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
     - Childcare, ‘sin taxes’ ‘green taxes’
   - Distributional arguments for differentiation are weaker
VAT in the UK

- UK zero-rates most food, water, reading matter, 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 income

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

Income Decile Group

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VAT reform: incentive to work at all

Participation tax rates

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VAT reform: incentive to increase earnings
Effective marginal tax rates

Employer cost (£/week)
Before reform
After reform
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
Implicit carbon taxes, 2009-10
Excluding VAT subsidy of domestic energy

- Coal-generated electricity, business
- Gas-generated electricity, business
- Gas for heating, business
- Coal-generated electricity, domestic
- Gas-generated electricity, domestic
- Gas for heating, domestic

£/tonne CO₂

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Congestion charging

• Congestion charging could have big benefits
  – Government estimates potential welfare gains at 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