Recent tax reforms: moving in the right direction?

Stuart Adam

HMRC/GES Economics of Tax conference, London, 20 October 2014

What is ‘the right direction’?

- See *The Mirrlees Review,* www.ifs.org.uk/publications/mirrleesreview
  - No view on how high or redistributive taxation should be
  - Asks how to raise revenue and redistribute more efficiently
  - A progressive, neutral system…
- Consider the system as a whole
  - Use the right tools for the right objectives
- Achieve progressivity as efficiently as possible
  - Personal taxes and benefits are the best tools for redistribution
  - Target incentives where they matter most
  - Take a lifetime perspective, considering income and expenditure
- Neutrality as an important benchmark
  - Tends to be simpler, fairer and less distortionary
  - Not always – but should have a high hurdle to justify exceptions

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The coalition government's priorities for tax

- Current government has increased tax overall
  - Biggest contributors: VAT increase and anti-avoidance measures

- Yet still found money for big tax cuts in its three priority areas
  - £12bn – income tax personal allowance
  - £8bn - headline rate of corporation tax
  - £6bn - fuel duty

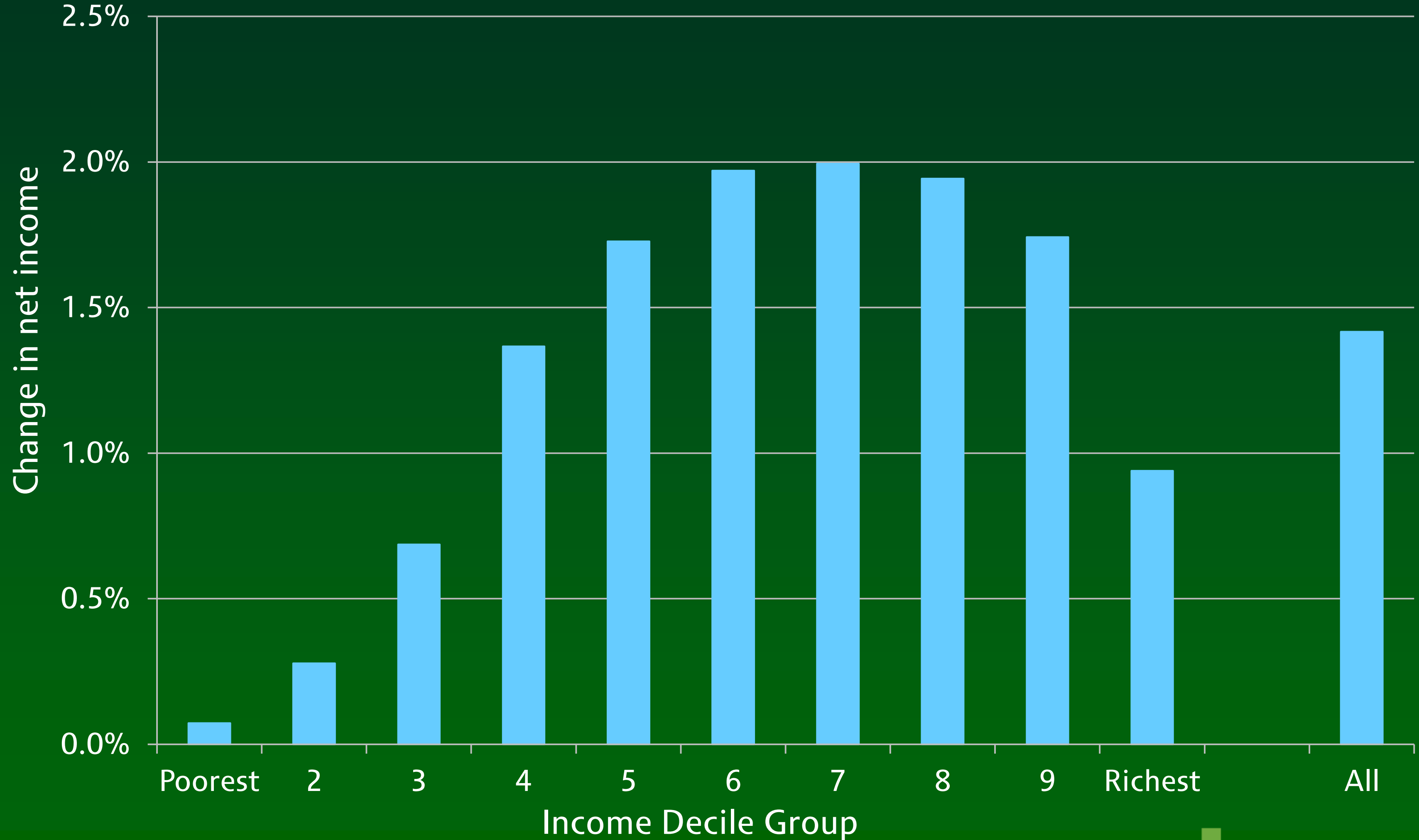
- Two of these three were ambitions clearly stated in advance
  - Fuel duty more piecemeal

Recent reforms to the income tax schedule

- Personal allowance to reach £10,500 in 2015-16
  - £2,855 higher than plans govt inherited – costs over £12 billion per year
  - Basic-rate taxpayers gain £571 a year; 2.4 million taken out of income tax

Increasing the personal allowance

Distributional impact of an increase from £10,000 to £12,500



Assumes higher-rate threshold held constant.
Source: Figure 7.4 of *The IFS Green Budget: February 2014*

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Recent reforms to the income tax schedule

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  - Basic-rate taxpayers gain £571 a year; 2.4 million taken out of income tax
- Higher-rate threshold will be £5,560 lower than plans inherited
  - 1.4m more higher-rate taxpayers

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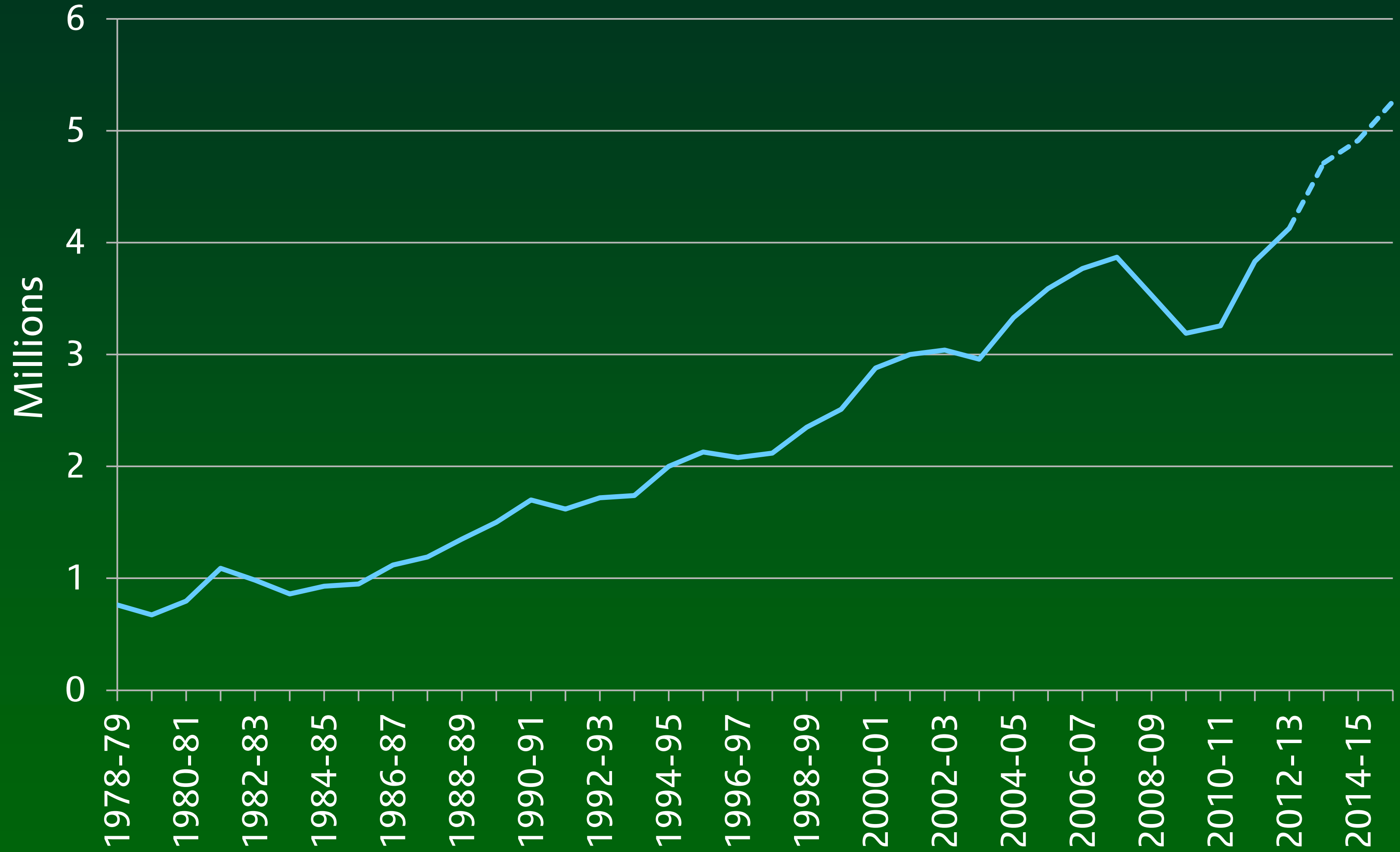
Number of higher-rate taxpayers



Note: includes additional rate taxpayers.
Source: HMRC Statistics and IFS projections

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- Higher-rate threshold will be £5,560 lower than plans inherited
  - 1.4m more higher-rate taxpayers
- 50% rate above £150,000 reduced to 45%
  - The 1% of taxpayers affected provide 30% of income tax revenue
  - Best guess is little revenue effect, but no-one really knows
- But bizarre 60% band above £100k remains in place

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Income tax schedule for earned income, 2014-15

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Other recent income tax reforms

Income tax now starting to depend on family circumstances again

- Being used to withdraw child benefit from those with high incomes
- 10% of tax allowance transferable to basic-rate spouse from 2015

➢ Both complicate the tax system

➢ Both withdrawn in strange ways

➢ No clear principle for how tax should depend on individual/joint income

Real-Time Information (RTI) reporting introduced in April 2013

- Greater use of technology must be right direction of travel
- But must also be ready to use the technology
  - HMRC systems not yet set up to make full use of extra data
  - 'Temporary' easing of requirements needed for many small firms

National Insurance contributions (NICs)

- NICs thresholds not increased in line with income tax allowance
- Hard to see an economic rationale for this
- Highlights absurdity of having two similar but separate taxes
  - Link between ‘contributions’ and benefits small and shrinking
  - NI could be transformed into a true social insurance scheme
  - Otherwise should be merged with income tax: a major simplification
  - Differences that do exist could mostly be kept in a merged tax if desired

Tax treatment of saving

- Income tax starting rate cut to zero and band widened
- ISA limit increased to £15,000 a year and cash/shares division ended
- Pension contribution limits reduced
  - But subsidies (NICs exemption of employer contributions and 25% withdrawn tax-free) still badly designed, and make even less sense with more flexible withdrawal options
- Re-introduced a higher CGT rate (28%) for higher-rate taxpayers…
  - Reduces the incentive to convert income into capital gains
- …but made entrepreneur's relief even more generous
  - Precisely where most scope to convert income into gains!

Tax treatment of saving

- CGT policy has gone round in circles
  - Tension between not penalising saving and not facilitating avoidance

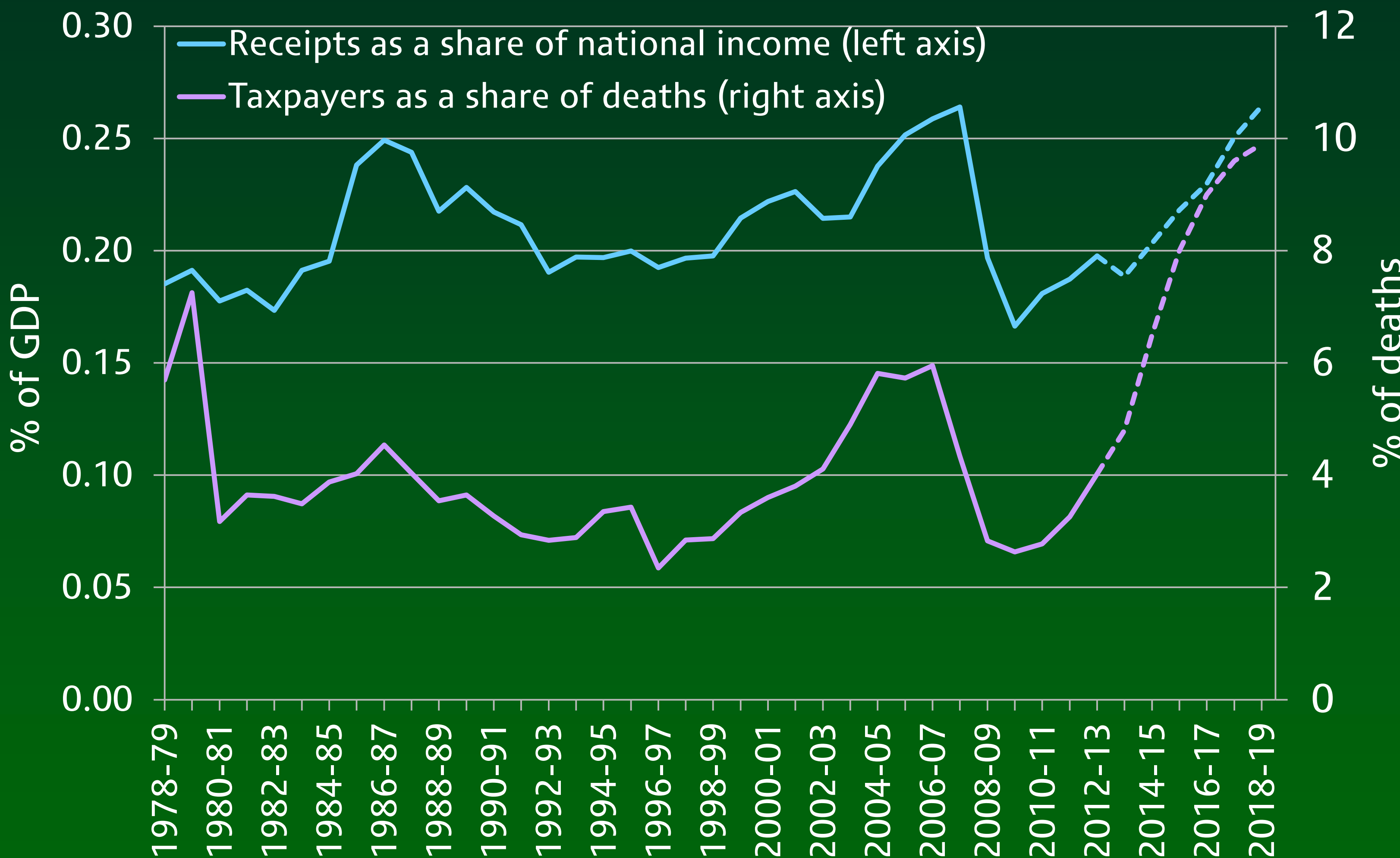
- Many unsolved problems in the current system for taxing saving
  - Saving in many forms discouraged
  - Effective tax rate fluctuates absurdly with inflation
  - Distorts asset allocations (e.g. owner-occupied vs rented housing)
  - Distorts choice between dividends, capital gains and salary
  - Distorts choice of employment vs self-employment vs incorporation
- ❖ Create complexity and anti-avoidance struggles as well as distortions

- Mirrlees Review proposed solution: exempt a ‘normal’ return; apply full labour income tax rates above that

Inheritance tax

- Threshold frozen from 2009-10 to 2017-18: 22% real-terms reduction
  - Despite Prime Minister’s stated desire to increase the threshold

Inheritance tax



Note: estates subject to inheritance tax, or capital transfer tax before 1986-87
Source: authors' calculations based on data from HMRC, OBR and ONS

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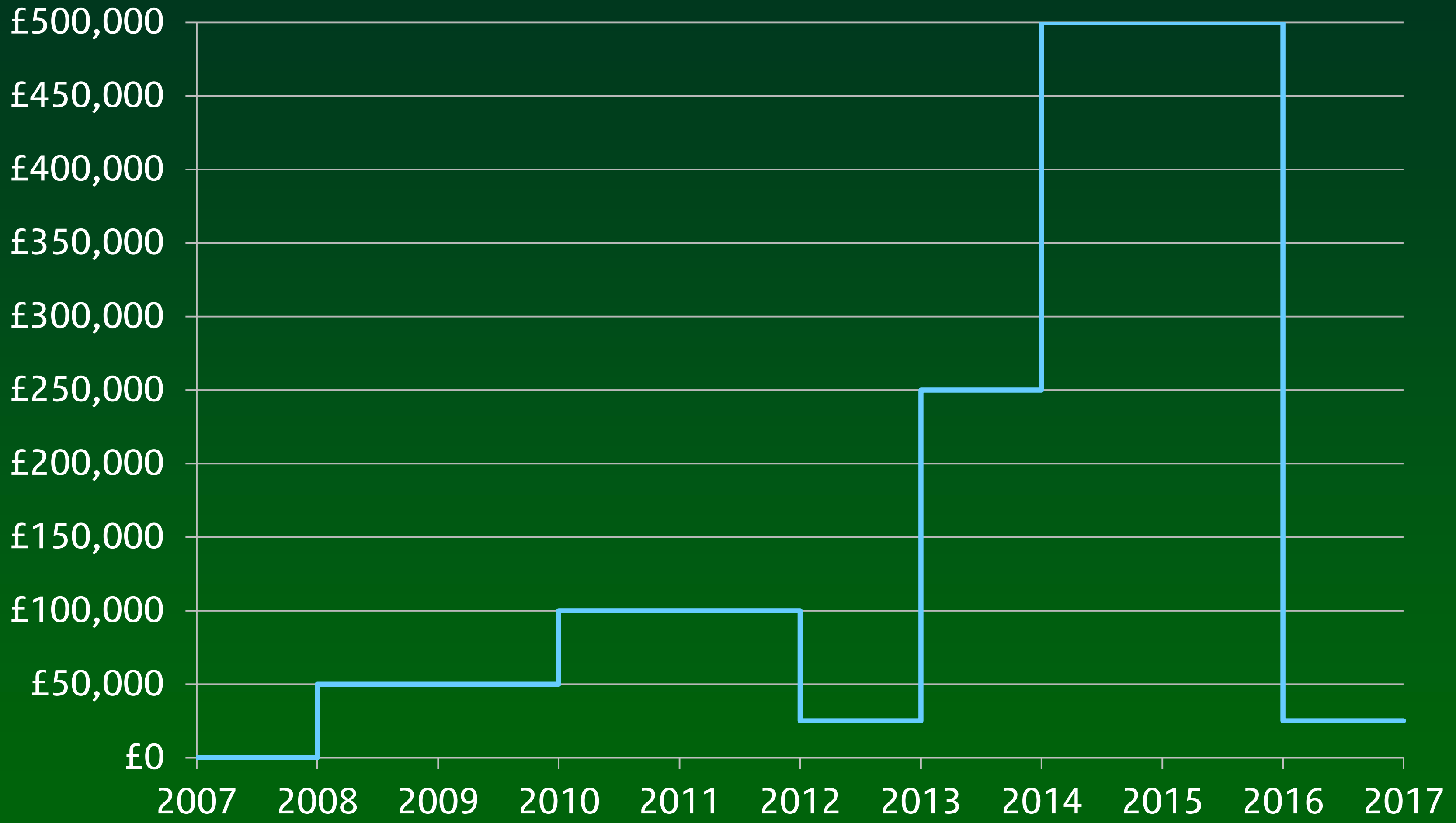
Inheritance tax

- Threshold frozen from 2009-10 to 2017-18: 22% real-terms reduction
  - Despite Prime Minister's stated desire to increase the threshold
- No structural reform
- Still unpopular and economically unsatisfactory
  - Easier to avoid for the very wealthy than the moderately wealthy?
- Does the government believe there is a principled case for this tax?
- Should either abolish or transform into tax on lifetime receipts
  - At the very least, remove some of most obvious avoidance opportunities

Corporation tax

- Unusually, government published a ‘corporate tax roadmap’ soon after taking office and has largely stuck to it
- Broadly sensible direction of reforms to taxation of foreign profits
- Cut main rate from 28% to 20%, at cost of £8bn
  - End of separate small profits rate is especially welcome
  - Introduction of Patent Box more questionable
- Policy on capital allowances less sensible
  - Main allowances cut: these are an efficient way to promote investment
  - Annual investment allowance has been a model of instability

Annual investment allowance



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  - Main allowances cut: these are an efficient way to promote investment
  - Annual investment allowance has been a model of instability
- Concern over debt-equity bias, but done little about it
- Mirrlees Review proposed an Allowance for Corporate Equity
  - Addresses debt-equity bias, discouragement to investment, distorted asset choices, and much more besides!
  - ❖ Must it be a choice between a lower rate and an ACE?

Anti-avoidance

Pursuing three approaches in parallel:

1. A raft of targeted measures in each Budget and Autumn Statement

2. General Anti-Abuse Rule (GAAR) introduced in July 2013

3. OECD project to counter base erosion and profit shifting (BEPS)
   - Tension with measures designed to attract profits to UK
   - Likely to make some progress but not solve fundamental problem
   - ➢ How much of a multinational's profit derives from UK production?
   - ➢ 'Arm's-length' prices often not measurable

The bank levy

- Better designed than bank bonus tax or financial transactions tax
- But seven rate changes since 2010 can’t be sensible!
- Why set a revenue target?

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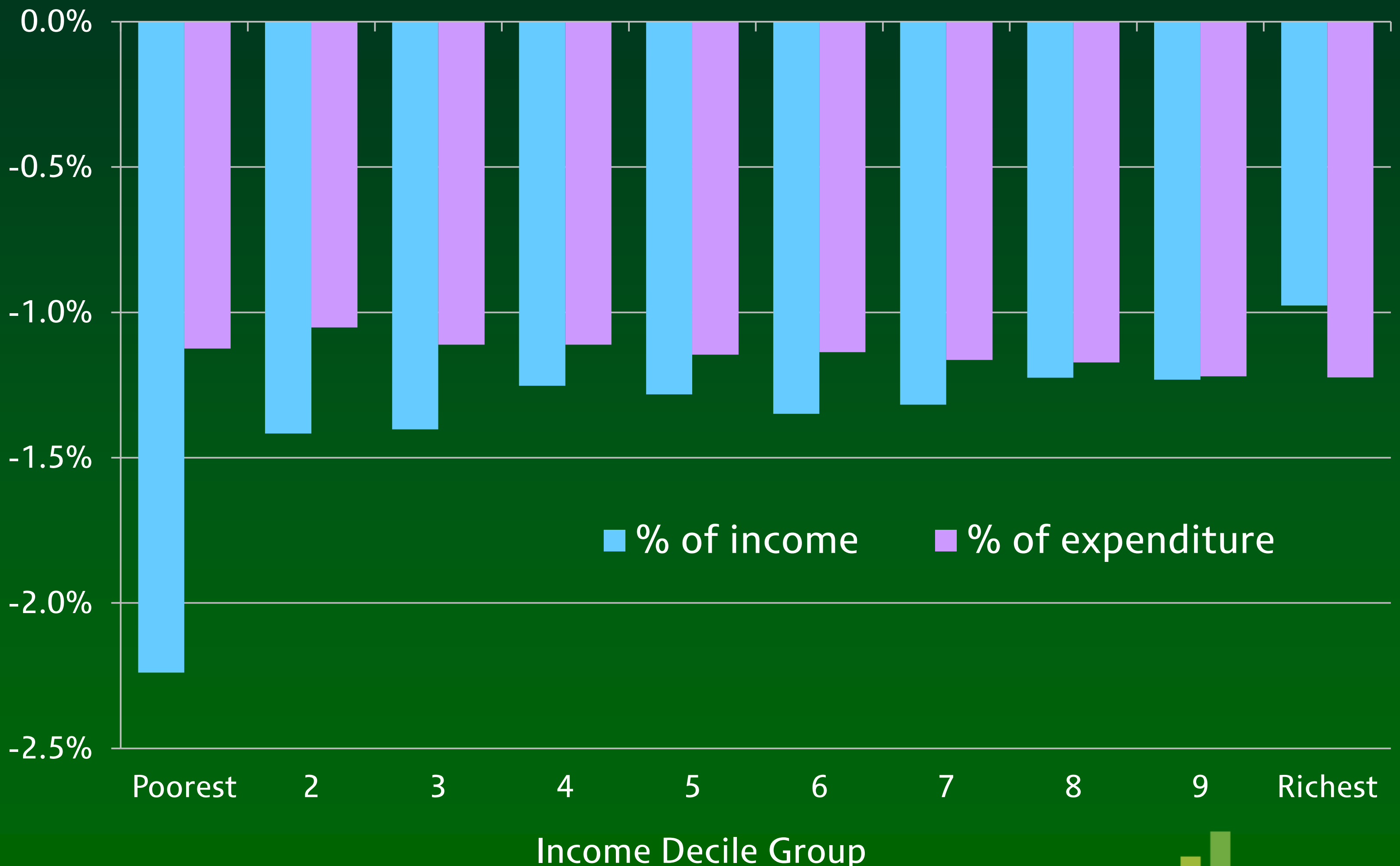
VAT

- Main rate increased from 17.5% to 20%, raising £13bn this year
- Not regressive as often claimed
  - Should look at VAT as % of current spending, not income

Distributional impact of increasing main VAT rate to 20% by income decile



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VAT

- Main rate increased from 17.5% to 20%, raising £13bn this year
- Not regressive as often claimed
  - Should look at VAT as % of current spending, not income
- But magnifies distortions caused by narrow tax base…
- Zero & reduced rates are a complex and inefficient way to redistribute
  - 5% rate on domestic fuel particularly bad given environmental concerns
  - Better alternatives are available!
- Exemptions are the most damaging aspect of VAT
  - Mostly mandated by EU rules
- No sign of serious reform of the VAT base
  - ‘Pasty tax’ became a hot potato and failed
  - Does this show impossibility of widening base, or need for more comprehensive change?

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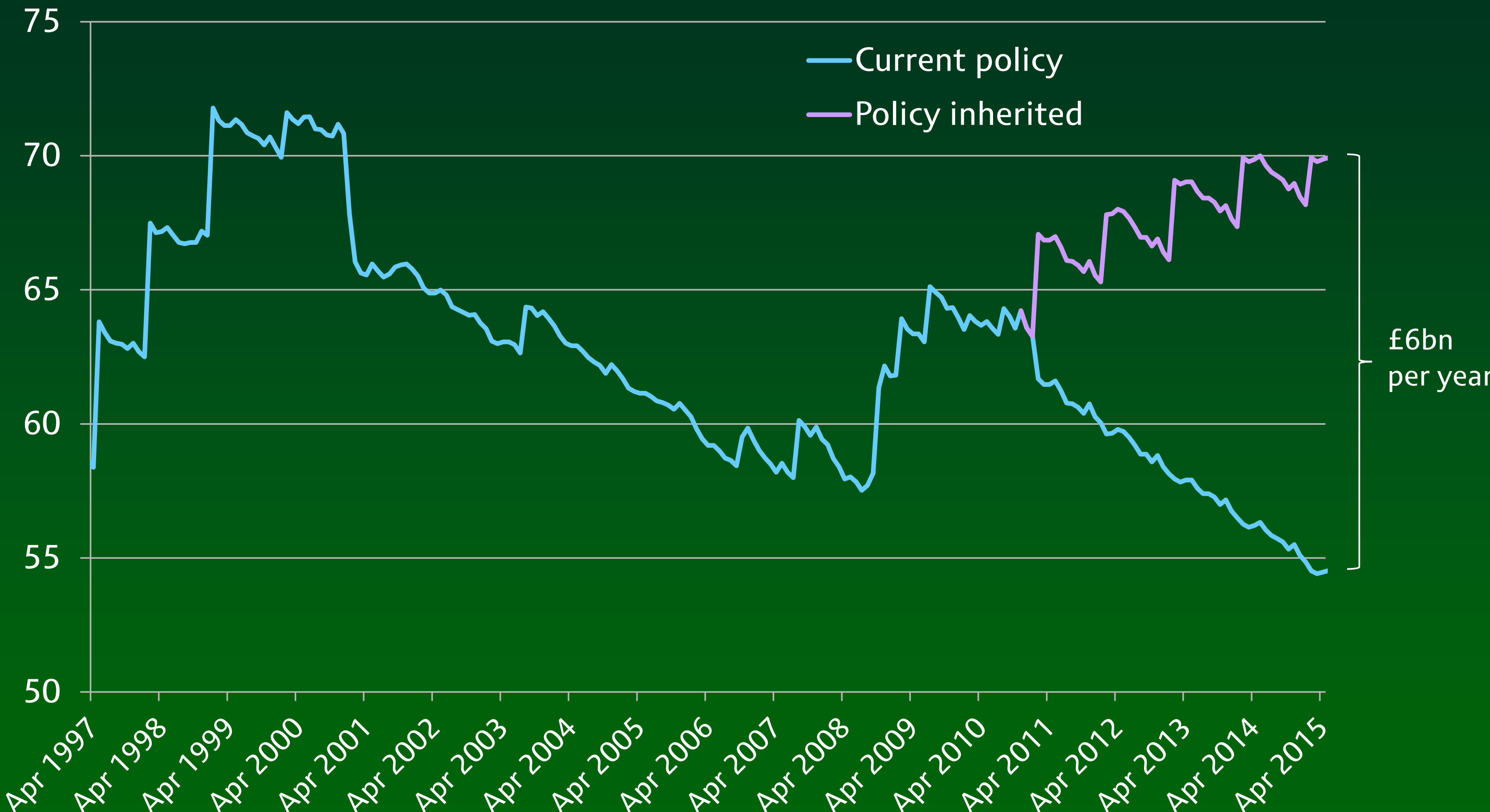
Real duty on a litre of petrol

Pence, April 2013 prices



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Fuel duty: to uprate or not to uprate?

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Property taxes

Stamp duty land tax

- Higher rates for sales >£1m; fundamental design flaws untouched
  - ‘Slab’ structure absurd: £1 higher price can mean £40,000 higher tax bill
  - More fundamentally, transactions should not be taxed at all
  - Should replace with better-designed property taxes

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Property taxes

Stamp duty land tax

- Higher rates for sales >£1m; fundamental design flaws untouched

Council tax

- Paid councils to freeze rates; fundamental design flaws untouched
  - Still based on 1991 property values in England and Scotland
  - Wide bands
  - Regressive
  - 25% discount for single occupancy

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Stamp duty land tax

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Business rates

- Abandoned long-run stability…
  - 5-yearly revaluation delayed for the first time
  - Rate failed to keep pace with inflation for the first time
  - ‘Temporary’ doubling of small business rate relief, extended 4 times
  - Temporary relief for retail properties introduced
- …while fundamental design flaws untouched
  - Discourages development and use of business property
  - Taxing value of land (excluding buildings) would not do this

Room for improvement
Ideas from the Mirrlees Review

- Strengthen work incentives at responsive points of the life-cycle
- Merge income tax and National Insurance
- Broaden the VAT base (with appropriate compensation package)
- Major overhaul of property taxation
- More consistent carbon price; target motoring taxes on congestion
- Reform the taxation of savings and profits
  - Give full allowance for amounts saved/invested
  - Apply same overall statutory rates to income from all sources

Tax policy-making

- Some recent improvements in institutional arrangements
  - Set up Office for Budget Responsibility and Office of Tax Simplification
  - More transparency re policy costings
  - Somewhat better consultation
- But many long-standing problems remain
  - Hyperactivity: perceived need to pull rabbits out of the hat in Budgets, Autumn Statements and party conferences (as well as before elections)
  - Short-termism: focus on fire-fighting and headline-grabbing rather than long-term strategy
  - Centralisation: tax policy-making very concentrated in HMT and HMRC, with few checks within government, little parliamentary scrutiny, and consultation mostly restricted to technical detail

Conclusions

- Small overall tax rise; significant shift in tax mix
  - VAT increased; income tax, corporation tax and fuel duty cut
- Changes mostly to tax rates – little change in tax base
  - Missed opportunity to address fundamental inefficiencies in tax structure
- Some improvements in institutional arrangements
  - But still problems with the way tax policy is made
  - So lack of clear strategy in many areas and for the tax system as a whole

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