

## Conclusions and Recommendations for Reform

The tax system plays a central role in all modern economies. Taxes account for between 30% and 50% of national income in most developed economies, with the UK lying somewhere in the middle of that band. The way in which these huge sums of money are raised matters enormously for economic efficiency and for fairness. As many countries look to address fiscal deficits by raising more money through their tax systems, the importance of getting the structure of taxes right can only increase.

The tax and benefit system should have a coherent structure based on clearly defined economic principles, such as those laid out in this volume. There should be a clear vision of the ideal system, in which the various elements fit properly together and from which unnecessary distortions have been eliminated. Making strides towards a coherent system such as this would be valuable at any time. It is likely to be even more valuable when the tax system needs to do more work.

We have looked at the major components of a modern tax system and, with a particular focus on the UK, we have developed a range of proposals for reform. In making these proposals, we have been guided by economic theory, by the evidence on the impact of taxes, and by knowledge about the distribution of incomes and the working of the economy.

In this, the 20<sup>th</sup> and final chapter of the book, we bring together the main lessons and conclusions of the whole review. We start by laying out the broad features of a good tax system. We move on to look at how the UK system stacks up against this ideal, before going through our main

recommendations for reform. We end by bringing these recommendations together into a single reform narrative, with some particular consideration of priorities for reform, timing, and transition. Where possible, we come down in favour of particular proposals. Often the arguments are more finely balanced and we refer readers to the preceding chapters for a more complete picture of each of the specific reforms and their alternatives.

### 20.1. A GOOD TAX SYSTEM

It is inevitable that taxation will impose costs beyond the actual sums that are raised and can be used to fund public spending. There are administrative costs to government and taxpayers in running the system, and welfare losses as people change their behaviour to reduce the tax they pay. The challenge in this review has been to design a tax system that can raise the revenue that government needs to achieve its spending and distributional ambitions whilst minimizing economic and administrative inefficiency, keeping the system as simple and transparent as possible, and avoiding arbitrary tax differentiation across people and forms of economic activity. In this section, we draw together our discussions in the rest of the book to outline the overall properties of a good tax system.

The core—though not the entirety—of our proposal is for a progressive, neutral tax system. Each of the three key words of that formula—‘progressive’, ‘neutral’, and ‘system’—is important.

First, consider the system as a whole.

A good tax system should be structured to meet overall spending needs. Earmarking of revenues for particular purposes should be avoided. There is no reason for spending on particular items to be tied to receipts from particular taxes. And earmarking of revenues that does not impose a binding constraint on spending is empty rhetoric: ‘an exercise in deceiving voters that their tax payments [control] government spending in a way which they simply will not, ... misleading taxpayers rather than expanding democracy’.<sup>1</sup>

<sup>1</sup> Institute for Fiscal Studies, 1993, 64–65.

More generally, not all taxes need to address all objectives. Not every tax needs to be 'greened' to tackle climate change as long as the system as a whole does so. And not all taxes need be progressive as long as the overall system is. In general, the right tools for achieving distributional objectives are direct personal taxes and benefits. Since the rates on these can be adjusted to achieve the desired degree of progressivity, other aspects of the tax system can be focused on achieving efficiency.

Second, seek neutrality.

A tax system that treats similar economic activities in similar ways for tax purposes will tend to be simpler, avoid unjustifiable discrimination between people and economic activities, and help to minimize economic distortions.

But neutrality does not always equate to minimizing economic distortions: it can sometimes be efficient to discriminate between different activities for tax purposes. Important examples are taxes on alcohol and tobacco and on activities that damage the environment. In such cases, there is a compelling case that people left to their own devices will behave in ways that harm themselves and others and which can be influenced by tax policy. Similar exceptions apply to pension saving and research & development (R&D), where society wishes to encourage beneficial behaviour. There are somewhat subtler arguments applying to goods associated with work (such as childcare), where there is a case for a more lenient tax treatment in order to offset the disincentive to work created by the tax system as a whole.

But such arguments must be treated with healthy caution. Even if a theoretically compelling case can be made, the advantages of departing from neutrality must be weighed against the disadvantages of complicating the system. Defining and policing boundaries between differently taxed activities is fraught with difficulty: it increases administrative and compliance costs, and creates perverse incentives to dress up one kind of activity as another. Hence, the hurdle for departing from neutrality should be high, requiring a strong and clear justification. This test is only likely to be passed by a handful of headline items such as environmentally harmful activities, 'sin taxes', pensions, R&D, educational investments, and childcare. This is a far narrower list than the exceptions that we observe in practice.

Third, achieve progressivity as efficiently as possible.

We have emphasized the primary role played by the rate schedule for personal taxes and benefits in achieving progressivity. There is an inevitable

trade-off between redistribution and work incentives. One cannot tax the rich, or top up the incomes of the poor, without affecting behaviour. But one can design the system carefully to minimize the efficiency loss associated with achieving progressivity. This means having a rate schedule that reflects knowledge of the shape of the income distribution and the responsiveness of people to taxes and benefits at different income levels. It also implies taking decisions over both whether to work (including when to retire) and how much to work into account in addition to other responses such as tax avoidance and migration.

It also makes sense to design the rate schedule to take into account other observable characteristics that reflect labour supply incentives, potential earning power, or needs. For example, mothers of school-age children and people around retirement age are particularly responsive to work incentives. They should, therefore, face lower effective tax rates than others. There are, of course, limits to how tax and benefit payments might be conditioned on characteristics, with some constituting unfair and illegitimate discrimination. And being more generous to people with certain characteristics can create an undesirable incentive to acquire those characteristics. There is also some tension here with seeking neutrality. So the hurdle for such departures should, again, be high.

In designing a tax system to be progressive, we need to think hard about the kind of progressivity we want. Much discussion focuses on the effect of taxes on people's current incomes. Ideally, though, we should try to assess the progressivity of the tax system in terms of people's lifetime resources, not just as an annual snapshot. One way of getting closer to doing this is to consider the distribution of expenditure and not just the distribution of income. Lifetime income and lifetime expenditure will be very similar (the main difference being bequests made or received); but annual income and annual expenditure will differ much more as people borrow and save to reflect fluctuating incomes and varying needs over their life cycle. In the absence of perfect measures of lifetime resources, shorter-term measures of income and expenditure can therefore provide complementary indicators of lifetime resources and should be considered carefully in combination with each other. We must also remember, however, that some people are constrained in how much they can borrow, making a snapshot of current income more relevant for them.

What does a progressive, neutral tax system look like?

When it comes to income taxation, there is a strong case for keeping things simple: a single tax on income with an allowance and (say) two or three rates, combined with a single benefit to support those with low income and/or high needs. The design of the rate schedule should reflect the best available evidence on how responsive people at different income levels and with different demographic characteristics are.

Income from all sources should be taxed according to the same rate schedule. However, unlike a standard income tax, our approach would allow all costs of generating that income to be deducted, as we explain below. Applying different rates to different income sources complicates the system, unfairly favours those taxed more lightly, distorts economic activity towards lightly taxed forms, and facilitates tax avoidance. Taxing income from all sources equally does not just mean taxing fringe benefits in the same way as cash earnings. It also means applying that same rate schedule to, *inter alia*, self-employment income, property income, savings income, dividends, and capital gains.

It makes sense to tax most business income before it leaves the company, through corporation tax. But we should reduce the personal tax rates on corporate-source income (dividend income and capital gains on shares) by the same amount to reflect the corporation tax already paid. The *combined* rates of corporate and shareholder taxation should equal the tax rates levied on employment and other sources of income.

This single rate schedule should be applied to income after allowing deductions for the costs incurred in generating income, such as work-related expenses and inputs to production. Failing to allow these deductions distorts economic decisions, encouraging low-cost–low-revenue activities over equally valuable high-cost–high-revenue activities. Of course, it is not always easy to distinguish expenditure related to income generation from consumption expenditure. But the principle at least is clear.

The principle also applies to saving and investment. Generating future income requires sacrificing current consumption. In that sense, saving and investment are costs associated with generating future income. This can be recognized in one of two ways:

- Cash saved or invested can be treated as a deductible expense when it arises, as currently applied to personal saving in the case of pension

contributions and to business investment in limited cases where 100% first-year allowances are available.

- A deduction could be given each year for the opportunity cost of capital previously saved/invested. This is the rate-of-return allowance (RRA) treatment of saving and the allowance for corporate equity (ACE) treatment of business investment, neither of which has ever been used in the UK although both are now used in other countries. For assets where only the risk-free ('normal') rate of return is likely to be earned, this approach can be simplified, and returns on such assets can just be tax free.

Timing aside, these two treatments are equivalent. With stable tax rates, the stream of allowances given each year under the second approach has the same present value as the up-front deduction given under the first approach. In both cases, the 'normal' rate of return to savings/investment is tax exempt. And, in both cases, any 'excess' returns above this will be taxed in full.

This approach helps to resolve a conundrum that policymakers around the world have struggled with for decades: the tension between preventing tax avoidance on the one hand and minimizing disincentives to save and invest on the other. Eager to encourage saving and investment, policymakers have sought to reduce tax rates on capital income; but wary of opening the door to widespread conversion of labour income into capital income, they have also sought to keep tax rates as closely aligned as possible. The result has usually been an awkward compromise, with capital income taxed at reduced rates (and often different forms of capital income taxed at different rates), leaving some disincentive effects and some scope for avoidance. Taxing capital income in full *while giving a full deduction for capital costs* addresses both problems.

Attempting to tax capital income without giving a deduction for capital expenditure causes a number of problems. In practice, capital gains can only be taxed when assets are sold, not when the increase in value occurs (giving rise to the inefficient 'lock-in' effect). Saving and investment will be discouraged more at some times than others unless full indexation for inflation can be achieved (something which has never been done). And investment in some assets will be discouraged more than in others unless deductions for depreciation match true economic depreciation (something which is impossible for legislation to achieve accurately). Not only do

‘standard’ capital taxes discourage saving and investment in general; they also (and perhaps more importantly) penalize different forms of saving and investment to different degrees, and therefore distort the form that saving and investment take.

While achieving neutrality between different forms of saving and investment is our general aim, there may be a good case for treating pension saving more generously. Behavioural evidence suggests that people tend not always to make decisions in far-sighted and rational ways. Individuals with inadequate retirement savings are also more likely to draw on costly state benefit programmes in retirement. Encouraging them to save in a pension when young makes this less likely.

A tax on income that exempts a ‘normal’ rate of return to capital, as we propose, is broadly equivalent to a tax on expenditure. Of course, there are other ways to implement a tax on expenditure, such as via a value added tax (VAT). Our starting point for VAT is the presumption that it be applied to all final consumption expenditure by households, but that expenditure on business inputs should be untaxed (which VAT achieves by allowing traders to reclaim VAT charged on their inputs). This means avoiding zero and reduced rates of tax on sales, and avoiding exemptions (which prevent deduction of input costs) as well. If it is difficult to impose VAT in the usual way on certain goods and services—notably financial services and housing—then economically equivalent taxes to substitute for VAT on these items should be sought. The tendency of government to adopt different tax rates across commodities frequently comes from failing to look at the tax system as a whole and to see that the rate schedule of personal income taxes and benefits is the instrument best suited to achieving redistributive ends.

Taxes levied on income without deducting the costs of generating that income, or levied on sales without deducting input costs, or levied directly on business expenditures, are in general grossly inefficient and have no place in a good tax system. This leads to a presumption against all kinds of transactions taxes, input taxes, and turnover taxes.

There are, however, some cases in which taxing all income (or expenditure) equally and deducting all costs is not the right approach.

Pure economic rents can, in principle, be taxed without creating an economic distortion. One example is the ‘excess’ return to capital; taxing such returns does not discourage saving and investment. In practice, it can

be difficult to pinpoint rents, and so we are wary of attempting to tax them at higher rates than ordinary income. But where rents can be identified accurately, targeted taxes can be applied. In particular, there is a strong case for levying a land value tax, which is a tax on pure rent—if the practical difficulty of valuing land separately from the buildings on it can be overcome.

Taxes used to correct market failures can also justify a non-uniform rate structure. Raising the price of activities that cause harm can be an efficient way to discourage them because it ensures that reductions occur among those who find it easiest to make them. The major environmental problems that ought to be priced are carbon emissions and congestion. There is also a good case for taxing tobacco and alcohol because of the combination of harm to others and unforeseen harm to themselves that smokers and drinkers do.

As an alternative to taxing damaging goods, a ‘cap-and-trade’ system of issuing limited permits for the good and allowing the permits to be traded can achieve a similar result of raising the good’s price and reducing its consumption by those who least need the good. It is important that such permits be auctioned rather than simply handed out, so that the revenue can be used to reduce other distortionary taxes (offsetting the work disincentives created by raising the price of the good in question). Whether taxation or a cap-and-trade system is used, however, it is vital to target the damaging activity precisely and to impose a consistent price across all sources of damage: neutrality between different sources of carbon, for example, is needed to ensure that climate change is tackled in the least costly way. Badly designed policies can easily dissipate the potential gains from discouraging damaging activities.

As noted above, the main difference between lifetime income and lifetime expenditure is gifts and bequests. There is a good case for taxing such transfers of wealth, particularly to the next generation. This has the potential to reduce the inequality of life chances between different children that arise by accident of birth, at a fairly low economic cost. To achieve this, we lean towards a tax on lifetime receipts. Efficiency and equity are best served if this is a tax on all receipts—all kinds of asset, whether transferred on death or during the donor’s lifetime. There are, though, inevitable practical difficulties associated with trying to tax transfers. If these difficulties mean that much

wealth that is transferred cannot be taxed, then a good tax system may be caught between two very much second-best situations—either leaving these transfers permanently untaxed, or trying to capture them by introducing limits to the tax exemption of normal returns to savings, with all the attendant problems with taxing capital income that we have highlighted.

This vision of a good tax system pulls together ideas from across all the chapters of this book. It is summarized in the left-hand column of Table 20.1 under five headings—taxes on earnings, indirect taxes, environmental taxes, taxation of savings and wealth, and business taxes. It will be clear by now that there are many aspects of the UK tax system that fail to live up to this ideal. They are detailed in the right-hand column of the table. A jumble of tax rates, a lack of a coherent vision of the tax base, and arbitrary

**Table 20.1.** A good tax system and the current UK tax system

A good tax system	The current UK tax system
<b>Taxes on earnings</b>	
A progressive income tax with a transparent and coherent rate structure	An opaque jumble of different effective rates as a result of tapered allowances and a separate National Insurance system
A single integrated benefit for those with low income and/or high needs	A highly complex array of benefits
A schedule of effective tax rates that reflects evidence on behavioural responses	A rate structure that reduces employment and earnings more than necessary
<b>Indirect taxes</b>	
A largely uniform VAT – with a small number of targeted exceptions on economic efficiency grounds – and with equivalent taxes on financial services and housing	A VAT with extensive zero-rating, reduced-rating, and exemption – financial services exempt; housing generally not subject to VAT but subject to a council tax not proportional to current property values
No transactions taxes	Stamp duties on transactions of property and of securities
Additional taxes on alcohol and tobacco	Additional taxes on alcohol and tobacco

(cont.)

discrimination across different types of economic activities are hallmarks of the current system. There are many examples in each category which we

**Table 20.1.** (cont.)

A good tax system	The current UK tax system
<b>Environmental taxes</b>	
Consistent price on carbon emissions	Arbitrary and inconsistent prices on emissions from different sources, set at zero for some
Well-targeted tax on road congestion	Ill-targeted tax on fuel consumption
<b>Taxation of savings and wealth</b>	
No tax on the normal return to savings – with some additional incentive for retirement saving	Normal return taxed on many, but not all, forms of savings – additional but poorly designed incentives for retirement saving
Standard income tax schedule applied to income from all sources after an allowance for the normal rate of return on savings – with lower personal tax rates on income from company shares to reflect corporation tax already paid	Income tax, National Insurance contributions, and capital gains tax together imply different rates of tax on different types of income—wages, profits, capital gains, etc. – some recognition of corporation tax in dividend taxation but not in capital gains tax
A lifetime wealth transfer tax	An ineffective inheritance tax capturing only some assets transferred at or near death
<b>Business taxes</b>	
Single rate of corporation tax with no tax on the normal return on investment	Corporation tax differentiated by company profits and with no allowance for equity financing costs
Equal treatment of income derived from employment, self-employment, and running a small company	Preferential treatment of self-employment and distributed profits
No tax on intermediate inputs – but land value tax at least for business and agricultural land	An input tax on buildings (business rates) – no land value taxes

have highlighted throughout the book. We now turn to discuss these deficiencies and make a set of concrete proposals which illustrate how the current system can be improved.

## 20.2. PROPOSALS FOR REFORM OF THE UK TAX SYSTEM

We have set out our vision of an effective tax system which eliminates many of the current distinctions between different activities, which incorporates what we know about responses to taxes to minimize undesirable impacts on behaviour, and which involves a consistent approach to taxing externalities. Our approach demands a coherent understanding of how incentives and progressivity operate across the tax and benefit system as a whole and across people's lifetimes.

In this section, we move from this high-level vision to compare the current UK system against some of these principles and to summarize some of our specific proposals. We illustrate the differences between our vision and the current UK system in two ways: first by setting out seven broad flaws of the current system and then by comparing specific features of a good system with the UK system.

Against the criteria set out in our vision, the seven major flaws in the UK tax system are:

1. Despite improvements for some groups in recent years, the current system of income taxes and welfare benefits creates serious disincentives to work for many with relatively low potential earning power. The benefit system in particular is far too complex.
2. Many unnecessary complexities and inconsistencies are created by the fact that the various parts of the tax system are poorly joined up. These range from a lack of integration between income taxes and National Insurance contributions (NICs) to a lack of coherence between personal and corporate taxes.
3. The present treatment of savings and wealth transfers is inconsistent and inequitable. There is no consistent tax base identified, saving is discouraged, and different forms of savings are taxed differently.

4. We remain some way short of having a coherent system of environmental taxes to address imperatives around climate change and congestion. The effective tax on carbon varies dramatically according to its source, and fuel duty is a poor substitute for road pricing.
5. The current system of corporate taxes discourages business investment and favours debt finance over equity finance. Its lack of integration with other parts of the tax system also leads to distortions over choice of legal form. Corporate taxes have also been subject to increasing international pressures.
6. Taxation of land and property is inefficient and inequitable. There is a tax on business property—a produced input—but not on land, which is a source of rents. Taxation of housing involves both a transactions tax and a tax based on 20-year-old valuations.
7. Distributional goals are pursued in inefficient and inconsistent ways. For example, zero and reduced rates of VAT help people with particular tastes rather than being targeted at those with low overall resources; and council tax is regressive for no obvious efficiency-improving reasons.

In the rest of this section, we go through our main specific proposals for reform, under each of the headings in Table 20.1. We cannot stress enough, though, that we divide the proposals up in this way largely for convenience of reading and understanding. As we have already emphasized, it is important to consider the proposals as an overall package. That package can be shaped to achieve different degrees of progressivity, depending on the precise parameters that are chosen for the income tax and benefit systems. But the efficiency of the tax system depends on how the different elements of the reform interact.

### **20.2.1. Earnings Taxation and Work Incentives**

The personal tax and benefit system should be progressive, coherent, and designed to reflect what we know about the shape of the income distribution and how different groups respond to work incentives.

Coherence requires first that the income tax system itself be sensibly structured. We need to move away from pointless complexities such as that

which sees the marginal rate rise from 40% to 60% at £100,000 of income before falling back to 40% at £112,950. More importantly, we need to move away from having separate systems of income tax and NICs, with different sets of rules and exemptions, pointlessly increasing administration and compliance costs and making the system less transparent. National Insurance is not a true social insurance scheme; it is just another tax on earnings, and the current system invites politicians to play games with NICs without acknowledging that these are essentially part of the taxation of labour income. The two systems need to be merged. Given our proposal to apply the same rate schedule to income from all sources, integration would be a good opportunity to, in effect, broaden the NICs base to cover self-employment and capital income in full. Since alignment of rates must include employer NICs, either employer NICs must be integrated along with employee NICs and income tax or else an equivalent tax would have to be levied on non-employment income—though we acknowledge that neither of these would be politically easy.

The second substantial change that we believe is a prerequisite for an effective tax and benefit system is a significant simplification and integration of the benefit system. The current structure of multiple benefits with an array of overlapping means tests leaves some people facing effective marginal tax rates of over 90%. It is complex, inequitable, and inefficient.

As well as reforms to the delivery of earnings taxation, we have considered reforms to the rate structure of personal taxes and benefits. We have examined the case for reducing effective tax rates for low earners (particularly in light of growing evidence that decisions over whether to work at all are more responsive to incentives than decisions over how much to work) and the question of the appropriate tax rate on the very highest incomes (bearing in mind evidence on the range of ways that high-income individuals can respond to taxation). Reforms in these areas could have major implications for employment, earnings, and tax revenues; but firm recommendations would require political value judgements that we are not in a position to make.

We have also looked at reforms that make better use of what we know about how behavioural responses to incentives vary by the ages of household members. We can more confidently make proposals in this area, since reforms can be designed that are neither progressive nor regressive overall,

redistributing mainly across the life cycle so that people face stronger incentives at the times they are most responsive to them. Targeting incentives where they are most effective can improve welfare overall, and the specific reforms we have simulated would generate large increases in employment rates.

First, work incentives should be strengthened for families whose youngest child is of school age, reflecting the finding that the mothers of older children are more responsive to the incentives in the tax and benefit system than are mothers of younger children. To illustrate one way this could be done in the current UK tax and benefit system, we simulated a reform to Child Tax Credit that would make it more generous (and so means-testing more extensive) for families whose youngest child is aged under 5, and less generous (with less means-testing) for families whose youngest child is aged 5 or over. Although there is substantial uncertainty, we estimate that these reforms could lead to a net increase in employment of around 52,000 (or roughly 0.2% more workers) and an increase in aggregate annual earnings of around £0.8 billion. In a life-cycle sense, these reforms would have offsetting effects once in place, with families who receive Child Tax Credit gaining when children are younger and losing later. Effectively, resources are shifted towards families with pre-school children.

Second, work incentives should be strengthened for those in their later working life, aged 55 to 70—a group that is highly responsive to incentives. To illustrate one way this could be done within the existing tax and benefit system—obviously the available instruments would be different if our other proposals were implemented—we simulated the impact of reducing the age at which employee and self-employed NICs stop being payable from state pension age to age 55, reducing the age at which a higher tax-free personal allowance is available from 65 to 55, and increasing the age of eligibility for Pension Credit to 70. The simulations point to an increase in employment of about 157,000 (or 0.6% of the workforce) and an increase in aggregate annual earnings of just under £2 billion. As with our Child Tax Credit simulations, much of the distributional impact would consist of offsetting effects over the life cycle.

The current tax and benefit system is unnecessarily complicated and induces too many people not to work or to work too little. By creating a simpler and more rational system, minimizing disincentives where they

matter most, the reforms we propose have the potential to deliver major economic gains.

### **20.2.2. Indirect Taxation**

By applying zero rates, reduced rates, and exemptions to large swathes of spending, the current VAT system creates a combination of administrative complexity, arbitrary distortions between different kinds of consumption, and inequitable treatment of consumers with different tastes. Increases in VAT rates—from 17.5% to 20% in January 2011, for example—just make these problems bigger. There are good economic efficiency arguments for taxing time-saving goods less heavily, and goods that require leisure time more heavily, in order to offset the general disincentive to work that taxation creates; but, with a few exceptions (notably childcare), we think the potential gains from introducing such differentiation are outweighed by the practical disadvantages.

International experience shows that a narrow VAT base is not inevitable. The UK zero-rates far more goods than almost any other country: for example, the UK and Ireland are the only EU countries to apply a zero rate to most food, water, books, and children's clothes. New Zealand provides a working example of how it is possible to apply the standard rate of VAT to almost all goods and services. The costs of having such a narrow VAT base are large. Considering just the distortion to spending patterns—ignoring the costs of complexity—simulations suggest that, if uniformity were optimal, extending VAT at 17.5% to most zero-rated and reduced-rated items would (in principle) allow the government to make each household as well off as it is now and still have around £3 billion of revenue left over. The true figure could be higher or lower than this.

The situation in the UK persists largely because of a failure to consider the system as a whole. In a modern tax system, VAT is a poor choice of tax to use to achieve redistribution. VAT should therefore be extended to virtually all goods and services at the full rate, but this should be done in combination with an appropriate package of reforms to the personal tax and benefit system to address the distributional and work incentive effects of broadening the VAT base. We have shown how this is feasible. Our core reform proposal

involves broadening the VAT base to include goods and services that are currently subject to a zero or reduced rate—mainly food, passenger transport, books and other reading matter, prescription drugs, children's clothing, and domestic fuel and power. Taken in isolation, this would raise around £24 billion with a VAT rate of 17.5%. But it would also hurt the worse off and have adverse effects on work incentives. To offset this, we have illustrated one possible package of cuts in income tax and increases in means-tested and non-means-tested benefits that would, in combination with VAT base broadening, create a revenue-neutral reform. On a snapshot measure, our overall package looks progressive when measured against people's expenditure, but slightly regressive when measured against income. It is likely to be approximately distributionally neutral on average across people's lifetimes—a good example of the limitations of looking at a snapshot of income and the importance of taking a lifetime perspective.

A novel and important feature of our proposals is the focus on work incentives and construction of a compensation package designed to avoid damaging them.

VAT cannot be extended so straightforwardly to all forms of consumption. Housing is not currently subject to VAT. But given where we start in the UK, it makes more sense to tax people's annual consumption of housing services than to levy VAT on new properties when they are built (or existing properties when they are next sold). Such a tax, proportional to the current consumption value of housing, would be a big improvement on the UK's current regime for taxing housing. Council tax is based on valuations that are 20 years out of date, it is highly regressive with respect to property values, and it gives a discount for sole occupancy—features that are unfair and encourage inefficient use of the housing stock. Stamp duty land tax, as a transactions tax, is highly inefficient, discouraging mobility and meaning that properties are not held by the people who value them most, and its 'slab' structure—with big cliff-edges in tax payable at certain thresholds—creates particularly perverse incentives. Replacing these two taxes on a revenue-neutral basis with a simple tax proportional to up-to-date consumption values of properties, essentially as a substitute for VAT, is a much-needed step forward.

VAT exemptions are especially damaging since they prevent firms from reclaiming VAT paid on their inputs, distorting the pattern of production.

We have focused on probably the most important of these exemptions—that for financial services. Exemption makes financial services too expensive for businesses and too cheap for households (so that it is too difficult for firms to obtain finance but too easy for households to borrow, for example). It creates a bias towards vertical integration and distorts international trade, as well as creating awkward boundaries between differently taxed activities. We do not set out in this book to solve the particular problems with the financial system exposed by the recent crisis—that is a matter for regulation at least as much as for taxes—but before imposing additional taxes on the financial sector, we should at least make sure that it is subject to the same taxes as other businesses. The way in which financial services are provided means that VAT could not be applied to them in the standard way, but there are several ways in which a tax economically equivalent to VAT could be applied. Finding the most practical way forward should be a priority.

As a purely practical matter, the practice of zero-rating exports creates a break in the VAT chain which makes VAT more vulnerable to tax evasion. Moving away from such zero-rating—imposing some VAT at borders, reclaimable by importers (so there is still no net tax levied but enforcement is made easier)—would be a worthwhile improvement.

We are not recommending an entirely uniform system of indirect taxes. More compelling are arguments for additional taxation of especially harmful activities. Taxes on alcohol and tobacco are good examples, and their continued use is important. The other major category of harmful activity is environmental damage, to which we now turn.

### **20.2.3. Environmental Taxes**

The case for pricing environmental externalities through the tax system is a strong one. There have been a number of innovations in environmental taxes in the UK in recent years. But it remains the case that there are two overwhelming priorities for the application of environmental taxes: greenhouse gas emissions and congestion on roads. Unfortunately, the current systems of taxes on these two externalities remain a long way from being coherent.

With an EU Emissions Trading Scheme (ETS) of rather limited coverage existing alongside a complex array of different and inconsistent domestic policies, effective taxes on greenhouse gas emissions vary dramatically according to both the source of the emission (the type of fuel, for example) and the identity of the user (domestic or business, for example). Indeed, the reduced rate of VAT payable on domestic fuel consumption acts as an effective subsidy to the creation of carbon emissions. This situation would be improved by our proposals to broaden the VAT base more generally, but further increases are required. We urgently need to impose a consistent price on carbon emissions, encompassing both a reformed ETS and a simpler, more coherent system for taxing emissions not covered by the ETS.

The economic costs of not having a coherent system of motoring taxation are large. The government estimates that annual welfare benefits of up to 1% of national income are available from a road pricing scheme that varies charges by place and time of day to accurately reflect actual congestion levels and costs. Introducing such a scheme would be expensive and controversial, and smaller and less accurate schemes may need to be devised on the way to such a comprehensive system. But the scale of benefits suggests that moving to a national system of road pricing is a priority. The quid pro quo for introducing congestion charging should be a major reduction in fuel duties, the current rates of which would (in the presence of congestion charging) be far higher than could be justified by carbon emissions alone. Whilst there are, of course, major practical challenges associated with such a development, there is a premium on acting quickly. As cars become more fuel efficient, and eventually electric cars replace traditional vehicles—a change that may well have to happen if we are to meet targets for reducing carbon emissions—the current system of fuel taxation will become even less effective at limiting congestion. It will also raise less and less revenue from motorists (leaving less to offer ‘in exchange’ for congestion charging).

#### **20.2.4. Taxation of Savings and Wealth**

The taxation of savings should treat different forms of savings in broadly comparable ways, should not introduce important incentives for individuals to consume earlier rather than later in their lifetimes, and should not have

effects that are unduly sensitive to the rate of inflation. Significant reforms are needed in the UK to reduce arbitrary differences in the tax treatment of different assets, to exempt from taxation, as far as possible, the normal return on savings, and to make the system inflation-proof. Getting the taxation of savings right is also important in ensuring that the personal and corporate tax systems line up.

These goals can be achieved by an approach that taxes only ‘excess’ returns, and which exempts from taxation the component of income and capital gains earned on savings that corresponds to a risk-free or ‘normal’ rate of return—for example, that paid on medium-term government bonds. Our main recommendations for reform would accomplish this by making interest on ordinary bank and building society accounts free from taxation, and by providing a ‘rate-of-return allowance’ (RRA) for substantial holdings of risky assets such as equities, which can provide higher returns. For simplicity, we would retain a tax-free treatment of the returns from smaller holdings of equities and mutual funds, along the lines of UK equity ISAs. As well as being more efficient than the current system, reducing tax distortions to the timing of consumption, we believe these proposals would also make it fairer. The current tax system treats most harshly those assets that are most important to individuals with smaller amounts of savings, particularly interest-bearing bank and building society accounts. More favourable tax treatments are provided for pension plans and owner-occupied housing.

The RRA would be calculated by applying a risk-free nominal interest rate to a cumulated stock of savings held in particular assets. No explicit indexation is required—the stock of savings here just corresponds to past purchases of these assets, net of past sales. Nominal income plus any nominal capital gains realized in the current year, in excess of the RRA, would then be taxed at the individual’s marginal income tax rate. In cases where the RRA exceeds the return on these assets realized in a particular year, the difference would be carried forward to set against nominal returns in later years, marked up by the same nominal interest rate used to determine the RRA. Other than specifying this nominal interest rate, no more information is required to operate this system than is needed to tax capital gains on these assets in a conventional income tax. In most circumstances, the normal rate of return can be well approximated by a nominal interest rate on medium-term government bonds. A similar

approach is used to tax dividends and capital gains on company shares in Norway.

As well as reducing the distortion in favour of current consumption over saving under a standard income tax, this RRA approach to the personal taxation of income from capital has important practical advantages. The taxation of capital gains raises major problems for a conventional income tax: taxing gains on realization rather than on accrual creates a 'lock-in' effect, encouraging people to delay the sale of assets whose value has risen; while taxing purely nominal gains makes effective tax rates highly sensitive to inflation. Piecemeal attempts to deal with the latter problem by taxing nominal capital gains at preferential rates invites tax avoidance, favouring the conversion of earned income into more lightly taxed capital gains where this is possible. The succession of wholly unsatisfactory reforms to capital gains taxation in the UK over the last 15 years bears witness to these problems. The RRA approach addresses all of them. It also operates coherently with corporate taxation, an important ingredient of any well-designed system of savings taxation. The rate of personal tax on excess returns from company dividends and capital gains on company shares would be reduced, relative to those on other assets, to reflect tax on the underlying profits that is paid at the corporate level. Indeed, the RRA in the personal income tax is a natural counterpart to the allowance for corporate equity, our preferred scheme for corporate taxation.

There are theoretically equivalent ways in which taxation of the normal return on savings could be eliminated. As a practical reform proposal, the RRA has potential advantages over the pure expenditure tax (EET) approach recommended in the Meade Report.<sup>2</sup> The RRA collects tax revenue up front and provides tax relief only as returns are realized, making the transition to it comparatively straightforward. It also mitigates the risk of loss of revenue occurring as a result of those who did the saving avoiding future tax liability by moving abroad before they draw down their savings. In the context of increased international migration, this is an important consideration.

That said, for pension saving the current expenditure tax treatment looks broadly right because alternatives have the potential to be highly complex.

<sup>2</sup> Meade, 1978.

Some tax advantage (above simple EET) is probably justified to encourage, or reward, the tying-up of savings in a form that restricts access for a long period. There is, though, a strong case for simplifying the current UK system of pension taxation, and changes should be made to eliminate the inconsistencies that make employer contributions substantially tax privileged relative to employee contributions. These latter anomalies result from the distinctions drawn between income tax and NICs, and between employer and employee NICs. So, if we could achieve our long-run vision of a system in which these are consolidated into a single tax on income, this issue would be avoided.

We do not have a single number to put on the costs of the distortions in the current system of savings taxation. However, work undertaken as part of this review<sup>3</sup> suggests that, even on a conservative reading of the economic literature, reducing taxation of the normal return to savings would have significant effects on the quantity and distribution of savings over the life cycle, thereby raising lifetime welfare.

For most people, our proposals on savings taxation would reduce the tax they pay on the returns to their savings. The main exceptions would be those who make large returns in the form of capital gains or who earn very high returns more generally.

Our proposals are driven by a view of savings as playing a crucial role in ensuring that the tax system is efficient and equitable over an individual's life cycle. But there is a case for thinking differently about wealth that is transferred between people—especially as an inheritance between generations. In our view, recent increases in wealth inequality, coupled with increases in housing wealth for particular groups, increase the case for taxing wealth transfers on both equity and efficiency grounds. The current UK inheritance tax is unfair in many ways—it fails to tax those who pass on gifts during their lifetime and benefits those who can arrange their affairs to escape taxation at death, while taxing more highly those (usually of more modest means) who cannot arrange their affairs so as to avoid taxation. It is inefficient because it creates many tax-driven behavioural changes and leads to some asset classes, such as agricultural and business assets, being tax

<sup>3</sup> Attanasio and Wakefield, 2010.

favoured for no clear reason except, presumably, the influence of the agricultural and family business lobbies. The different treatments of capital gains realized at death and those realized during working life also lack justification in the context of our broader proposals to reform savings taxation. We do not think that a tax on estates at death is the best way to approach these issues—there is a stronger case, in principle, for a tax on lifetime receipts, taxing transfers received on an ongoing and cumulative basis. There are important administrative and transition challenges to be addressed in bringing such a proposal to fruition. However, as a long-term proposition, the case for moving in this direction is persuasive.

### **20.2.5. Business Taxation**

Our recommendations for business taxation have three main components.

First, we are proposing to abolish the current system of business rates and replace it with a system of land value taxation, thereby replacing one of the more distortionary taxes in the current system with a neutral and efficient tax. Business rates are not a good tax—they discriminate between different sorts of business and disincentivize development of business property.

Our second proposal concerns the treatment of small businesses and self-employment. The current system distorts choices over organizational form—the choice between employment and self-employment on the one hand, and the choice between running an unincorporated business or a small company on the other hand—as well as decisions over the form of remuneration—for example, whether the sole proprietor of a small company pays herself in the form of salary or dividends. These discrepancies are inequitable and lack any clear rationale. The difference between the corporation tax rates paid by firms with higher and lower profits also lacks a compelling justification.

Our recommendations would align the taxation of income from employment and self-employment, increasing the NICs paid by self-employed individuals to match those paid by employers and employees combined in relation to employment (preferably in the course of integrating NICs with the personal income tax). To align the tax treatment of distributed profits with the tax treatment of income from employment, a minimal approach would increase the taxation of dividend income received by

individuals by an amount broadly equivalent to the NICs paid by employers and employees on wages and salaries. Again, this could be done as part of the integration of income tax and NICs. Capital invested by individuals both in business assets of sole traders and partnerships and in equity issued by companies would be eligible for the rate-of-return allowance described in Section 20.2.4. In both cases, this would remove the ‘normal’ returns on these investments from personal taxation.

Our third proposal on business taxation is the introduction of an allowance for corporate equity (ACE) within the corporate income tax. The ACE provides an explicit deduction for the cost of using equity finance, similar to the existing deduction for the cost of interest payments on debt finance. This levels the playing field between different sources of finance. Like the RRA, the ACE can be designed to eliminate the effect of the corporate tax on the required rate of return for all forms of corporate investment. Different assets that firms invest in are treated equally, with no sensitivity of tax liabilities to the rate of inflation. With this form of corporate tax base, investment projects that just earn the minimum required or ‘normal’ rate of return are effectively exempt from corporate taxation, and revenue is collected from those investments that earn above-normal rates of return, or economic rents.

Exempting the normal rate of return on capital from corporate taxation fits well with our proposal to exempt the normal rate of return on capital invested in the business sector from personal taxation—as would be achieved by a rate-of-return allowance for corporate equities and unincorporated business assets. Suitable alignment of tax rates on corporate profits, dividend income, capital gains on company shares, and other sources of personal income can then ensure that owner-managers of small firms have no tax incentive to pay themselves in the form of dividends rather than salaries, and achieve an equal tax treatment of income derived from employment, self-employment, or running a small company. Much complex anti-avoidance legislation would then become redundant.

Experience with the operation of an ACE-type allowance in Belgium and other countries suggests that this approach is both feasible and compatible with EU Treaty obligations. Some opportunities for international companies to shift taxable profits out of the UK would be reduced by the introduction of an ACE—notably the scope for using debt borrowed (and tax deductible)

in the UK to equity-finance subsidiaries operating (and taxed) in other jurisdictions with lower corporate tax rates.<sup>4</sup> Other mechanisms through which multinational firms can reduce their UK corporate tax liabilities, such as the manipulation of transfer prices, would remain. However, at a given corporate tax rate, these opportunities would be no greater than under the current corporation tax base.

The introduction of an allowance reflecting the underlying cost of using equity finance would have a significant revenue cost. This could be recouped by raising the corporate tax rate, but in our view this would be a mistake. The appropriate rate at which to tax rents earned in the corporate sector must balance the advantages of taxing sources of rent that are largely immobile against the disadvantages of (attempting to) tax sources of rent that are highly mobile and that are likely to relocate to other jurisdictions should the UK tax rate become out of line. Inevitably, this depends on corporate tax rates in other countries, which have fallen over the last three decades and which may well fall further with increased economic integration. Increasing the corporate tax rate would also increase incentives for multinational firms to shift taxable profits out of the UK. If the current UK corporate tax rate is more or less appropriate, the implication is that by taxing the normal return on equity-financed investments, we are currently raising too much revenue from corporate taxation. Our recommendations are thus to introduce an ACE without increasing the corporate tax rate, to accept that less revenue will be collected from the corporate tax, and to rebalance the shares of revenue from corporate and other taxes as part of an overall package of reforms to the tax system as a whole.

In this context, it is particularly important to understand the issue of tax incidence and who bears the costs of distortions introduced by the tax system. By raising the cost of equity-financed investment, the corporate income tax also tends to reduce the overall level of corporate investment. In an open economy, the cost of this distortion will largely be borne by domestic workers. Owners of capital can invest elsewhere. Lower investment in the UK implies less capital per worker and lower labour productivity. In the long run, this will be reflected in lower real wages, making domestic

<sup>4</sup> Any purchase of equity in a subsidiary company would reduce the ACE available to the parent company.

workers poorer. Taxing wages directly would allow the same revenue to be collected with more capital per worker and hence more output per worker—a more efficient outcome that would also leave domestic workers better off, notwithstanding the higher tax rate on labour income.

As with other elements of our proposed reform package, it is possible to put at least some indicative scale on the value of reform. It has been estimated that a revenue-neutral reform package introducing an ACE with an offsetting increase in a broad-based tax on consumption would, for the UK, deliver long-run increases of 6.1% in investment, 1.7% in wages, 0.2% in employment, and 1.4% in GDP, leaving the representative consumer better off by an amount equivalent to 0.2% of GDP.<sup>5</sup> While these simulations are subject to wide margins of error, they do confirm in a rigorous empirical framework that eliminating the taxation of the normal return to equity-financed corporate investment could result in a significant increase in capital per worker. This in turn could produce worthwhile gains in wages, employment, output, and welfare. Crucially, this does depend on using another part of the tax system to recoup the revenue cost of the ACE. Offsetting the revenue loss by increasing the corporate tax rate would be much less attractive, inducing multinational firms to shift both real activity and taxable profits out of the country.

### 20.3. THE REFORM PACKAGE AND TRANSITION

Our main proposals are summarized in Table 20.2. Between them, they represent a radical set of reforms aimed at creating a much more efficient and effective tax system. They would take the UK tax system much of the way towards being a progressive, neutral system. The combination of excluding the normal rate of return to capital from tax, aligning tax rates on income from all sources, and significantly widening the VAT base would move a long way towards neutrality. We have shown how progressivity can

<sup>5</sup> See de Mooij and Devereux (2009, table B.4). Using a similar approach, Radulescu and Stimmelmayer (2007) estimated somewhat larger gains for Germany from a revenue-neutral introduction of an ACE combined with an increase in the rate of VAT.

be maintained—or changed if desired—through using the personal tax and benefit system. This is where the progressivity in the system as a whole should come from. It is important to combine this with reforms that simplify and rationalize the benefit system and that ensure that personal taxes and benefits are designed to take account of what we know about people's responsiveness to incentives. Where there is a strong case for deviating from neutrality—as where environmental externalities exist—such departures

**Table 20.2.** Main recommendations

<b>Taxes on earnings</b>
Merge income tax with employee (and ideally employer) NICs
End the opaque practice of tapering personal allowances and move to a transparent, coherent rate schedule
Introduce a single integrated benefit, getting rid of the very highest effective marginal tax rates (90% and more) faced by some low earners
Strengthen work incentives for those whose youngest child is of school age and for 55- to 70-year-olds relative to others
<b>Indirect taxes</b>
Remove nearly all the current zero and reduced rates and, where possible, exemptions from VAT. Introduce a comprehensive package compensating the less well-off on average whilst maintaining work incentives.
Retain a destination basis for VAT while ending the zero-rating of exports
Introduce a tax equivalent to VAT on financial services
Replace council tax and stamp duty land tax on housing with a tax proportional to the current value of domestic property, to stand in place of VAT on housing
<b>Environmental taxes</b>
Introduce a consistent price on carbon emissions, through a combination of extended coverage of the EU Emissions Trading Scheme and a consistent tax on other emission sources. This would include a tax on domestic gas consumption.
Replace much of the current tax on petrol and diesel with a national system of congestion charging

(cont.)

Table 20.2. (cont.)

<b>Taxation of savings and wealth</b>
Take interest on bank and building society accounts out of tax altogether
Introduce a rate-of-return allowance for substantial holdings of risky assets (e.g. equities held outside ISAs, unincorporated business assets, and rental property) so that only 'excess' returns are taxed
Tax capital income and capital gains above the rate-of-return allowance at the same rate schedule as earned income (including employee and employer NICs), with reduced rates for dividends and capital gains on shares to reflect corporation tax already paid
Maintain and simplify the current system of pensions taxation, ending the excessively generous treatment of employer contributions and replacing the tax-free lump sum with an incentive better targeted at the behaviour we want to encourage
At least remove the most obvious avoidance opportunities from inheritance tax and look to introduce a comprehensive lifetime wealth transfer tax
<b>Business taxes</b>
Introduce an allowance for corporate equity into the corporation tax to align treatment of debt and equity and ensure that only 'excess' returns to investment are taxed
Align tax treatment of employment, self-employment, and corporate-source income
Replace business rates and stamp duty land tax on business property with a land value tax for business and agricultural land, subject to confirming practical feasibility

need to be much better designed and more clearly focused on the externality created than at present. This should involve consistent pricing of carbon and charges for motorists that reflect the main externality they cause, i.e. congestion.

Whilst implementing all these changes would undoubtedly represent a revolution in tax policy, it is also possible to overstate the degree of change. We have looked to achieve our progressive, neutral system not with a single tax on expenditure or income, but through a mix of taxes very similar to those in place today—VAT, personal income tax, and corporation tax would remain, though the base for each would be different. From a practical point of view, maintaining a variety of taxes like this is likely to be important simply to diversify revenue sources. And, of course, maintaining a

progressive personal tax and benefit system is necessary for effective redistribution.

That said, the range and scale of our proposals are such that we have set out a prospectus not for the next Budget or the one after that, but for a long-term programme of reform. Practical and political difficulties will need to be overcome before some of these proposals can be implemented. In some cases—some of the VAT proposals and some proposals on carbon pricing, for example—international agreements will need to be reached before implementation is possible.

It is fair to ask, then, what are our priorities—which of the recommendations are the most substantial, which can be implemented quickly, and which will require a longer period before implementation? Equally, there are several areas we have discussed where we have indicated that we are unsure of what is possible from a practical point of view or where we do not believe the evidence is yet clear enough to be sure of the appropriate reform agenda.

The most important of our recommendations are those that would end what are clear current distortions in the tax system and where we think the evidence is strongest that they could increase economic welfare. Among these we would certainly include applying VAT to a wider range of goods and services (including substitutes for VAT on housing and financial services), moving towards a system of congestion charging for motorists and consistent pricing of greenhouse gas emissions, and reforming the system of personal taxes and benefits to make it simpler and apply low effective tax rates to those groups known to be most responsive to incentives.

Just as far-reaching are our proposals to overhaul the taxation of savings and profits in a way that would exclude the normal rate of return from taxation and align the tax treatment of income from earnings, savings, self-employment, and companies. Extending NICs to self-employment and capital income would be the biggest step towards ending the incentive to convert labour income to capital income; this would fit naturally with integration of income tax and NICs, though integration must encompass employer (as well as employee) NICs or else an equivalent tax should be levied on non-employment income. The introduction of an ACE would also ensure that the damaging bias in favour of debt over equity finance for companies is eliminated. As we suggested earlier, we believe that our

approach in this area has the potential to resolve the ongoing and almost universal tension between preventing tax avoidance on the one hand and minimizing disincentives to save and invest on the other. We can charge similar marginal rates of tax on all income whilst excluding normal returns to capital from taxation, thereby maintaining incentives to save and invest whilst minimizing opportunities for avoidance.

Importance, though, does not necessarily tell us much about the appropriate timing. Some changes may require considerable development and investment, time for consultation, or time for people to understand and adjust to them. Congestion charging is important, but the planning and investment required would not allow it to happen for several years—though that planning should start soon. We have outlined radical changes to savings and business taxation. In an ideal world, these changes would be announced quickly and in a way that would not allow people and companies to plan their affairs in anticipation of the transition. In practice, such an immediate change could not be consistent with good policymaking. Substantial planning and consultation would be required before measures could plausibly be implemented, with timescales measured in years rather than months.

There are other potentially important changes where we have not been able to say conclusively exactly how they could be made. The most important of these is probably finding a way to apply VAT or a surrogate to financial services, where we have outlined possible ways forward without having designed the definitive solution. We would also like to replace business rates with a land value tax, something that depends upon having a reliable means of valuing land separately from the buildings on it. We believe this might well be possible, but would certainly want to see more work done to confirm that. Meanwhile, our tentative proposals to introduce a form of lifetime accessions tax depend on solving a range of implementation problems, and we have, perhaps, less confidence these could be overcome.

But this is no counsel of despair. Preparations for most of this reform programme could, and indeed should, start in earnest very quickly. Many of the problems we face at present arise from a lack of long-term planning and strategy and a failure to address issues that require such planning. But there is also much that could be implemented in much shorter order. There is no reason why stamp duty land tax on housing and council tax should not be

replaced with a tax on the consumption value of housing (standing in place of VAT) as soon as a hugely overdue revaluation exercise can take place. Extending VAT to most goods and services could be implemented quite quickly alongside a compensation package—though there may be a case for phasing this in gradually to dampen the effects on those who would lose out. Reforms to earnings taxation and the benefit system should also be feasible sooner rather than later. Getting rid of a number of specific problems, such as the tapering of allowances which creates such bizarre marginal rate structures, could be done virtually overnight. The same is true of ending the taxation of interest-bearing accounts, removing the most obvious inheritance tax loopholes, and making changes to how the benefit system accounts for age.

Of course, in such a major set of changes, there are difficulties that go well beyond the practicalities of reform. A system designed as we have suggested would affect people and businesses very differently from the system we have now. Even if we could gain general agreement that the system we envisage would be a good place to reach, we would not necessarily find it easy to get there. While a transfer of legal tax liabilities from companies to individuals would not change the ultimate incidence at all in the long run, it will certainly look like a simple tax increase to most people. While we may, rightly, be concerned primarily with tax burdens on individuals across their lifetimes, any change will come in while each individual is at a particular point in their life cycle—and they are bound to focus on its immediate impact.

All these things undoubtedly make change politically challenging. But there are changes that we have suggested that go beyond the politically challenging. They impose real costs on people, and costs that may vary systematically and in ways that some may not consider equitable. These are of three types.

First, there are many reforms we have proposed that, while distributionally neutral on average, undoubtedly hit some people in particular circumstances: those who prefer to spend their money on books and cakes rather than DVDs and biscuits, or those who are self-employed, for example. In one sense, there is no getting around this type of issue in any reform that makes anyone worse off. Intellectually, the right thing to do is consider which is the better equilibrium—one in which we are benefiting the self-

employed at the expense of everyone else, or one with neutrality between those in different forms of work. Practically, the transition is a challenge.

Second, we have argued that, over the life cycle, many of our reforms even out. A rise in VAT and a fall in other taxes will hit people when their consumption is high relative to their income, and benefit them when income is high relative to consumption. An increase in benefits for families with young children and a cut in benefits for families with older children should, on average, cancel out over a lifetime. Again, the 'on average' is important—there will be winners and losers. But there is a different point as well. If I already have older children, the fact that the reform will even out for the next generation is of little comfort. I have missed the boat and I am simply left worse off. This effect can be obviated to some extent by phasing the reform in, and our discussion of this reform suggests how that could be done. It is more difficult to deal with the life-cycle effect of the VAT proposals. To the extent that older people have consumption high relative to their income, it is no comfort to the current generation of older people that they would have benefited from the new system when they were younger, had it been in place. But the reform package we illustrate does not, in fact, mean pensioners losing out on average.

Third, there is the issue of capitalization. Our proposed reforms—particularly reforms to capital taxation—will impact on the value of some assets, and therefore create windfall gains and losses for asset holders, in ways that some will consider unjust. For example, replacing council tax and stamp duty land tax with a tax proportional to current property values will reduce the value of some properties and increase the value of others. Our proposed reforms to inheritance tax will presumably reduce the value of agricultural land and of unquoted businesses.

These are important issues, and real costs will be imposed on people. Change will have to be managed carefully and often brought in gradually. In some cases, that might make the transition easier. In some cases, particularly where the issue is about hitting particular cohorts of individuals, it may be important to make the transition a gradual one. But many of the costs relative to the status quo are unavoidable. They need to be weighed in the political scales. Our view is clear, though: the long-term benefits of change far outweigh the transitional costs. We cannot forever succumb to the tyranny of the status quo.

That status quo involves complexity, unfairness, and significant economic costs. One consequence of it, on which we have already commented, is the amount of taxpayers' energy that goes into avoiding tax and governments' energy that goes into combating avoidance. The more complex and inconsistent the tax base, the more avoidance will be possible and the more legislation will be required, so the more effort is put into shoring up tax revenues rather than into following a coherent strategy. Certainly, one of the central problems of dealing with tax avoidance in the UK has been the propensity of governments to tackle the symptom—by enacting ever more anti-avoidance provisions aimed at the particular avoidance scheme—rather than addressing its underlying cause—often the lack of clarity or consistency in the tax base. Following our agenda should tackle some of the underlying inconsistencies and unnecessary dividing lines within the UK's tax system and hence should produce a system that is more robust against avoidance. 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. We are not so naive as to believe that our proposals will banish avoidance to the outer limits of the tax system, and, given the exponential growth in anti-avoidance legislation in recent years, there may be a case for reconsidering the enactment of a statutory general anti-avoidance rule or principle (a 'statutory GAAR') as is found in Australia, Canada, and New Zealand, all of which share a common legal heritage with the UK. But the primary response should be to address the fundamental causes of avoidance rather than blindly resorting to anti-avoidance provisions, whether of a general or a specific nature. Simply demonizing tax avoiders and exhorting them to behave better is also a feeble stratagem. Lord Kaldor's dictum that 'the existence of widespread tax avoidance is evidence that the system, not the taxpayer, is in need of reform' is surely the right starting point.<sup>6</sup>

The need for reform is evident, as is the need for a clear and coherent strategic policy direction. That strategic direction needs to be set out and understood. Individual policy initiatives need to be assessed against it. There is an urgent need for government to set out and pursue a long-term agenda

<sup>6</sup> Kaldor, 1980.

of tax reform. The political benefits of doing so should have been well-enough signposted by the experience of the 1997–2010 Labour government, which went through a series of poorly-thought-out changes and reforms that were later reversed at considerable political cost. The introduction then abolition of a 10% income tax band, the introduction then abolition of a bizarre capital gains tax regime that rewarded people according to how long they held assets, and the introduction then abolition of a zero rate of corporation tax on low profits are just three of many policy mistakes arising from a lack of direction.

We hope our report can at least set the ground on which an effective long-term strategy can be built. At the very least, this should help avoid the cost and disruption of unplanned and incoherent change. We hope it could ensure a much better and more effective tax system going forward.

#### 20.4. CONCLUSIONS

In recent years, nearly 40p in every pound earned in the UK has been taken in tax. And the growth in government to such levels was perhaps one of the most striking developments of 20<sup>th</sup> century history. Taxes at the level that we now see have a significant impact on all of us individually. They also affect the economy's aggregate performance and the ability of government to spend on essential public services. Whatever the total level of taxation and public spending, it is better if the government ensures that the tax system is designed to do least harm to the productive potential of the economy and to economic welfare more generally, and that the system is viewed as fair.

But governments find it difficult to carry out tax policy in a consistent way. Unlike the economic ideal that we have discussed throughout this volume, tax policy is created in a political process with much concern for how it plays on the evening news and ultimately at the ballot box. Given the potential for the distortion of policy through this, there are some genuinely encouraging aspects of tax policy over the past 30 years. The taxation of savings and of mortgages, and some elements of corporate taxation, have improved over time, and some work incentive issues have been improved through the

expansion of in-work support for low earners, and indeed by cuts in the very high top rates of income tax that existed in the 1970s.

But the picture is not all good. Governments have frequently set about increasing taxes not where they are least economically damaging, but where they are least transparent or most transiently popular. This has led to mistakes which later required rectification (which itself created political tensions). Often, poor economics ultimately becomes poor politics.

Governments also, understandably, shy away from making tough decisions, postponing pain, which on occasion stores up much greater problems in future. The facts that we still pay a tax based on the value of our houses in 1991 and that we still have two separate systems of income taxation are both products of failure to tackle politically difficult anomalies in the tax system.

Government in a media-driven democracy is difficult and there is a need to work within the bounds of the politically feasible. But there is a better way to make tax policy. There are taxes that are fairer, less damaging, and simpler than those we have now. To implement them will take a government willing to be honest with the electorate, willing to understand and explain the arguments, willing to listen to and to consult experts and public alike, and willing to put long-term strategy ahead of short-term tactics.

And the costs of not doing so, while opaque, are very large. Our best estimates suggest that economic welfare could be improved by many billions of pounds annually if the taxation of income, expenditure, profits, environmental externalities, and savings were reformed in the ways we have suggested.

As readers of this book will have gleaned, some of the required changes are easily understood and perfectly simple. Others are rather less so. We hope we have made a contribution to the debate, to the search for clarity, and to the process of holding government to account. But this is a project for the long term. We, and we hope our readers, will continue to put pressure on government to rationalize taxes, to be honest with us when changes are made, and to be bold when boldness is required. It is time for government to grow up and map out a rational course for tax policy.