at present it is hard to discern any clear vision of how the government thinks savings should be taxed.

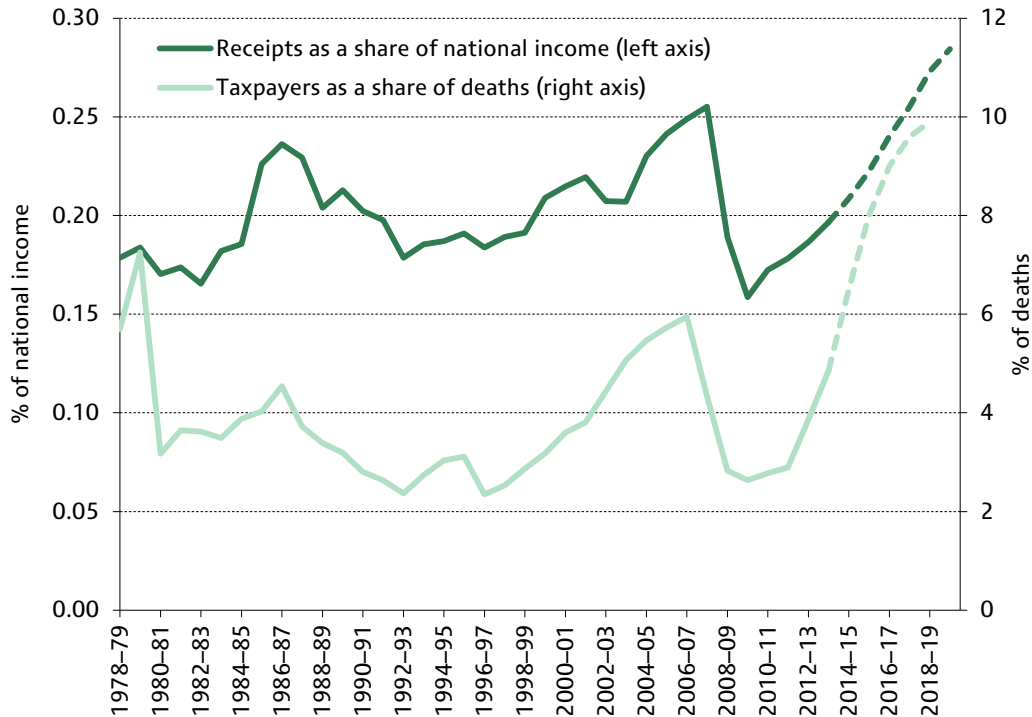
5.4 Inheritance tax

As well as taxing the income and capital gains generated by (some) assets, the UK also levies 40% inheritance tax on (some) wealth that is transferred on or shortly before death. The Conservatives' 2010 general election manifesto – and, as recently as October 2014, the Prime Minister²⁹ – expressed a desire to increase the inheritance tax threshold. Yet in fact the threshold has been frozen in cash terms at £325,000 since 2009–10 and the 2013 Budget announced that the freeze would continue through to 2017–18. This eight-year freeze represents a cut of 20% or £64,800 relative to CPI inflation. Because of this and because of rising asset prices, Figure 5.1 shows that the number of estates liable for inheritance tax is forecast to rise from 4.9% of deaths in 2013–14 (and just 2.6% in 2009–10, before the threshold freeze) to 9.9% in 2018–19, and revenue from this tax is forecast to rise from 0.20% of national income in 2013–14 (and 0.16% in 2009–10) to 0.27% in 2018–19, its highest level since at least 1973–74. It is notable that the coalition has presided over a gradual increase in inheritance tax whereas the last significant cut to inheritance tax was implemented by the previous Labour government, which in October

²⁸ See chapters 13 and 14 of Mirrlees et al. (op. cit.).

²⁹ See <http://www.theguardian.com/money/2014/oct/15/david-cameron-inheritance-tax-threshold>.

Figure 5.1. Inheritance tax receipts and taxpayers



Note: Figure shows total receipts and number of estates liable for inheritance tax and (for years before 1986–87) capital transfer tax at death.

Source: Past receipts and number of taxpaying death estates from HMRC Statistics, <https://www.gov.uk/government/organisations/hm-revenue-customs/about/statistics>; forecast receipts from Office for Budget Responsibility, *Economic and Fiscal Outlook: December 2014*, <http://budgetresponsibility.org.uk/economic-fiscal-outlook-december-2014/>; national income from Office for Budget Responsibility, Public Finances Databank, March 2015, <http://budgetresponsibility.org.uk/data/>; past number of deaths from Office for National Statistics, Vital Statistics, <http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tc%3A77-353343> and Office for National Statistics, Mortality Statistics, <http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tc%3A77-327590>; forecast taxpayers as share of deaths from Office for Budget Responsibility, *Economic and Fiscal Outlook: March 2014*, Supplementary Data Release, <http://budgetresponsibility.org.uk/economic-fiscal-outlook-march-2014/>.

2007 made any unused proportion of the nil-rate band transferable to a surviving spouse or civil partner, effectively doubling the inheritance tax threshold for many couples.³⁰

While inheritance tax has been increased, and the Prime Minister says that he wants to reduce it, there is strikingly little discussion of what inheritance tax is intended to achieve – in particular, why we should want to tax transfers of wealth on or near death but not throughout life. A case can be made for abolishing inheritance tax completely. But there is also a case for taxing transfers of wealth to the next generation to promote equality of opportunity, and the Mirrlees Review argued that a more logical approach than the current one – albeit with practical challenges – would be to tax individuals at progressive rates on the total amount of gifts and inheritances that they receive over their lifetime.³¹ Short of that, there are substantial reliefs, such as for agricultural land and unquoted business assets, that are hard to justify and make the tax easier to avoid. Merely adjusting

³⁰ Note that the sharp fall in inheritance tax payers and receipts in 2008–09 reflects falls in asset prices associated with the financial crisis as well as this reform.

³¹ See chapter 15 of Mirrlees et al. (op. cit.).

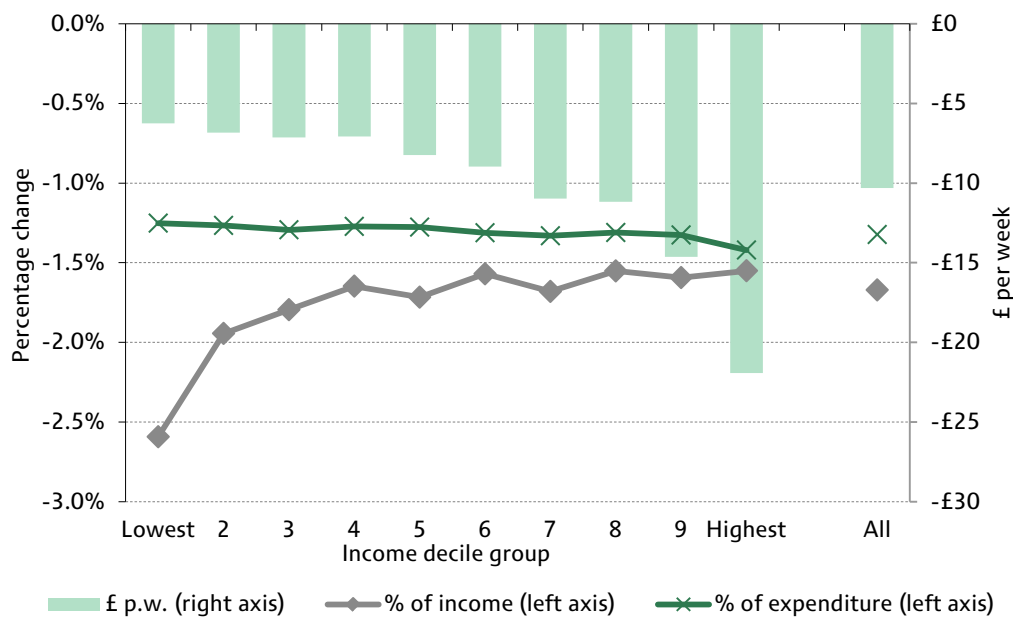
the inheritance tax threshold fails to address the deeper problems with the structure of the tax.

6. Indirect and environmental taxes

The rise in the main rate of VAT from 17.5% to 20% in January 2011 is the coalition’s single biggest tax change, estimated to yield £14.0 billion in 2015–16. It is often described as regressive, and indeed the grey line in Figure 6.1 shows that the loss falls from 2.6% of income in the lowest income decile group to 1.6% in the highest income decile group. This impression is misleading, however. It arises mainly because, at any given point in time, low-income households typically spend a lot (and therefore pay a lot of VAT) relative to their incomes. But households cannot spend more than their income indefinitely. Over a lifetime, income and expenditure must be equal (except for bequests given and received and the possibility of dying in debt); households spending a lot relative to their income at any given point in time are often those experiencing only temporarily low incomes and either borrowing or running down their savings in order to maintain their expenditure smoothly at a level more befitting their lifetime resources.³²

We can get a clearer picture of the distributional impact of VAT over a lifetime – abstracting from how much people are borrowing or saving at any point in time – by looking at whether VAT is a bigger percentage of expenditure, rather than income, for higher-income households. Figure 6.1 therefore shows the impact of the coalition’s VAT rise as a percentage of expenditure as well as the impact as a percentage of income. On

Figure 6.1. Distributional impact of the increase in the main rate of VAT



Note: Income decile groups are derived by dividing all households into 10 equal-sized groups according to income adjusted for household size using the McClements equivalence scale.
 Source: Authors’ calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on updated data from the 2012 Living Costs and Food Survey.

³² Such temporarily low incomes can arise for a variety of reasons: people who are temporarily unemployed, people with volatile income from self-employment, students, those taking time out of the labour market to raise children, retirees drawing on past savings, and so on.

that measure, the increase in VAT looks slightly progressive, with the average loss rising from 1.25% of expenditure for the lowest income decile group to 1.42% of expenditure for the highest income decile group. That arises because the items that are zero- or reduced-rated for VAT, and therefore not affected by a rise in the main rate – food being by far the biggest – take up a larger share of the budgets of poorer households. Over a lifetime, we would expect richer households to devote a larger share of their resources to goods subject to VAT at the main rate and therefore to lose more from such a VAT increase than poorer households: that is what the dark green line in Figure 6.1 reflects.³³ A rise in the main rate of VAT is therefore best thought of as being slightly progressive, though it is much less progressive than an income tax or NICs rise because there is no VAT-free allowance on the first tranche of household expenditure analogous to the allowances in income tax and NICs.

Like increasing income tax, increasing VAT weakens work incentives by reducing the amount of goods and services that additional earnings can buy after tax. Increasing the main rate also increases the scale of the distortion towards buying zero- and reduced-rated goods and services instead of standard-rated ones. The UK has an exceptionally narrow VAT base by international standards, and the big difference in tax rates between different goods and services both distorts people's spending decisions and complicates the system. Zero and reduced rates on items such as basic food and domestic fuel disproportionately benefit poorer households (though the rich still benefit more in cash terms), but the Mirrlees Review showed that a similar degree of redistribution could be achieved more efficiently through other means.³⁴ The coalition has done little to reform the VAT base. The trivial (and unsuccessful) 'pasty tax' and 'caravan tax' proposals in Budget 2012 merely serve to highlight the lack of more substantive reform.

Turning to excise duties, there has been a big increase in duties on tobacco and small changes in those on alcohol (increases for wine and spirits and a reduction for beer). But in revenue terms these are dwarfed by changes to duties on road fuels.

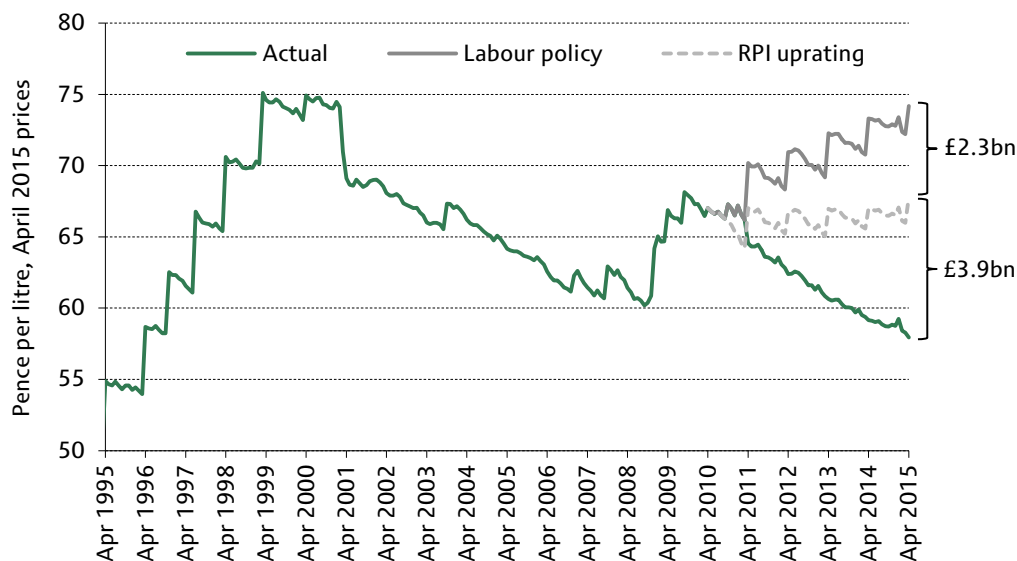
Figure 6.2 shows how the real level of duty on a litre of fuel has changed over the last 20 years.³⁵ There have been big swings in policy. The Major and (initially) Blair governments operated a fuel duty 'escalator', which automatically increased duties by more than inflation each year. The escalator was abandoned in 2000 and, following fuel price protests, Labour started a long period of real-terms reductions, until 2007 when the duties started to rise again. When the coalition took office, it inherited plans for another escalator. The coalition not only cancelled Labour's escalator, but has cut fuel duties in real terms. In April 2015, fuel duties will be 15% (10p per litre) lower than if the April 2010 duties had simply been uprated in line with the RPI (a £3.9 billion tax cut) and 22% (16p per litre) lower than if the coalition had continued with the fuel duty escalator inherited from the previous government (a £6.2 billion tax cut).

³³ For more analysis of VAT payments by income and expenditure and their relationship to lifetime resources, see S. Adam, D. Phillips and S. Smith (in consortium), *A Retrospective Evaluation of Elements of the EU VAT System*, European Commission, 2011, <http://www.ifs.org.uk/publications/5947>.

³⁴ See chapter 9 of Mirrlees et al. (2011, op. cit.).

³⁵ RPI inflation is used to express duties in April 2015 prices, since the RPI is the measure that has been used for default uprating throughout the period.

Figure 6.2. Fuel duties over time (April 2015 prices)



Note: Updated to April 2015 prices using past RPI data from Office for National Statistics, 'Consumer price inflation reference tables January 2015', <http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tc%3A77-323621> and forecast RPI from Office for Budget Responsibility, *Economic and Fiscal Outlook: December 2014*, <http://budgetresponsibility.org.uk/economic-fiscal-outlook-december-2014/>.

Whether cutting fuel duties was good policy (as opposed to good politics) is debatable. The evidence is clear that fuel duties are much higher than can be justified by the carbon emissions from driving. But by far the biggest harm done by motoring – and therefore the best reason for taxing it – is the congestion it causes. Yet fuel duties are not well targeted at reducing congestion, since the congestion caused by burning fuel depends on the time and location of journeys in a way that fuel duties do not. Urban rush-hour journeys should be discouraged more than rural or night-time ones; fuel duties cannot achieve that. The Mirrlees Review therefore argued that most of fuel duties should be replaced with a nationwide system of congestion charging, an idea that no longer seems to be on the political agenda.³⁶

But whether or not fuel duties should have been reduced, the manner in which it was done has been less than ideal. In contrast to the clear direction of travel on the income tax personal allowance or the corporation tax rate, the government did not announce early on that it intended to reduce fuel duties gradually in real terms. Rather, the announcements could be politely described as piecemeal, with each April's inflation adjustment postponed (sometimes repeatedly) before ultimately being cancelled. To take just one example, the uprating originally due in April 2011 was postponed to January 2012 in Budget 2011, to August 2012 in Autumn Statement 2011, then again to January 2013 before finally being laid to rest in Autumn Statement 2012. That is no way to make policy. On top of this was the shambles of the 'fair fuel stabiliser', announced in Budget 2011, whereby fuel duties were to increase by 1p per litre above inflation (and the corporation tax rate on North Sea profits fall) if the oil price fell below \$75 per barrel. In the 2014 Autumn Statement, just when it looked like that would happen, the fair fuel stabiliser was abolished: the tax rate on North Sea profits was reduced slightly, but there was to be no increase in fuel duties. Since the policy was of questionable merit in the first

³⁶ See chapter 12 of Mirrlees et al. (2011, op. cit.).

place, abandoning it was no bad thing. But it would have been better not to announce the policy at all; the manner of its abandonment does little for the credibility of contingent policy commitments.

Fuel duties are by far the UK's biggest environmental tax, and they have been reduced substantially. Nevertheless, the government can claim to have fulfilled the promise in the Coalition Agreement that 'We will increase the proportion of tax revenue accounted for by environmental taxes'.³⁷ This is because there has been a rapid increase in the revenue from smaller environmental levies such as the Carbon Price Floor, the Renewables Obligation and Feed-In Tariffs, which are counted towards tax revenue even when the sums involved are kept and recycled within the industry. But the hotchpotch of small levies has done little to address the inconsistent price applied to carbon emissions, which is lower for households' emissions than for businesses' and lower for gas than for electricity. Indeed, relative to other forms of consumption, gas consumption by households is actually subsidised, via the reduced rate of VAT. To reduce greenhouse gas emissions in the least costly way, it would be better if all sources of emissions were taxed at the same rate.³⁸

7. Property taxation

Britain has three main taxes on property: council tax, an annual tax on residential property; business rates, an annual tax on non-residential property; and stamp duty land tax (SDLT), a tax on residential and non-residential property transactions.

7.1 Council tax

The overall level of council tax is set by individual local authorities (LAs), but every year since 2011–12 LAs in England have been offered additional funding from central government if they chose not to increase council tax rates in cash terms.³⁹ The size of the grant on offer has varied from year to year, and consequently so has the proportion of councils choosing to take it up. In 2011–12, a payment equivalent to a 2% council tax increase was offered and all councils chose to freeze council tax and take up the grant. The freeze grant offered was equivalent to a 2.5% increase in council tax rates in 2012–13 and 1% each year since 2013–14;⁴⁰ in 2014–15, 60% of councils froze council tax rates.⁴¹

³⁷ Page 31 of HM Government, *The Coalition: Our Programme for Government*, <https://www.gov.uk/government/publications/the-coalition-documentation>.

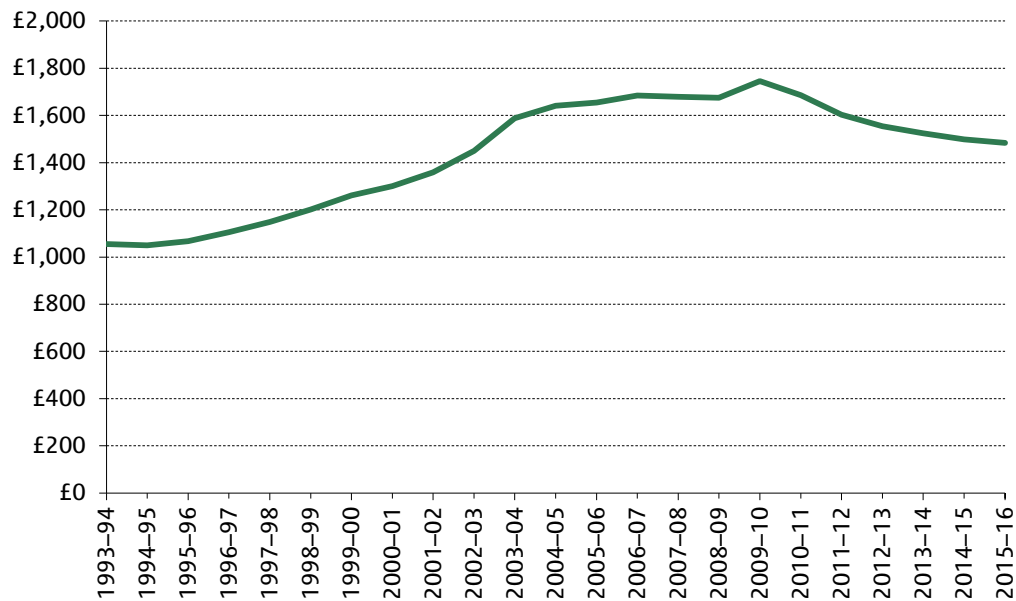
³⁸ See A. Advani, S. Bassi, A. Bowen, S. Fankhauser, P. Johnson, A. Leicester and G. Stoye, *Energy Use Policies and Carbon Pricing in the UK*, IFS Report R84, 2013, <http://www.ifs.org.uk/publications/6915>.

³⁹ Similar offers have been made by the devolved administrations in Scotland and Wales. Since our focus here is on the UK coalition government, we restrict attention to England.

⁴⁰ See House of Commons Library, 'English local government finance: issues and options', Research Paper 14/43, 2014, <http://www.parliament.uk/briefing-papers/RP14-43/english-local-government-finance-issues-and-options> and https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/407206/Letter_to_LAs_-_2015-16_indicative_freeze_grants_publishing_2_.pdf.

⁴¹ Data on the proportion of authorities accepting the council tax freeze grant each year since its introduction are available at <https://www.gov.uk/government/statistics/council-tax-levels-set-by-local-authorities-in-england-2014-to-2015>.

Figure 7.1. Average band D council tax rate in England, April 2015 prices



Source: Department for Communities and Local Government, <https://www.gov.uk/government/statistical-data-sets/live-tables-on-council-tax>; Chartered Institute of Public Finance and Accountancy, <http://www.cipfa.org/about-cipfa/press-office/latest-press-releases/council-tax-freeze>; Office for National Statistics, 'Consumer price inflation reference tables January 2015', <http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tc%3A77-323621>; Office for Budget Responsibility, *Economic and Fiscal Outlook December 2014*, http://budgetresponsibility.org.uk/pubs/December_2014_Charts_and_tables-web516.xls.

The result, as shown in Figure 7.1, is that average band D council tax rates in England have fallen in real terms by 12% since 2010–11. Relative to continuing the average rate of increase from 2007–08 to 2010–11 (the 'no-change' baseline used by HM Treasury), this amounts to a total giveaway across Great Britain of £2.8 billion in 2015–16, a cost shared between local and central government. Council tax is charged at a much lower percentage of property value for high-value properties than for low-value properties, and cutting it therefore disproportionately benefits poorer households.⁴² But the coalition has not addressed the anomaly of why council tax should be less than proportional to property values at all. It is hard to find a good reason for this, and the Mirrlees Review recommended that it should be transformed into a simple percentage of property value.⁴³

The government has actively defended an even more obvious anomaly in council tax: that it is still based on the relative values of different properties in 1991. It is patently ludicrous to tax people based on what their properties were worth (or would have been worth) nearly a quarter of a century ago. Yet as early as September 2010 the Communities and Local Government Secretary, Eric Pickles, proudly announced that he was ruling out an update throughout the coalition's term of office, apparently in order to 'protect the privacy of law-abiding citizens and ... [call] time on the surveillance state' (though the government does not seem to find it similarly intrusive to demand to know people's incomes, for example) and to avoid '[pushing] up taxes on people's homes'

⁴² This is strongly mitigated by the existence of means-tested council tax support, which means that many of those with low incomes and financial assets do not pay full council tax anyway. But high levels of non-take-up, combined with cuts to council tax support introduced by local authorities since it was localised (and funding for it reduced) in 2013, mean that the overall pattern is nonetheless somewhat progressive.

⁴³ See chapter 16 of Mirrlees et al. (2011, op. cit.).

(though there is no reason a revaluation should increase council tax bills on average).⁴⁴ The council tax system has come to look ever more absurd as successive governments have refused to undertake a revaluation. Remedying this is a challenge that will become both more important and more difficult as time goes by.

7.2 Business rates

Until recently, business rates had been one of the most stable parts of the tax system, having barely been changed at all since 1990 except for regular revaluations. Recent years, however, have seen a swelling stream of new announcements. The main reforms introduced by the coalition are:⁴⁵

- The regular five-yearly revaluation of properties due to take place in 2015 has been delayed until 2017.
- Tax rates in England and Wales were increased (in nominal terms) by 2% in April 2014 and April 2015, rather than the 3.2% and 2.3% respectively implied by the usual RPI uprating.
- The (supposedly) temporary doubling of small business rate relief, initially introduced by Labour for the period from October 2010 to September 2011, has been extended by the current government on five separate occasions and is now set to run until April 2016.
- Retail properties with an estimated 2008 annual market rental value of up to £50,000 are eligible for a discount of up to £1,000 in 2014–15 and £1,500 in 2015–16.

All but the first of these are tax cuts, which will no doubt be welcomed by the hard-pressed businesses that benefit from them.⁴⁶ But that does not mean they are necessarily the best use of taxpayers' money.

Individually, most of the policies look hard to justify. If we are to have a tax on property values, it is preferable to base it on current values, or at least on the most up-to-date values possible, so a strong rationale would be needed for extending the life of outdated valuations. The stated rationale for delaying was to avoid sharp changes in bills. But delaying the revaluation merely postpones the required adjustment – and probably makes the eventual changes in bills larger rather than smaller. It would be better to move in the opposite direction: frequent, regular revaluations would mean changes in bills were small, gradual and routine. Meanwhile, the favourable treatment of low-value properties and retail properties lacks a clear justification. It is even less clear why the temporary policies, if desirable at all, should be desirable only for a particular period. For example, why should retail properties be treated more favourably than most other business properties in 2014–15 and 2015–16 but not thereafter?

⁴⁴ <https://www.gov.uk/government/news/pickles-pledge-no-council-tax-revaluation-rises>.

⁴⁵ In addition to those listed here, there have been moves towards greater localisation of business rates (see Section 9, footnote 60) and some smaller reforms. For a fuller discussion, see S. Adam and H. Miller, 'Business rates', in C. Emerson, P. Johnson and H. Miller (eds), *The IFS Green Budget: February 2014*, 2014, <http://www.ifs.org.uk/publications/7072>.

⁴⁶ Delaying revaluation is revenue-neutral overall, but redistributes tax liabilities among businesses. Offices in London and the West Midlands and retail premises in northern England, among others, look like being losers from this delay, while the largest winners are offices in the East Midlands and retail premises in the East Midlands and London.

Collectively, all of these changes to business rates create undesirable instability. Businesses make investment decisions factoring in their expected future tax liability. If the government continually alters the tax regime, it increases uncertainty, making an assessment of the after-tax returns to an investment more difficult, and ultimately deterring businesses from investing. Repeatedly extending 'temporary' reliefs on an ad hoc basis can also make it difficult to rescind what was originally intended to be a short-term policy and can end up inadvertently changing the structure of the tax system.

While the coalition has tinkered extensively with business rates, it has not addressed the fundamental problem with the tax. Taxing buildings used for business purposes creates a disincentive to develop and use business property. The Mirrlees Review argued that, subject to confirming practical feasibility, business rates should be replaced with a system of land value taxation based on what each site would be worth in the absence of any buildings on it – thus creating no disincentive to develop or use property.⁴⁷ Short of such a radical revamp, there are smaller improvements that could be made.⁴⁸

7.3 Stamp duty land tax

Until recently, the coalition government's biggest change to SDLT was to follow in its Labour predecessor's footsteps by adding new, higher bands at the top of the property value scale. The coalition inherited an SDLT with a top rate of 4% on transactions above £500,000 and introduced, for residential property only, new rates of 5% above £1 million and 7% above £2 million. This is estimated to raise £500 million in 2015–16.⁴⁹

The 2014 Autumn Statement introduced a more radical reform to SDLT on housing, following the lead of the Scottish government, which had already announced such a change. Previously, the relevant tax rate for a particular transaction applied to the full sale price, not just the part above the relevant threshold. This so-called 'slab structure' meant that a £1 higher purchase price could be associated with a tax bill thousands of pounds higher (see Figure 7.2).⁵⁰ Since 4 December 2014, this is no longer the case and SDLT works more like income tax, with each rate applying to the amount above the corresponding threshold and no sharp jumps in liability (sometimes called a 'slice structure'). As part of this change, the coalition chose a new set of SDLT rates which meant even higher bills for a relatively small number of the very highest-value transactions but lower bills for the vast majority, at a net cost of about £800 million per year.

Moving away from a slab structure is unquestionably an improvement. It is therefore hard to understand why, unlike in Scotland, it was done only for residential property: SDLT on non-residential property continues to have a slab structure, and the same arguments for changing it apply. And for both residential and non-residential property, the more fundamental problem with SDLT has not been addressed. One of the most basic

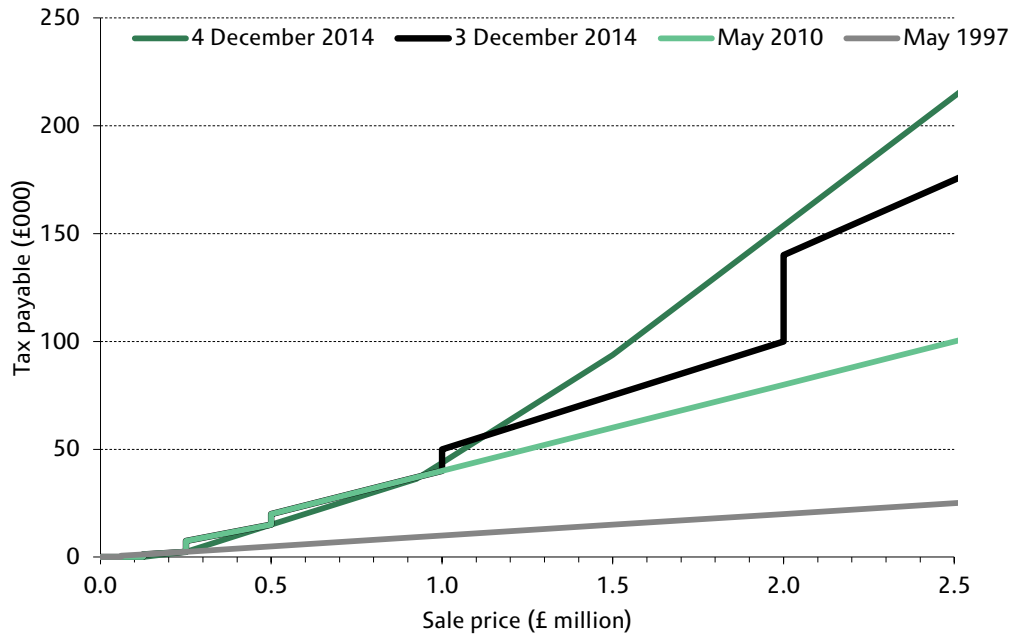
⁴⁷ See chapter 16 of Mirrlees et al. (2011, op. cit.).

⁴⁸ See S. Adam and H. Miller, 'Business rates', in C. Emerson, P. Johnson and H. Miller (eds), *The IFS Green Budget: February 2014*, 2014, <http://www.ifs.org.uk/publications/7072>

⁴⁹ The government also introduced a 15% rate on purchases above £2 million made by certain 'non-natural' bodies such as companies.

⁵⁰ The resulting distortions in the housing market are neatly illustrated in chart 1.13 of HM Treasury, *Autumn Statement 2014*, <https://www.gov.uk/government/publications/autumn-statement-documents> and analysed formally in M. Best and H. Kleven, 'Housing market responses to transaction taxes: evidence from notches and stimulus in the UK', 2015, http://www.henrikkleven.com/uploads/3/7/3/1/37310663/best-kleven_landnotches_feb2015.pdf.

Figure 7.2. Stamp duty on housing transactions



tenets of the economics of taxation is that transactions taxes should be avoided. Assets should be held by the people who value them most; the effect of a transactions tax such as SDLT is to discourage mutually beneficial transactions, so that properties are not held by the people who value them most. If a family in a small house want to move to a larger one (because they are having children, for example) while a neighbouring family in a large house want to move to a smaller one (perhaps because their children have grown up and left home), SDLT might discourage them from buying each other's houses, leaving both families worse off. At a macroeconomic level, one manifestation of this is to reduce labour mobility, as people are discouraged from moving to where suitable jobs are available. The Mirrlees Review argued that SDLT should be abolished altogether and the revenue made up elsewhere⁵¹ – perhaps from a reformed council tax in order to avoid giving out windfall gains to owners of high-value properties.

8. Evasion and avoidance

Tax evasion (illegally failing to pay one's full tax liability) and tax avoidance (legally arranging one's affairs to reduce tax liability without necessarily changing the underlying economic nature of one's activities) have been prominent issues in recent years, prompted by some high-profile examples.

HMRC estimates that tax evasion in 2012–13 (the latest available estimate) was little changed from when the coalition took office, at just over 3% of the revenue the tax system should theoretically deliver.⁵²

⁵¹ See chapter 16 of Mirrlees et al. (2011, op. cit.).

⁵² This figure includes evasion, criminal attacks and the hidden economy. A broader definition (including 'failure to take reasonable care', for example) yields higher estimates but also little change over time. See table 1.4 of HM Revenue & Customs, *Measuring Tax Gaps 2014 Edition*, 2014, <https://www.gov.uk/government/statistics/measuring-tax-gaps>. HMRC defines total theoretical liabilities as the revenue it thinks it would collect if all taxpayers complied with the letter and spirit of the law.

HMRC also publishes estimates of tax avoidance, which are similarly unchanged up to 2012–13, at 1.5% of theoretical liabilities,⁵³ but avoidance is defined very narrowly – it does not include international profit-shifting or taking dividends instead of salary, for example – and so is little guide to the scale and evolution of tax avoidance as popularly understood. We cannot say how much higher the latter would be, though it is almost certainly not as high as simple extrapolation from lurid media case studies might imply since not all taxpayers take the aggressive positions that attract media attention.

To some extent, moral indignation aroused by tax avoidance and evasion might discourage them. This effect is likely to be limited and uneven, affecting individuals and firms in the public eye more than less visible taxpayers taking similar actions. Concrete actions are needed.

Combating evasion is a matter of enforcement, and so a natural starting point is to look at how well resourced HMRC has been. Like many other departments', HMRC's budget has been cut. But its ability to tackle evasion also depends on how resources are directed within HMRC: to some extent, compliance activities have been prioritised, perhaps at the expense of routine customer service.⁵⁴ And technological improvements can help too: the National Audit Office reports that investment in a new technology called Connect, which allows rapid data search to find evidence of potential evasion, 'has enabled HMRC to reduce the number of people they have working in their Risk and Intelligence function by 40% while still increasing the compliance revenue they collect or protect.'⁵⁵

International aspects of anti-evasion activities are increasingly important. Here there have been some definite strides made, though perhaps not with as much effect as might have been hoped. What are perhaps the two highest-profile examples both involve offshore accounts in Switzerland:

- The government reached agreement with the Swiss authorities in October 2011 to tackle offshore evasion by UK holders of Swiss bank accounts. It originally estimated that the agreement would generate £5 billion for the exchequer by March 2016, but later reduced its estimate to £1.7 billion.⁵⁶
- HMRC has been criticised for slow progress in acting on information about 3,600 UK taxpayers with HSBC accounts in Switzerland.⁵⁷

The government's approach to tackling tax avoidance has had three main prongs:

⁵³ This figure includes 'tax avoidance' and 'disputed legal interpretation'.

⁵⁴ For example, the National Audit Office notes that 'HMRC has previously worked towards answering 90% of telephone calls, but has not come close to this level of performance. For 2014–15 it has revised this target to 80% of calls answered, but it does not expect it will be able to achieve this' (page 30 of Comptroller and Auditor General, 'Increasing the effectiveness of tax collection: a stocktake of progress since 2010', 2015, <http://www.nao.org.uk/report/increasing-the-effectiveness-of-tax-collection-a-stocktake-of-progress-since-2010/>).

⁵⁵ Page 14 of Comptroller and Auditor General (2015, op. cit.).

⁵⁶ For details and discussion of reasons for the original overestimate, see box 4.3 of Office for Budget Responsibility, *Economic and Fiscal Outlook December 2013*, <http://budgetresponsibility.org.uk/economic-fiscal-outlook-december-2013/>.

⁵⁷ See the report of the Public Accounts Committee, 18 November 2014, <http://www.publications.parliament.uk/pa/cm201415/cmselect/cmpubacc/458/45802.htm> and recent media coverage such as in *The Guardian*, 8 February 2015, http://www.theguardian.com/business/2015/feb/08/hsbc-files-expose-swiss-bank-clients-dodge-taxes-hide-millions?CMP=share_btn_tw and BBC Panorama, 9 February 2015, <http://www.bbc.co.uk/programmes/b052sk1h>.

- The principal weapon has still been to clamp down on specific avoidance schemes when they are uncovered (often through the Disclosure of Tax Avoidance Schemes, or DOTAS, provisions introduced by the previous Labour government). Every Budget and Autumn Statement has included a raft of anti-avoidance measures, most of them small individually but collectively forecast to raise billions of pounds. There is no clear dividing line between reducing avoidance opportunities and broadening the tax base, so it is hard to separate out 'anti-avoidance' measures and quantify their intended revenue yield. It is even harder to know whether the measures in fact bring in the sums forecast.
- A general anti-abuse rule (GAAR) was introduced in July 2013. It was deliberately narrowly drafted, aimed only at highly abusive schemes rather than a wider concept of avoidance. International experience suggests that its success will depend a great deal on how the courts interpret it. But to date there have been no test cases of the GAAR – not necessarily because it has no practical application, or because it is a completely effective deterrent, but because it takes time for relevant transactions to arise, come to the attention of HMRC, be investigated and come to court. It is still very early days for the GAAR.
- There has been action to tackle international base erosion and profit shifting (BEPS), principally through enthusiastic participation in the OECD's BEPS project and more recently through the announcement that the UK will unilaterally introduce a 25% 'diverted profits tax'. This is discussed in a separate IFS briefing note.⁵⁸

The GAAR and the BEPS project represent a move beyond the traditional approach of simply dealing with each avoidance scheme as it is uncovered. But they are still tackling the symptoms rather than the underlying cause – often a lack of clarity or consistency in the tax base. As the Mirrlees Review noted, 'If activities were taxed similarly, there would be no (or, at least, much less) incentive for taxpayers to dress up one form of activity as another – and there would correspondingly be little or no revenue loss to the Exchequer if they did so.'⁵⁹ If tax evasion is a function of enforcement, avoidance is a function of the tax base. Preventing tax avoidance is not an administrative exercise to be layered on top, but inextricably intertwined with the design of tax policy. Design a coherent tax policy and the problem of avoidance will be much reduced.

9. Tax policymaking

The most remarkable change the coalition has made to the way that tax policy is made is to devolve significantly more tax powers to the different parts of the UK. Taxation in the UK has historically been exceptionally centralised by international standards, so these changes mark a significant departure:

- Scotland will introduce replacements for UK-wide SDLT and landfill tax in April 2015, and will be able to vary all income tax rates (in tandem) on non-savings income by up to 10 percentage points – rather than just the basic rate by up to 3 percentage points, as at present – from April 2016. Although not to be legislated until after the election, all the main parties are committed to implementing the Smith Commission proposals,

⁵⁸ H. Miller and T. Pope, 'Corporation tax changes and challenges', IFS Briefing Note BN163, 2015, <http://www.ifs.org.uk/uploads/publications/bns/BN163.pdf>.

⁵⁹ Page 501 of Mirrlees et al. (2011, op. cit.).

which would also devolve air passenger duty and aggregates levy and would give Scotland almost complete freedom in setting income tax rates and thresholds for non-savings income.

- Wales will introduce its own replacements for SDLT and landfill tax from April 2018. If the Welsh people were to vote 'yes' in a referendum, the Welsh Assembly would also be able to vary each income tax rate (individually) on non-savings income by up to 10 percentage points.
- Northern Ireland will be able to set its own corporation tax rate following an announcement in the 2014 Autumn Statement, expected to be effective from April 2017.
- Local authorities in England have also been given slightly greater control over council tax and business rates.⁶⁰

This devolution of tax-setting powers seems rather ad hoc, with different taxes devolved to different parts of the UK. Corporation tax is to be devolved to Northern Ireland but not Scotland or Wales, while SDLT and much of income tax are devolved to Scotland and (to an extent) Wales but not Northern Ireland. Air passenger duty in Scotland is to be fully devolved, in Northern Ireland has been devolved only for long-haul flights and in Wales is currently the subject of much debate. The apparent lack of an overall strategy for what taxes ought to be devolved makes it hard to know whether there will be further devolution and what form it will take: Scots, for example, might ask why Scotland should not have the power to alter corporation tax rates if Northern Ireland does. The broader ongoing discussions of the constitutional future of the UK may also have ramifications for tax policy. It seems likely that devolution of tax powers will remain unstable for some time to come.

For the moment, however, most tax policymaking remains in the UK government's hands. And there have been some welcome innovations in the way that the UK government makes tax policy. The coalition has:

- published, early in its term of office, a corporate tax road map⁶¹ (which it has largely stuck to) and a tax consultation framework⁶² (on which its subsequent record has been patchy, but on the whole still better than previous governments');
- given more advance notice of the dates of Budgets and Autumn Statements;
- published most Finance Bill clauses in draft several months in advance to elicit feedback;

⁶⁰ The 2011 Localism Act removed central government's powers to cap council tax increases in England directly (powers that constrained many councils during the 1990s and a few in the late 2000s), though it instead requires local authorities to seek approval in a referendum if they propose increases deemed excessive by central government, and in practice central government heavily influences LAs' choice of council tax rates by making grant levels depend on council tax increases. The 2012 Local Government Finance Act gave LAs in England more control over council tax discounts and exemptions, and gave them responsibility for determining council tax reductions for low-income families in place of the previously centralised council tax benefit (this is discussed in S. Adam and J. Browne, *Reforming Council Tax Benefit*, IFS Commentary C123, 2013, <http://www.ifs.org.uk/publications/6183>). The same two pieces of legislation also allowed LAs almost complete discretion to offer business rates discounts and allowed them to keep a share of any growth in business rates revenue that comes from new developments until 2020.

⁶¹ <https://www.gov.uk/government/publications/the-corporation-tax-road-map>.

⁶² <https://www.gov.uk/government/publications/tax-consultation-framework>.

- published policy costings documents alongside Budgets and Autumn Statements, giving more information about the revenue impacts of tax reforms, and set up the Office for Budget Responsibility⁶³ to audit those costings (among other tasks); it has also published analysis of the 'dynamic' effects of two tax cuts (reductions in corporation tax and in fuel duties),⁶⁴ albeit with serious limitations to the analysis and with a striking asymmetry in its failure to publish corresponding analysis of tax increases such as the VAT rise;
- set up the Office of Tax Simplification,⁶⁵ which has helped to simplify the tax system a little (or at least to slow down the growth in its complexity), though the OTS has been under-resourced and the government has tended to act on its recommendations for administrative adjustments while shying away from its calls for more substantive reforms. The OTS is still only on a temporary footing – it will disband after the election unless an active decision is made to renew its term – and its role has also been limited by a remit that allows it to look at existing law but not at proposals in development.⁶⁶

While helpful, these innovations have not removed the principal long-term problems with tax policymaking. Hyperactivity remains a concern, with a perceived need to pull rabbits out of the hat in Budgets, Autumn Statements and party conferences (as well as before elections). So does short-termism, with a focus on firefighting and headline-grabbing rather than long-term strategy. And tax policymaking within Westminster remains concentrated in the Treasury and HMRC, with few checks within government, little parliamentary scrutiny and consultation mostly restricted to technical detail.

10. Future challenges

The next government will begin its term of office borrowing 3.6% of national income over and above that which can be expected to disappear as the economy recovers. This has led all three main political parties to commit to further fiscal consolidation over the next parliament. How much (if at all) tax rises should contribute to reducing the budget deficit will be a central question for the incoming government. So too will be the design of any tax increase: how the government chooses to raise a given amount of additional revenue affects both the distribution of the tax burden across the population and the pattern of economic activity. Tax rises could exacerbate the weaknesses of the current tax system or begin to eliminate them.⁶⁷

A longer-term challenge that future governments will face is how to respond to the growing concentration of income in the hands of a small number of people. Those at the very top of the income distribution have seen their incomes race away from the rest of the distribution over recent decades: between 1978 and 2012, the share of net income

⁶³ <http://budgetresponsibility.org.uk/>.

⁶⁴ <https://www.gov.uk/government/publications/analysis-of-the-dynamic-effects-of-corporation-tax-reductions> and <https://www.gov.uk/government/publications/analysis-of-the-dynamic-effects-of-fuel-duty-reductions>.

⁶⁵ <https://www.gov.uk/government/organisations/office-of-tax-simplification>.

⁶⁶ See T. Bowler, 'The Office of Tax Simplification: looking back and looking forward', IFS Tax Law Review Committee, Discussion Paper 11, 2014, <http://www.ifs.org.uk/publications/7476>.

⁶⁷ For a discussion of the various options a future government might consider if it wished to raise taxes in the next parliament, see S. Adam and B. Roantree, 'Options for increasing tax', in C. Emmerson, P. Johnson and R. Joyce (eds), *The IFS Green Budget: February 2015*, 2015, <http://www.ifs.org.uk/publications/7530>.

received by the top 1% of households more than doubled from 3.0% to 7.1%.⁶⁸ Future governments may want to respond to this by increasing taxes on the better-off and alleviating the burden on the less fortunate. But another consequence of increased inequality is that the government is already quite reliant on a small number of well-off taxpayers for a large proportion of tax revenues. For example, in 2014–15, a quarter of all income tax revenue came from just 0.5% of the adult population (about 250,000 individuals). This reliance leaves the public finances vulnerable to changes in the behaviour of a small group of individuals who are considerably more mobile and responsive to tax changes than the rest of the population. Balancing distributional goals against risks to the public finances from relying on a small number of extremely well-off individuals is not a straightforward matter.

Mobility of high-net-worth individuals and their incomes is one example of a broader challenge: the changing nature of the global economy is making tax bases more mobile and harder to pin down. Whether we think of levying VAT on sales or corporation tax on profits, it is harder to tax digital services such as music streaming than to tax physical goods that are manufactured and sold in easily identifiable places. Globalisation and technological change are not new and, contrary to some predictions, they have not so far prevented governments from raising large amounts of tax revenue. Yet the challenge is nonetheless real and constantly evolving. The UK can respond unilaterally: for example, in the corporate tax field, the current government has both pursued internationally competitive tax rates and introduced a new diverted profits tax ('Google tax') to try to prevent the tax base being shifted out of the UK.⁶⁹ But international cooperation is crucial in this area and multilateral steps are also being taken, including increasing information exchange between tax authorities in different countries, making more demands of tax havens, reforming EU VAT rules, and the OECD-led Base Erosion and Profit Shifting (BEPS) initiative. Much depends on how successful these are and how they are taken forward. Both unilaterally and multilaterally, it is up to the next UK government to decide what role to play.

Closer to home, future governments will need to manage the devolution of tax-setting powers to Scotland, Wales, Northern Ireland and local authorities. Existing plans for tax devolution must be delivered effectively, and it is by no means clear that current commitments are the end of the road. Tax policy is one important part of the ongoing debate on the UK's constitutional future.

There are long-standing weaknesses in the tax system that are still to be addressed. They were set out in detail in the Mirrlees Review and we do not rehearse those arguments again here; some have been mentioned in previous sections. But some of the weaknesses in specific parts of the tax system have recently become, or are becoming, more pressing.

The discrediting of the RPI, and the introduction of more tax thresholds that are not routinely indexed to inflation at all, have highlighted the need for a systematic approach to uprating nominal values in the tax (and benefit) system. Given its flaws, it is hard to justify the continued use of the RPI for uprating indirect taxes and business rates. And the growing number of tax thresholds that are not routinely uprated are storing up problems. As income growth picks up, more taxpayers will face the withdrawal of child benefit, the

⁶⁸ See J. Cribb, A. Hood and R. Joyce, 'Living standards: recent trends and future challenges', IFS Briefing Note BN165, 2015, <http://www.ifs.org.uk/uploads/publications/bns/BN165.pdf>.

⁶⁹ These measures are discussed in H. Miller and T. Pope, 'Corporation tax changes and challenges', IFS Briefing Note BN163, 2015, <http://www.ifs.org.uk/uploads/publications/bns/BN163.pdf>.

60% effective income tax rate associated with withdrawal of their personal allowance, and the additional rate of income tax. Why these thresholds should remain fixed in nominal terms while the thresholds for paying basic- or higher-rate income tax do not is unclear. As the number of individuals affected by these tax thresholds grows, so too will the political pressure to increase them; it would be better to uprate them as a matter of routine than to end up with sudden and unpredictable increases.

This government's relaxation of restrictions on how accumulated funds in defined contribution pensions can be used should also prompt an examination of the generous subsidies to pension saving that exist: the 25% of a pension fund that can be withdrawn free of income tax and especially the complete absence of employer or employee NICs on employer pension contributions. These are usually defended as being compensation for the fact that pensions are a highly inflexible form of savings, available only after a certain age. If, for reasons of public policy, we want people to lock money away for long periods, we are likely to have to provide them with a good reason for doing so. It was never clear that this could justify the magnitude of subsidies we currently have, but in any case the argument is significantly weaker given the coalition's reforms. It is of some concern that current political discourse (and the Labour Party's recent proposals⁷⁰) focuses not on reviewing these subsidies but on less sensible increases in pension taxation: further reducing the limits on pension saving or – more worryingly – restricting the rate of income tax relief on pension contributions, a wholly misguided policy. Pensions taxation is in need of reform, but avoiding the wrong reforms is as important as introducing the right ones.

A future government will also have to deal with the increasing inadequacy of fuel duties. Fuel consumption per kilometre driven is falling and will continue to do so, potentially falling close to zero in the long run as new technologies replace petrol and diesel engines. Since the principal harm done by motoring is not the fuel burned but the congestion caused, the best response to the weakening link between driving and burning fuel would be to move to a nationwide system of congestion charging as proposed by the Mirrlees Review – though that would of course be a major political challenge. On top of the effect of increasing fuel efficiency, the seeming inability of recent governments even to keep the level of fuel duties constant in real terms also poses a risk to the public finances. If fuel duties were to be frozen over the next five years, revenues would be an estimated £4.1 billion a year lower by 2019–20 than if they rose in line with RPI inflation as current public finance forecasts imply, necessitating other large tax increases or spending cuts.

Finally, council tax continues to get ever more out of date. Thanks to the spineless refusal of successive governments to undertake a revaluation, we find ourselves in the absurd position that tax bills in England and Scotland are still based on relative property prices in 1991. Without a revaluation, by the end of the next parliament council tax will be based on property valuations that are 29 years out of date. It is hard to believe that anyone seriously thinks it should eventually be based on valuations from 39, 49 or 59 years previously. Over time, the current arrangement will come to be seen as more and more untenable. At some point, some government will have to grasp the challenge of making the case for intelligent reform.

⁷⁰ Discussed in C. Emmerson and G. Tetlow, 'Labour's proposed pensions takeaway', IFS Observation, <http://www.ifs.org.uk/publications/7613>.

11. Conclusions

While the emphasis of the coalition's deficit reduction plans has been on spending cuts, the overall direct impact of tax changes has also been to reduce borrowing, by £16.4 billion in 2015–16: the net effect of £64.3 billion of tax rises and £48.0 billion of tax cuts. The biggest tax increases were implemented early in the parliament: a rise in the main rate of VAT from 17.5% to 20%, a reduction in the amount that can be saved in tax-privileged pensions, and a 1 percentage point increase in all rates of NICs that had already been pencilled in by the previous Labour government. A steady stream of smaller reforms and a raft of anti-avoidance and anti-evasion measures have also made a sizeable contribution, particularly in increasing income tax revenues.

Within this overall tax increase, however, the government has managed to find scope for three big tax cuts. Foremost among these is the increase in the income tax personal allowance to £10,600 in 2015–16. This measure primarily benefits working-age families in the upper half of the income distribution – few of the poorest families contain a taxpayer, while two-earner couples (who tend to have higher family incomes) benefit twice over from the increase – though reductions in the higher-rate threshold have taken money away from higher-rate taxpayers. Taken together, changes to the personal allowance and the higher-rate threshold implemented by the coalition have a net cost of £8.0 billion. Another area of priority for the coalition has been reducing the main rate of corporation tax, which has fallen from 28% in 2010–11 to 20% by 2015–16 at a cost of £7.6 billion. Both of these priorities were clearly signalled by the coalition when it took office. Not signalled in advance was a series of announcements of real-terms cuts to fuel duties, which in April 2015 will be 15% lower than if the April 2010 duty had simply been uprated in line with the RPI, a £3.9 billion tax cut.

In this briefing note, we have analysed each area of the tax system in turn. A clear theme emerges. For the most part, the reforms introduced by the coalition have involved changes to rates and thresholds but little attempt to address the fundamental structural deficiencies of the tax system:

- VAT has been increased but its base virtually untouched.
- Fuel duties have been cut but their (increasing) unsuitability for tackling congestion has not been addressed.
- Corporation tax has been cut but its base continues to distort investment and financing decisions.⁷¹
- Income tax and NICs rates and thresholds have been adjusted but the two taxes have not been integrated and anomalous features such as the 60% income tax rate have not been addressed.
- Business rates have been cut but made more unstable and continue to discourage property-intensive production.
- Council tax has been cut but allowed to get ever more out of date.
- Tax-privileged pension saving has been further circumscribed but the privileges themselves left intact.

⁷¹ See H. Miller and T. Pope, 'Corporation tax changes and challenges', IFS Briefing Note BN163, 2015, <http://www.ifs.org.uk/uploads/publications/bns/BN163.pdf>.

- Inheritance tax has been increased but its loopholes not closed.
- Capital gains tax has been increased but with no clear strategy for dealing with the tension between minimising disincentives to save and minimising avoidance opportunities.

There have been some welcome structural reforms, but even there the job seems incomplete:

- Stamp duty land tax has moved away from a slab structure for housing but not for non-domestic properties and the more fundamental problems with the tax remain.
- The use of the discredited RPI to uprate cash values has been ended for direct taxes but not for indirect taxes. More problematically, an increasing number of thresholds in the tax system are not uprated at all.

The coalition has made some admirable improvements to the institutions of tax policy, enhancing transparency and allowing better scrutiny. But the way in which it has announced tax policy has not always been so admirable. Some areas, such as fuel duties and business rates, have seen a stream of ad hoc, often temporary, announcements overtaking each other without a clear statement of principles or long-run intentions.⁷² Arguably, the ad hoc and inconsistent approach being taken to devolution of tax-setting powers to different parts of the UK creates similar uncertainty.

There is a better way to make tax policy. The corporate tax road map was a good start, setting out a direction of travel and providing an element of predictability. The next government would be well advised to apply this approach to more elements of the tax system, and indeed to the tax system as a whole. That would help taxpayers to plan, provide a benchmark for assessing the policies actually implemented, and facilitate debate on whether the strategy laid out is the right one. Taking the time to articulate a strategy might even lead to the adoption of better tax policy.

⁷² The annual investment allowance and the bank levy also fall into this category, as discussed in Miller and Pope (2015, op. cit.).