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
   • But stamp duties, business rates 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
     ➢ ‘Green taxes’, ‘sin taxes’, childcare
   • Distributional arguments for differentiation are weaker
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 benefit rates. Plus…
- Extra 3.4% means-tested benefits, 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 expenditure

- % rise in non-housing expenditure
- % rise in income
- Cash gain/loss (£/week, RH axis)

Expenditure Decile Group

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VAT reform: incentive to work at all
Participation tax rates
VAT reform: incentive to increase earnings
Effective marginal tax rates

![Graph showing effective marginal tax rates before and after reform.](image)
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 £7bn (though insurance premium tax recoups £2bn)

• 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
• Could either tax new build, or stream of consumption
• From where the UK starts, the latter makes more sense
• Tax the annual consumption value of housing: substitute for VAT
• Looks like a sensibly reformed council tax
  – Based on up-to-date valuations (rather than 1991 values)
  – Proportional to values (rather than pointlessly regressive and banded)
  – No discounts for single occupancy (rather than 25% discount)
• And replace stamp duty on housing in the process
  – Initially on a revenue-neutral basis
A ‘housing services tax’
Note: rough guide only – see Chapter 16 for details

![Graph showing the relationship between current property value and council tax bill vs. housing services tax bill](image-url)
Implicit carbon taxes, 2009-10
Excluding VAT subsidy of domestic energy

- Coal-generated electricity, business: £30/tonne CO₂
- Gas-generated electricity, business: £40/tonne CO₂
- Gas for heating, business: £7/tonne CO₂
- Coal-generated electricity, domestic: £25/tonne CO₂
- Gas-generated electricity, domestic: £30/tonne CO₂
- Gas for heating, domestic: £6/tonne CO₂

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Congestion charging

- Congestion charging could have big benefits
  - Eddington Review: potential welfare gains maybe 1% of national income
- In contrast, fuel duty and vehicle excise duty not well targeted
  - But far too high to justify by carbon emissions alone
- And will get even worse
  - Increased fuel efficiency; shift to electric cars?
- National road pricing should replace much of fuel duty
- A premium on acting quickly
  - Before lose what little we have
  - And while still a quid pro quo to offer
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
  – The former would remove the need for insurance premium tax
  – The latter would replace council tax and stamp duty on housing

• Move towards consistent pricing of greenhouse gas emissions

• Replace most of fuel duty with a national system of road pricing