



Institute for
Fiscal Studies

Tax By Design: The Mirrlees Review

Indirect and environmental taxation

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Outline

- Two guidelines for indirect taxation
- Broadening the VAT base
- Financial services
- Housing
- Environmental taxation

We arrive at two guidelines for indirect taxation

1. Tax final consumption only

- VAT generally achieves this
- Transaction taxes, business property taxes and VAT exemptions do not

2. Tax goods at the same rate

- Complexity creates strong presumption against differentiation
- There are sound economic efficiency arguments for differentiation
- But case sufficiently strong in only a few cases
 - Alcohol, tobacco, environmentally damaging products
 - Childcare
- Distributional arguments for differentiation are weaker

Evaluating VAT in the UK

- UK zero-rates most food, water, books, children's clothes,...
 - Clearly for distributional, not efficiency, reasons → should be ended
 - Other countries show that it is not inevitable
- Reduced rate on domestic fuel looks particularly bad given environmental concerns
- Exemptions violate *both* of our principles

Broadening the VAT base (1)

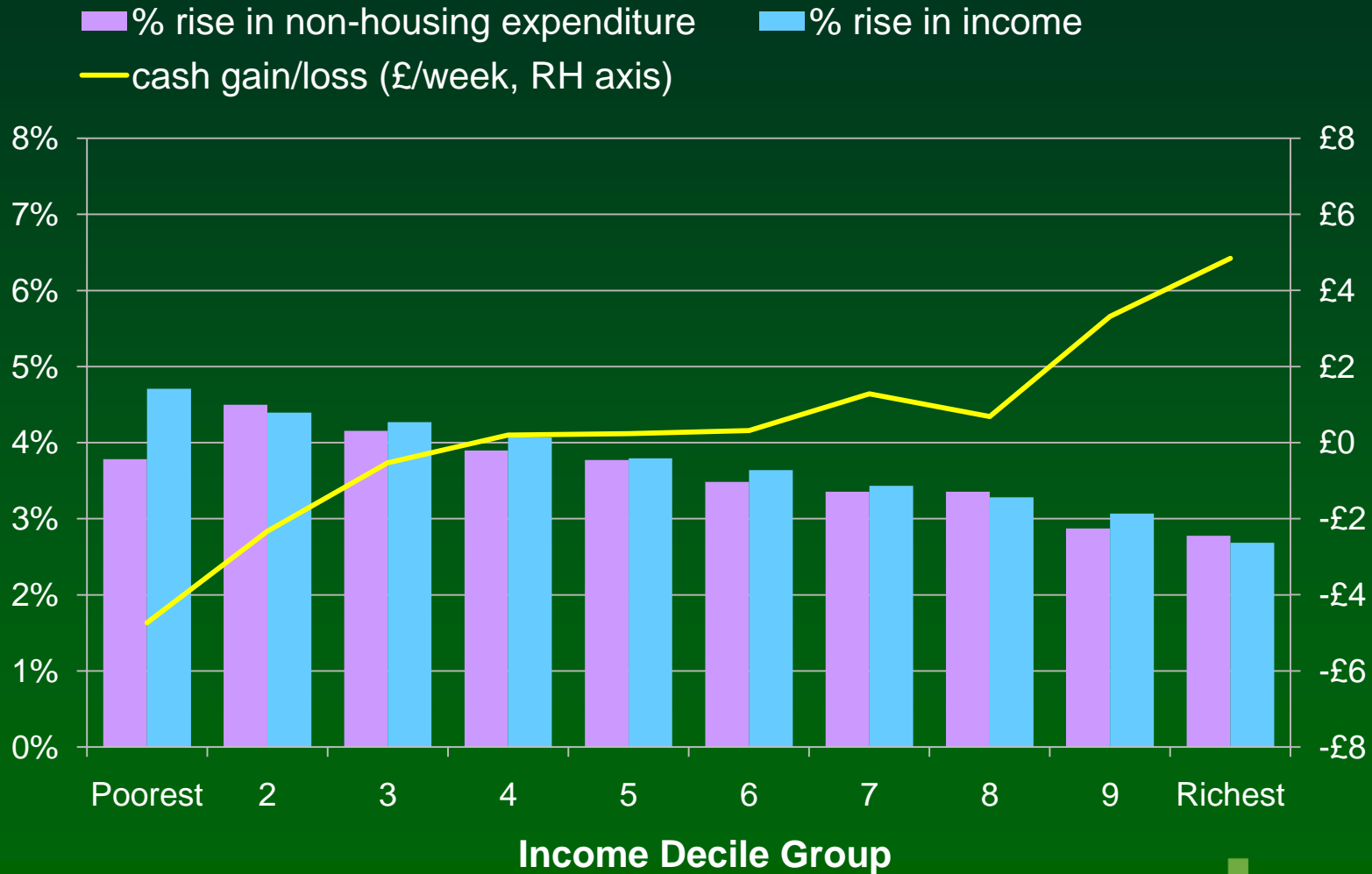
- We simulate removing almost all zero and reduced rates
- Raises £24bn (with a 17.5% VAT rate) if no behavioural response
- Reduces distortion of spending patterns
 - If uniformity were optimal, could (in principle) compensate every household and have about £3bn left over
- But on its own, would be regressive and weaken work incentives
- Can a practical package avoid this?

Broadening the VAT base (2)

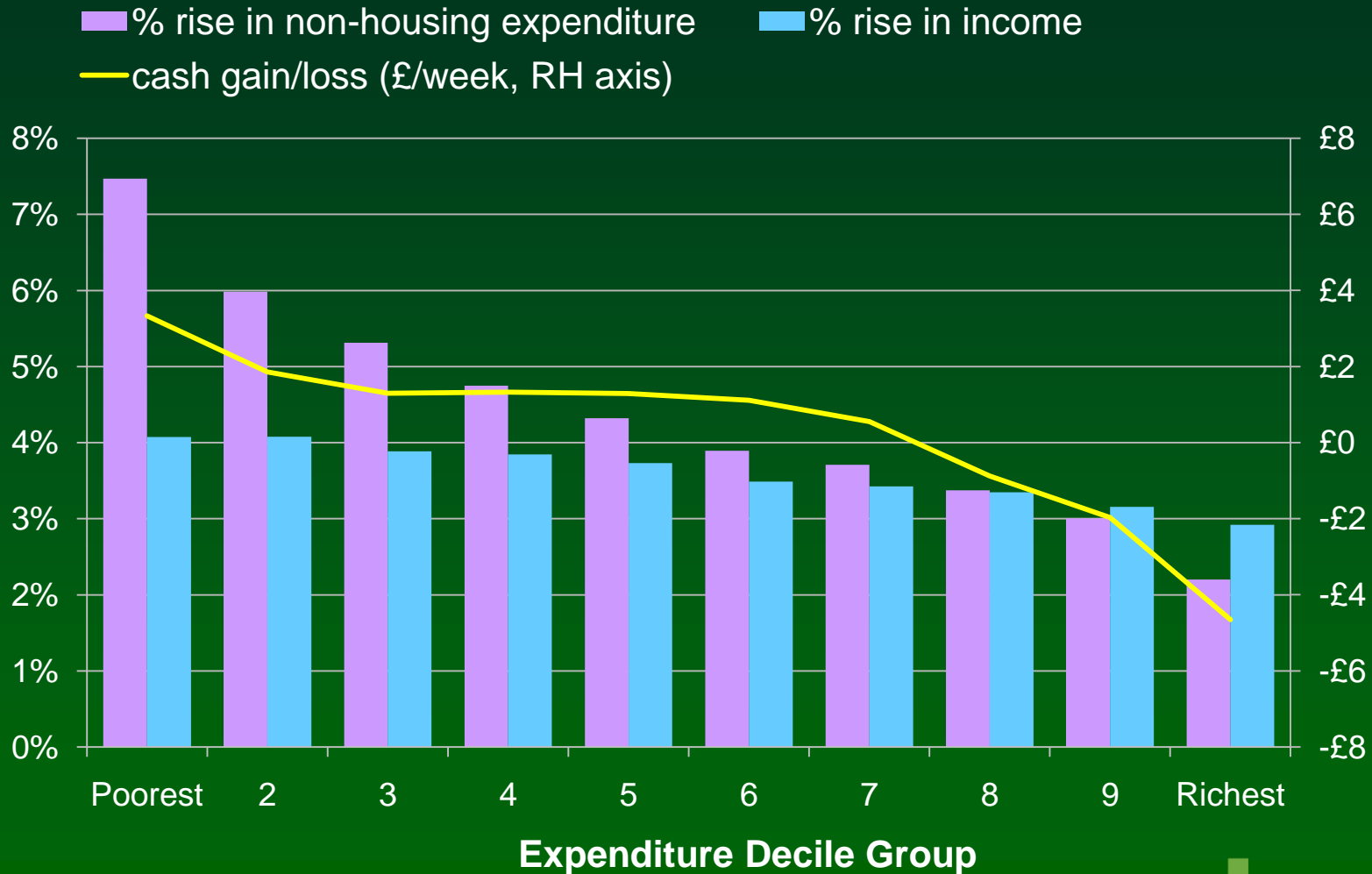
We illustrate one way of using the money:

- Automatic 3.4% indexation of all tax thresholds and transfer rates. Plus...
- Extra 3.4% income-related transfers, 2% state pension, 10% child benefit
- £1,000 increase in income tax allowances
- £4,530 cut in income tax basic rate limit and NIC upper earnings limit
- 2p cut in basic rate, 1½p cut in higher rate, of income tax

VAT reform: effects by income

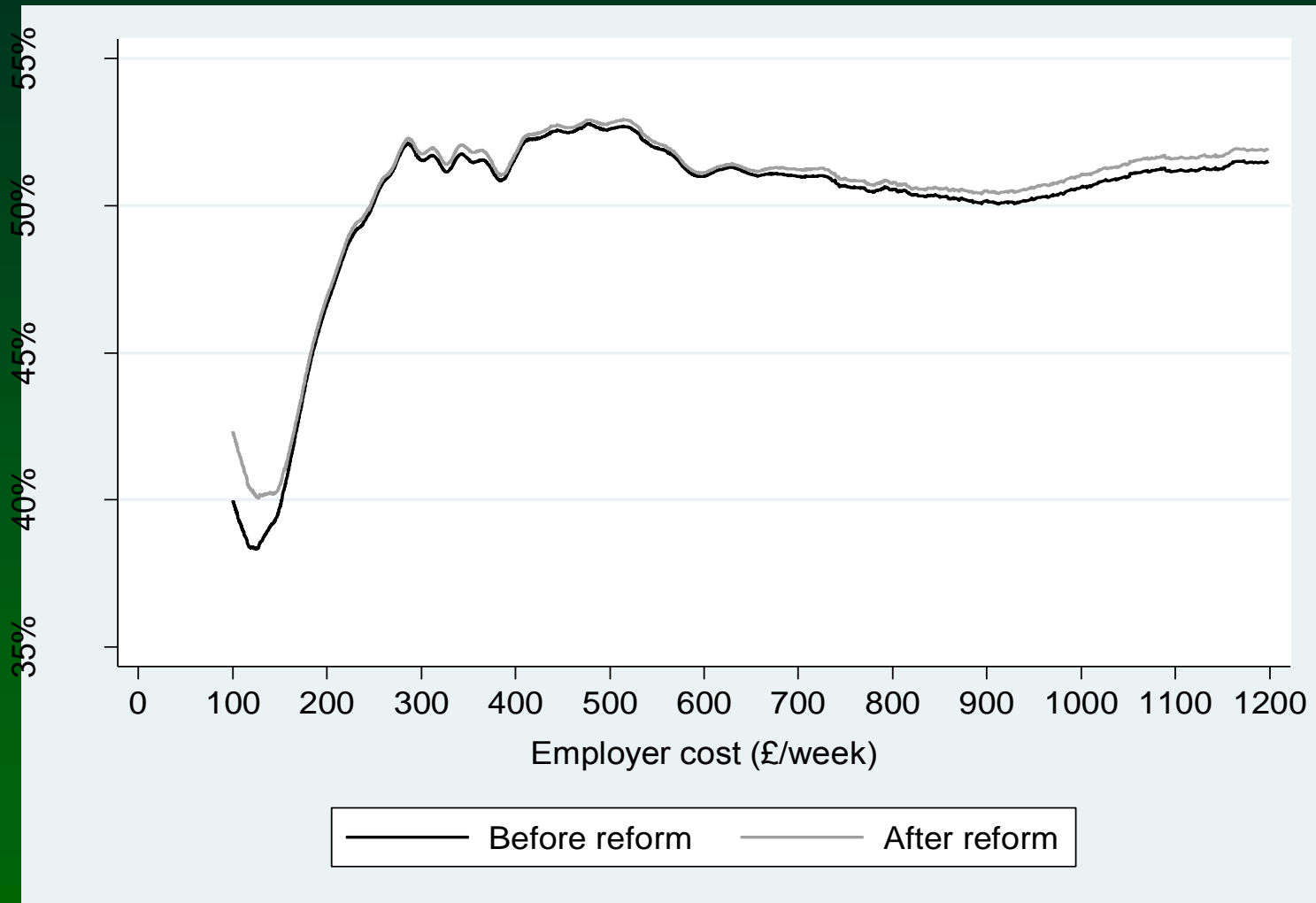


VAT reform: effects by expenditure



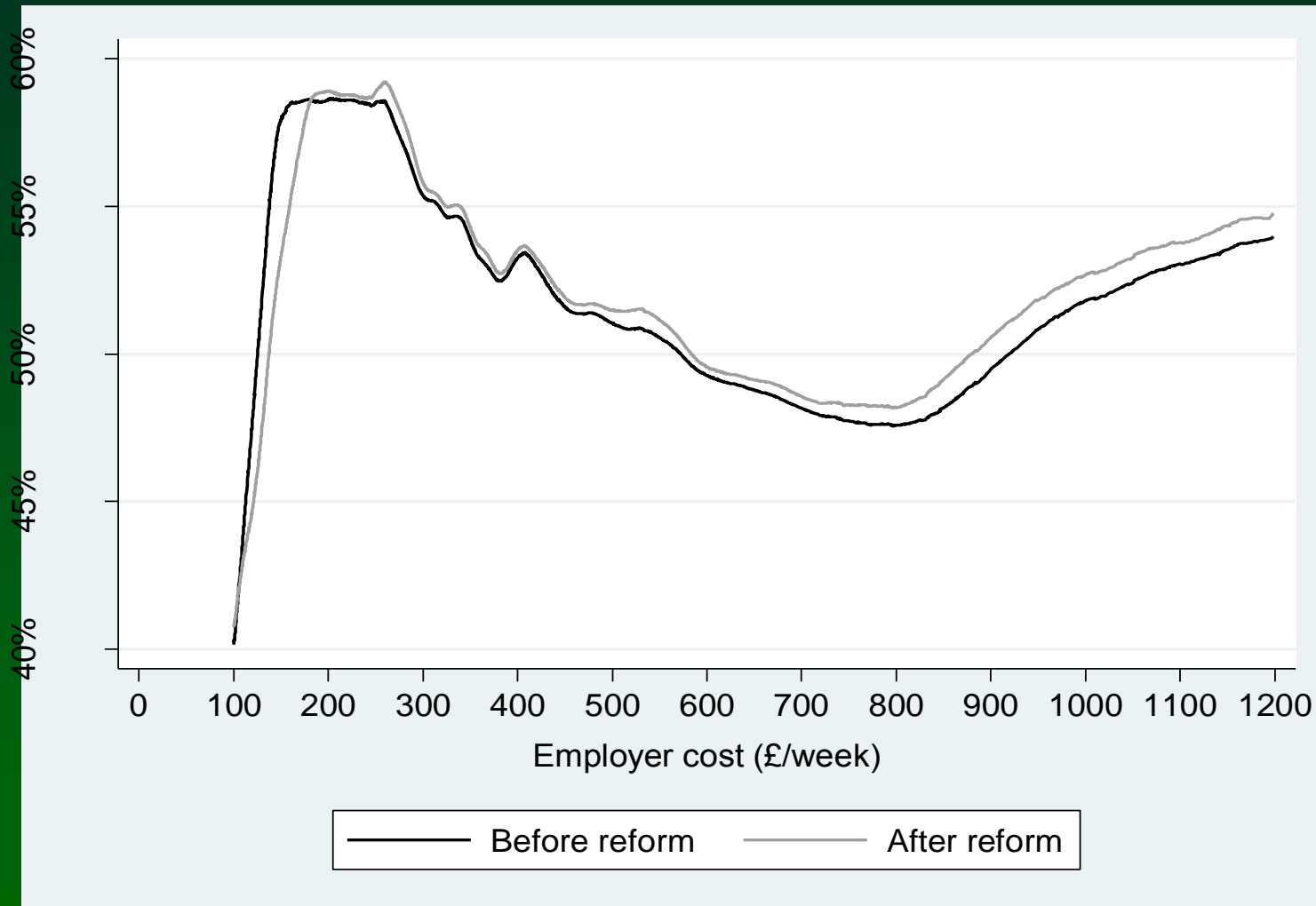
VAT reform: incentive to work at all

Participation tax rates



VAT reform: incentive to increase earnings

Effective marginal tax rates



VAT and financial services

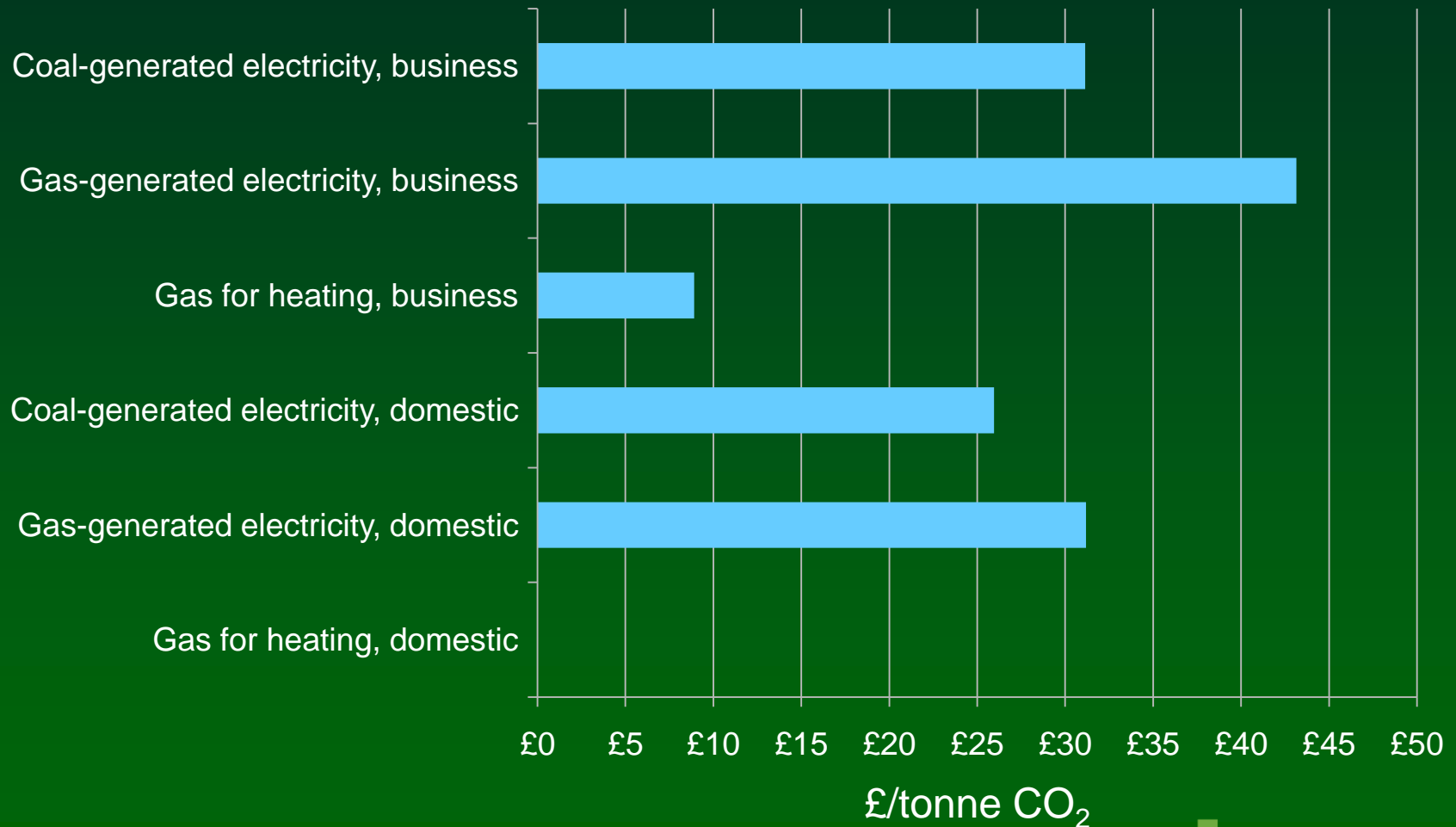
- Consumption of financial services should be taxed
- Exemption causes serious problems
 - Financial services too cheap for households, too expensive for firms
 - Costs around £10bn (though insurance premium tax recoups £3bn)
 - Bias to self-supply, distorted competition, input allocation problems,...
- Can't be taxed through standard VAT mechanism
- But there are equivalent alternatives
 - Cash-flow tax, Tax Calculation Accounts, Financial Activities Tax,...
- Need detailed study to find the most practical option

Taxing consumption of housing services

- Housing should be taxed like other consumption
 - But not currently subject to VAT in the UK
- Could either tax new building, or stream of consumption
- From where the UK starts, the latter makes more sense
- Tax the annual consumption value of housing: substitute for VAT
- An improvement to the UK's existing (badly designed) property tax
 - Regressive banded structure, based on 1991 values, 25% discount for single occupancy
- And replace stamp duty on housing in the process

Implicit carbon taxes in the UK, 2009-10

Excluding VAT subsidy of domestic energy



Congestion charging

- Congestion charging could have big benefits in the UK
 - Government estimates potential welfare gains may be 1% of GDP
- Existing taxes on fuel and car ownership not well targeted at congestion
 - But far too high to justify by carbon emissions alone
- National road pricing should replace much of fuel duty

Summary of main recommendations

- End almost all zero rates, reduced rates and exemptions in VAT
 - Use revenue to compensate poor and maintain work incentives
- Apply equivalent taxes to financial services and housing
 - In some cases replacing inferior existing taxes
- Target additional taxes accurately on damaging activities
 - Move towards consistent pricing of greenhouse gas emissions
 - Replace most of fuel duty with a national system of road pricing