

# Better Budgets: making tax policy work

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Taxes, like death, are unavoidable. But we can design our taxes. We are not bound to have a tax system as inefficient, complex, and unfair as our current one. To improve things, we need to see the system as a whole, we need to design the system with a clear understanding of the population and economy on which it operates, and we need to apply economic insights and evidence to the design. We also need a much more informed public debate and a much better set of political processes than the ones we currently have.

So my co-authors and I said in the introduction to the Mirrlees Review<sup>2</sup> published in 2011. The question is: what is it that prevents better decision-making and the creation of a better system?

It's not the lack of importance. Four pounds in every ten generated in the economy is collected in tax. The way the tax system is designed inevitably has a huge effect on the operation of the economy. That is inescapable. By designing the system better, there are really substantial economic benefits to be reaped. As we showed in the Mirrlees Review, the costs of a poorly designed tax system run into many billions of pounds in reduced output and welfare. In that review, we also set out one possible strategy for unlocking some of these benefits, a strategy based on treating the tax system as just that, a system, and recognising that there are often substantial costs associated with treating similar activities differently.

And it's not that there haven't been some attempts to improve the process of tax policymaking. The current government has attempted to produce a more coherent structure for developing tax proposals, from policy formulation through to legislation and implementation.<sup>3</sup> This new approach to tax policymaking is backed up by the Tax Professionals Forum.<sup>4</sup> There is also the innovation of the Office of Tax Simplification.

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<sup>1</sup> With thanks to Malcolm Gammie, Carl Emmerson and Stuart Adam for helpful comments.

<sup>2</sup> 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*, OUP for IFS, Oxford, 2011 (<http://www.ifs.org.uk/mirrleesReview/design>).

<sup>3</sup> [http://www.hm-treasury.gov.uk/tax\\_policy\\_making\\_new\\_approach.htm](http://www.hm-treasury.gov.uk/tax_policy_making_new_approach.htm).

<sup>4</sup> [http://www.hm-treasury.gov.uk/tax\\_forums\\_tax\\_professionals.htm](http://www.hm-treasury.gov.uk/tax_forums_tax_professionals.htm).

Nor is it a want of consultation. The amount of consultation in the current policymaking process is almost overwhelming.<sup>5</sup>

But there do seem to be three very substantial barriers to better policy.

First, tax policy is made annually (or increasingly biannually) in Budgets (and Autumn Statements). No government or opposition lays down a strategy for the tax system as a whole. There is every indication that policies are made in isolation, and with little sense of how they fit together over the long run. While there is much consultation, most of the effort is put into tinkering with the existing system to try to make the bits that don't work well work a bit better without necessarily thinking more fundamentally about why the bits in question are not working well, or continue to give rise to 'avoidance' issues. There is little attention paid to any form of long-term strategic framework for the development of the tax system as a whole.

Second, there is a remarkable lack of challenge within the executive and effective scrutiny and challenge from the legislature. The Treasury challenges spending departments. Who is to challenge the Treasury when it makes tax policy? The enhanced role of HM Treasury, in the wake of the O'Donnell Review,<sup>6</sup> may at times have limited the challenge that comes from HM Revenue and Customs. While the Treasury Select Committee and the Public Accounts Committee have increased their oversight of tax policy, they remain poorly resourced for focusing on such a large and complex issue.

Third, the general quality of political and public debate is limited, allowing poor policy to be passed off as good all too easily, resulting in an unhelpful focus on specific parts of the tax system, and often making change politically difficult. Very specific elements of the system – notably rates of income tax – achieve totemic significance far beyond their true importance, while changes to other parts of the system are often given wholly inadequate attention.

## Strategy

The current government has set out some elements of a tax strategy – for example, on corporation tax and on the income tax personal allowance – though

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<sup>5</sup> See [http://www.hm-treasury.gov.uk/tax\\_updates.htm](http://www.hm-treasury.gov.uk/tax_updates.htm).

<sup>6</sup> G. O'Donnell, *Financing Britain's Future: Review of the Revenue Departments*, Cm 6163, HM Treasury, 2004 ([http://webarchive.nationalarchives.gov.uk/+/hm-treasury.gov.uk/budget/budget\\_04/associated\\_documents/bud\\_bud04\\_odonnell\\_index.cfm](http://webarchive.nationalarchives.gov.uk/+/hm-treasury.gov.uk/budget/budget_04/associated_documents/bud_bud04_odonnell_index.cfm)).

neither is by any means complete. With respect to the corporation tax regime, the stated aim is to make it 'the most competitive in the G20'.<sup>7</sup> That leads to a lower headline rate and indeed the 'Patent Box'. But how it helps determine the appropriate treatment of multinationals' profits – the focus of much recent coverage – is less clear. And the focus on the income tax personal allowance, by ignoring the second main tax on earnings – National Insurance contributions – is at best a partial strategy.

And in common with its predecessor, this government has revealed little by way of a wider strategy. This makes bad policy too easy to make. The last government's introduction, and then abolition, of a 10p rate of income tax, a 0% rate of corporation tax, and very low rates of capital gains tax for assets held more than two years, all exemplify the lack of consistency – and the economic and political costs – associated with a lack of strategy.

This government has seen the costs in a different form. It is easy to draw the wrong lessons from the 2012 Budget, famous for the way it resulted in the term 'omnishambles' being popularised. The Budget's perceived omnishambolic nature resulted from a series of unpopular tax changes, two of which were soon ditched. The infamous set of policies included the abolition of the higher personal allowance for pensioners, the extension of VAT to cover pasties (and other warm food) and the inclusion of charitable donations in a cap on the total amount of income tax relief that individuals could claim.

Most of these policies could form part of a perfectly sensible tax strategy. Had the Chancellor announced in 2010 that, once the government had achieved its ambition of a £10,000 income tax allowance, it would make sense to treat pensioners the same as everyone else rather than have a very slightly bigger allowance for them, it seems likely that would have been greeted as a sensible reform. Instead, he sprang the announcement on an unsuspecting world – and didn't help his cause by referring to it as a measure to simplify the system.

The design of VAT is even more important for the structure of the tax system. With a standard rate of 20% and a wide range of products where VAT is charged at 0%, we already have a series of close-to-random cliff edges in the system where goods one side are charged at 20% and goods the other side are charged at 0%. We at IFS have long argued that a broader VAT base (as most other countries have) would make more economic sense. One way to get there would

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<sup>7</sup> See HM Treasury, *Corporate Tax Reform: Delivering a More Competitive System*, 2010 ([http://www.hm-treasury.gov.uk/corporate\\_tax\\_reform.htm](http://www.hm-treasury.gov.uk/corporate_tax_reform.htm)).

be gradually to bring in goods, a pasty at a time as it were. But that's not what the policy looked like last year. It was not presented as part of a long-term strategy.

The nearest we have seen to clear strategic direction in recent years has arguably come from HMRC in the administration of the system. Thus changes in PAYE or the way in which large companies' tax affairs are handled, or HMRC powers and penalties, seem to involve longer-term strategic thinking. But that is down to HMRC as an administrator of the tax system rather than longer-term thinking about the shape of the tax system.

As we set out in 2011,<sup>8</sup> the lack of a strategy for policy can have serious costs:

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

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

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<sup>8</sup> P. Johnson, 'Defining a tax strategy', in M. Brewer, C. Emmerson and H. Miller (eds), *The IFS Green Budget: February 2011*, IFS Commentary 117, 2011 (<http://www.ifs.org.uk/budgets/gb2011/11chap9.pdf>).

system as a whole, then we are bound to have difficulty evaluating any particular change to it.

### **Challenge and scrutiny**

Parliamentary oversight of tax policy is arguably less effective than is oversight of many other elements of public policy. Part of this arises from the particular nature of the Finance Bill. In addition, the Treasury Select Committee is probably too poorly resourced to scrutinise the whole of Treasury activity, in particular complex issues of taxation.

In 2003, Sir Alan Budd said in a Tax Law Review Committee (TLRC) report that ‘the truth of the matter is that the House of Commons has neither the time nor the expertise nor, apparently, the inclination to undertake any systematic or effective examination of whatever tax rules the government of the day places before it for its approval’.<sup>9</sup> Things have improved somewhat since then. There are signs that both the Treasury Select Committee and the Public Accounts Committee are being more active in the tax field than in the past, though whether they are having more impact is less clear. What is not in doubt is that their job is made all the harder by the lack of a coherent strategy against which to measure the performance of the executive.

The current government has also improved the legislative process by ensuring that almost all Finance Bill legislation is exposed in draft (usually in the Autumn Statement with a view to legislation in the following Budget). One thing this has done is allow the House of Lords Economic Subcommittee to hold its sessions on the Finance Bill in January by reference to the draft proposals. While the limited role of the Lords in the Finance Bill process remains anachronistic, this is a move in the right direction.

There are clearly ways of further improving the scrutiny of tax policy. The establishment of a tax policy select committee, as recommended by Lord Howe in his 2008 report *Making Taxes Simpler*,<sup>10</sup> is one option. Providing parliament with significantly more expertise and resources than are currently available is another – perhaps modelled in part on the US Congressional Budget Office. One could imagine a wider role for the Office for Budget Responsibility. Involving the House

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<sup>9</sup> Page 5 of A. Budd, ‘Making tax law’, Tax Law Review Committee, Discussion Paper 3, 2003 (<http://www.ifs.org.uk/comms/budd03.pdf>).

<sup>10</sup> *Making Taxes Simpler*, Final Report of a Working Party chaired by Lord Howe of Aberavon, July 2008.

of Lords more would provide a third leg to increased accountability. And having the executive provide a strategic policy framework against which it can be held accountable would set an overarching context for such accountability.

In addition, there has tended to be less evaluation of tax policy than of policies in other areas. There is certainly no systematic process in place to review the effectiveness of changes one or two years after they have been made. This is a role that could be played by a select committee or other body with some degree of independence from the executive.

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

## **HMRC and HMT**

Since the O'Donnell Review of 2004,<sup>11</sup> responsibility for tax policymaking has been split between HMRC and HM Treasury, with the latter taking lead accountability and responsibility for policymaking and the former being responsible for 'policy maintenance'. Work for the TLRC<sup>12</sup> concluded that 'the experience of the past five years has shown that the current organisation of tax policymaking is not working as effectively as it should to produce clear, effective tax policies and a coherent, competitive tax system' (page 1). In an echo of our earlier discussion, the report goes on to say that, 'at times, it can appear that those involved are solely focused on the immediate tax problem they are tackling and the wider implications of a measure are not considered' (page 2).

In common with other commentators, the TLRC Discussion Paper stresses concerns that HM Treasury, where there can be a lack of knowledge and

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<sup>11</sup> G. O'Donnell, *Financing Britain's Future: Review of the Revenue Departments*, Cm 6163, HM Treasury, 2004 ([http://webarchive.nationalarchives.gov.uk/+hm-treasury.gov.uk/budget/budget\\_04/associated\\_documents/bud\\_bud04\\_odonnell\\_index.cfm](http://webarchive.nationalarchives.gov.uk/+hm-treasury.gov.uk/budget/budget_04/associated_documents/bud_bud04_odonnell_index.cfm)).

<sup>12</sup> T. Bowler, 'Tax policymaking in the UK', Tax Law Review Committee, Discussion Paper 8, 2010 (<http://www.ifs.org.uk/comms/dp8.pdf>).

continuity in tax policy, is too much the senior partner in the policymaking process, with inadequate input from those at HMRC who really understand how the system works. And there is uncertainty among stakeholders over how the tax policy partnership between HMRC and HMT actually works. The paper suggests that this has led to a number of problems:

- *A disconnect between those responsible for tax policy and those operating in the field.* There is a perception that tax policy expertise is undervalued in HMRC, which consequently does not contribute as effectively as it could to policymaking, whilst policymakers in the Treasury understand too little of the effects of their decisions. In a paper for the Mirrlees Review, Alt, Preston and Sibieta report an interviewee as saying that ‘the reallocation weakened the link between HMT and assessment of what happened in the field. Now the process has a clear divide with policy in HMT, but real-world experience is at HMRC and they don’t communicate as well as if they were all in one organization. It also affects career structures: now, if you are interested in tax policy, you go to HMT. If you start there the chance you will understand what happens in the field or on the ground is low. Policy becomes divorced from an understanding of how it is affecting behaviour in the field’.<sup>13</sup>
- *An inadequately unified approach to the tax system, leading to increasingly disjointed tax policy and contributing to the complexity and inaccessibility of the tax system.* The TLRC paper suggests that ‘experience indicates that this previous structure [i.e. the pre O’Donnell Review structure in which tax policymaking was more firmly entrenched in the revenue departments] in fact brought greater control over the interaction of changes and a more unified approach to management of the tax system’ (page 5) and that HMRC has become narrowly focused on revenue protection and reducing avoidance within the system, rather than helping to create a system that works effectively in itself.
- *A lack of clarity of responsibility for policy, which affects stakeholders.* Numerous stakeholders have reported concerns that lack of clarity over where policymaking responsibility lies has led to confused consultations and poor policymaking. The Tax Faculty of the Institute of Chartered Accountants in England and Wales (ICAEW) has made this point forcefully to the Treasury

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<sup>13</sup> Pages 1214–15 of J. Alt, I. Preston and L. Sibieta, ‘The political economy of tax policy’, in J. Mirrlees et al. (eds), *Dimensions of Tax Design: The Mirrlees Review*, OUP for IFS, Oxford, 2010 (<http://www.ifs.org.uk/mirrleesreview/dimensions/ch13.pdf>).

Select Committee.<sup>14</sup> Witnesses also highlighted concerns about working relationships between HM Treasury and HMRC in evidence to the Select Committee on Economic Affairs when it reviewed a consultation on capital gains tax and residence and domicile. The Committee's report noted that some witnesses highlighted what they saw as a 'difficulty in lack of coherent communication and understanding between HMT and HMRC'.<sup>15</sup>

- *An undervaluing of technical tax knowledge and a lack of experience at HM Treasury causing problems with the effective development of tax policy.* In particular, Treasury officials are often seen as clever, but inexperienced in tax, and with little idea about issues faced in implementing tax policy. There is a more general concern about the very high turnover of Treasury officials and the problems that creates both for coherent policymaking and for building relationships.

Since that TLRC report was written, key developments have included the appointment of a new Tax Assurance Commissioner to a Permanent Secretary level position at HMRC with an explicit role as policy adviser to the Chancellor. How this is working, and how it will develop, in the context of the current HMRC/HMT framework remains to be seen. It certainly has the potential to strengthen the input of HMRC and may be part of a wider shift in influence. It is difficult to be certain what division of responsibilities would be optimal, but the persistence of the concerns raised above – similar issues have been raised by numerous stakeholders over a significant period – suggests the need for an extensive and public review.

## **Public debate**

It happens to be, at the time of writing, just a matter of days since the Labour Party announced its brand new tax policy – to reintroduce a 10p starting rate of income tax. The almost universal view of the commentariat is that this was good politics. It demonstrated that the party is on the side of low-income people.

It may be good politics, but it is poor tax policy. As we wrote at the time:<sup>16</sup>

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<sup>14</sup> At paragraphs 32–34 of Memorandum submitted by Tax Faculty of the Institute of Chartered Accountants in England and Wales, 17 January 2007, <http://www.publications.parliament.uk/pa/cm200607/cmselect/cmtreasy/192/7012413.htm>.

<sup>15</sup> At paragraphs 16 and 18 of Select Committee on Economic Affairs, *2nd Report of Session 2007–08: The Finance Bill 2008*, vol. I, Report (quoted in the TLRC Discussion Paper).

<sup>16</sup> <http://www.ifs.org.uk/publications/6606>.

The proposal for a new 10p starting rate of income tax has no plausible economic justification. It would complicate the income tax system and achieve nothing that could not be better achieved in other ways. It appears to repeat the same error perpetrated by Denis Healey in 1978 (undone by Geoffrey Howe in 1980), Norman Lamont in 1992 and Gordon Brown in 1999 (which he himself undid at considerable political cost in 2007). To have observed lower starting rates of tax being introduced and abolished by governments of both complexions over the last three decades and then to propose the same thing again suggests a remarkable failure to learn from history.

It is seen as good politics in part because rates of income tax are totemic within the tax debate. That is one reason why the main rates of income tax have not been raised since 1975 – nearly four decades during which rates of National Insurance contributions, and also of VAT, have been consistently increased.<sup>17</sup> We have not arrived at our current balance between these three, our biggest taxes – income tax, VAT and NI – as a result of any kind of rational debate. Income tax rates have moved in one direction, down, even as fiscal drag has brought millions more into the higher, 40p band. NI rates have moved ever up as they seem to have a less high profile in the public debate – and a majority of people seem to be under the complete misapprehension that they are hypothecated towards paying for the NHS or pensions. And rates of VAT have risen in fits and starts, while its coverage has barely changed.

## Conclusions

There have been some steps towards improving the tax policymaking process. Coalition government is ensuring more cross-government consultation. We have statements of strategy on corporate tax. The role of HMRC in policy development may be strengthening again. Evaluation of policy is inadequate and sporadic, but it is improving. Access to data by researchers is getting better.

But we are still a long way from a satisfactory situation. Some recent policymaking, not least proposals to allow relief on capital gains tax in exchange for giving up some employment rights – a policy the OBR fears may end up costing a billion pounds a year – suggests that the lessons of the recent past have not been learnt. Tax policy is inevitably a difficult and highly political area. But there are things that can be done to improve the process for making policy.

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<sup>17</sup> Other than when the reduced rate of VAT on domestic energy was cut in 1997 and the temporary decrease in the standard rate of VAT between 1 December 2008 and 31 December 2009.

There should be a tax strategy and objectives set out by each Chancellor against which policy proposals can be measured. This would increase transparency and accountability and, if followed, would also increase stability and certainty.

More challenge and scrutiny should be introduced into the policymaking process both within the executive and by the legislature. If necessary, parliament should be given greater resources, the House of Lords should play a greater role, and consideration should be given to creating a specific select committee devoted to tax policy.

We need an explicit process for reviewing the effectiveness of tax policy post implementation.

There is a case for at least a public review of the working of the relationship between HM Treasury and HMRC.

The Autumn Statement should be more explicitly focused on consultation on fiscal policy and the presentation of the latest economic and fiscal forecasts. It should not be an additional opportunity for Chancellors to pull rabbits from hats.

There is an urgent need for an improvement in the public debate about tax policy.

And of course we need politicians willing to be honest in their communication, open and long term in their thinking, analytical in their approach and courageous in their decisions. National welfare really is reduced by billions of pounds because we have a tax system that is not well designed. Finding ways to improve the policy development process should be a matter of priority for all political parties.

We need to see taxes as part of a system rather than individually, we need a strategy against which to judge proposals, and we need more transparency and more challenge and accountability in the tax policymaking process.