

The Political Economy of Tax Policy

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EXECUTIVE SUMMARY

This chapter reviews major changes in British tax-setting institutions in the past thirty years and highlights four key points about the politics of tax policy, which are summarized below. The chapter also makes policy recommendations, such as for improving scrutiny and parliamentary accountability; these are also summarized below.

A 'passive' movement to the right

The chapter analyses whether changes in voter preferences and strategic party positioning could explain declines in statutory rates of income tax. What we discover is that electoral support has moved to the right, though voters seem to have followed rather than led the changing content of party manifestos. Voters have always favoured redistribution, particularly from those with the highest incomes to those with the lowest incomes. Whilst preferences for redistribution have been declining over time, it is notable that the large cuts in statutory rates of income tax took place at a time when attitudes to redistribution were at their most favourable, and when a majority of voters voted for parties who did not favour these cuts. Whether this move to the right will persist and to what extent it is now a fact of political life is hard to say.

Policy drift and persistence

Our case study of the R&D tax credit provides a number of lessons, the primary one being that enacting tax policy can create interest groups and constituencies in favour of that policy. Even when they did not lobby for the policy in the first place, like the large firms in our study, they will lobby both for persistence and extensions that allow policy to drift from its original motivation. Therefore, any potential tax reformer should remember that any new allowances enacted or favourable tax treatments provided to particular groups could prove difficult to remove and may be distorted into something different over time.

While the example of the R&D tax credit vividly illustrates policy persistence as well as drift, the past thirty years has seen other areas of specific tax privilege phased out, most notably the married couples allowance and mortgage interest tax relief. The timing of these reforms suggest that it is helpful to phase out changes gradually and during a period when it can plausibly be claimed that other taxes are being cut or rationalized.

Disconnected tax debates

The framing of tax policy debates can be crucial. Framing the VAT zero-rating of children's clothing in isolation has helped maintain it; framing the estate tax in isolation also helped those lobbying for its abolition in the US. Such framing could easily result from a lack of public understanding about the interconnectedness of the tax system.

However, in order to pursue sensible tax policy it is essential to see the tax system as a *system* rather than to consider its different elements in isolation. So disconnected tax debates may be particularly counter-productive for tax policy as compared with other areas of public policy. This has a lesson for the Mirrlees Review, which may need to combine tax reforms in different areas to provide a broad-based set of reform measures, making clear that there is give and take across different population groups.

Transparency and accountability

There is a limit to how well-informed the electorate can be expected to be for the purpose of holding the government to account and ensuring good quality tax policy. However, institutional reforms which improve transparency and public understanding would help avoid situations where government can make increasing use of tax policy instruments that are either ill-understood by voters—as in the case of the relationship between National Insurance contributions, NHS spending, and state benefit spending—or those that are less visible or transparent to voters—such as VAT or fiscal drag.

Do other institutions play an accountability role where the electorate leaves off? Parliament plays some role, but lacks informational resources to play it well, and is hardly involved at all in the crucial pre-legislative stage. External organizations provide some level of scrutiny and accountability, helping to improve tax legislation and making it more likely that the economic impact of proposals is fully thought through.

A proposal for greater scrutiny

A degree of parliamentary accountability through greater levels of pre-legislative scrutiny of tax policy would be highly desirable. Of course, a lack of effective parliamentary accountability extends to other areas of policy, beyond taxation, and is a general political concern. However, the degree of

pre-legislative parliamentary scrutiny is even weaker for tax policy, since in other areas policy proposals are regularly published in White Papers or Green Papers. Although there is pre-legislative scrutiny of draft tax proposals by tax professionals and other interested parties, Parliament is rarely involved in this process.

The best vehicle for pre-legislative scrutiny is the select committee system. We leave it as an open question as to whether scrutiny of tax policy is best undertaken by the existing Treasury Select Committee or by a new select committee on taxation. But it is clear to us that ensuring higher levels of pre-legislative scrutiny should be a priority for government.

Alongside this, in order to undertake effective pre-legislative scrutiny, MPs require more resources. At present, much advice and support comes through external organizations, and this could be extended. However, another possibility is a formal in-house service akin to the Congressional Budget Office in the US, which could be explicitly charged with providing analysis of tax policy for MPs.

More broadly, we believe that serious thought should be given to instituting a body to oversee the public finances. A group of experts with genuine knowledge of the operation of tax systems could be put in place to offer advice and to audit revenue and spending figures. This body could be accessible and accountable to Parliament as well as to the executive with appointments appropriately scrutinized. As well as scrutinizing government plans, the body could offer advice to all parties, particularly around election times. To provide meaningful scrutiny and advice, any such body would require access to more data than is currently provided to Parliament. As well as providing more data to this body, providing more data to the public could improve external scrutiny, for example, by publishing all assumptions behind fiscal forecasts.

13.1. INTRODUCTION

After an authoritative and exhaustive economic analysis of options for tax reform, the Meade Report concluded that:

We believe that the combination of a new Beveridge scheme (to set an acceptable floor to the standard of living of all citizens), of a progressive expenditure tax regime (to combine encouragement to enterprise with the taxation of high levels of personal consumption), and a system of progressive taxation on wealth with some discrimination against inherited wealth, presents a set of final objectives for the structure of direct taxation in the UK that might command a wide consensus of

political approval and which could be approached by a series of piecemeal tax changes over the coming decade.¹

However, whilst some piecemeal changes such as changes to taxation of certain forms of saving did move the UK tax system towards these final objectives, there was no ‘new Beveridge system’ nor implementation of a wealth tax. In order that the Mirrlees Review would give greater consideration to which reforms ‘might command a wide consensus of political approval’, we were charged with writing a chapter that explicitly analysed the political economy of taxation.

Beyond considering what reforms might be politically feasible, we believe that the purpose of studying the political economy of taxation, ultimately, is that a good tax system has to be politically sustainable within the institutions of government, and political economy helps us understand political sustainability. Empirically, there are some policy outcomes that are hard to understand without political economy but less puzzling with it. Some British examples that will be discussed below include the passage and subsequent repeal of the poll tax, absence of VAT on children’s clothing, and the co-existence of National Insurance and personal income tax. However, we will look closely at two cases: why lowered top and basic rates of income tax have proved sustainable in an era of rising income inequality and why a tax credit for research and development aimed originally at small finance-constrained companies has grown so much.

When looking at examples like these, it is not new to say ‘it’s political’, but we are trying to do more than that. We want to be more systematic in studying politics, and to study it in ways that are consistent with the tools and methods of economics, in order to draw lessons. Looked at this way, our purpose might seem to be part of specifying the constraint set, but it is again more than this. In tax policy, distributional issues are central, so getting to sustainability is not going to be just an issue of getting good advice on efficiency from economists. Administration is also part of this, but sustainability is not just an issue of collectability. Tax policy should be credible, especially in a dynamic setting, so considering elections and information is critical. We analyse specific features of the political system that shape tax reforms to give insight into specific institutional remedies that can improve the quality of tax policy. In all these ways political economy makes us think more rigorously about constraints on policy, about what recommendations are feasible and sustainable.

Political economy research suggests three main conflicts of interest that tax policy resolves through institutional processes. The first is a *class-interest view*

¹ Meade (1978).

of politics: citizens have different views about taxation based on their position in the income distribution. In a world in which citizens have different views about how taxes should be levied, political systems affect whose interests are represented and how. The second is between *organized and unorganized interests*: organized interests typically have advantages in securing favourable policy outcomes in return for electoral contributions that can be used to persuade voters. One issue is whether electoral incentives are sufficient to limit any misappropriation of public money. The third conflict is that between *citizens and government*. Making economic activity taxable allows decision makers in governments to appropriate resources for their own objectives and to use them in ways that citizens may not like. Our case studies (below) emphasize these conflicts and issues.

This chapter will make much use of previous research on political economy, but will also consider attitudinal data from the British Social Attitudes (BSA) Survey and data on tax shares collated by the OECD. For the purposes of further understanding the political economy of taxation, we felt that it was important to gain insight from those at the heart of the process. Therefore, we conducted a series of interviews with individuals who have been intimately involved in the tax policy process over the past thirty years. These include former special advisors, senior civil servants, and individuals on the other side of the process in the business community. These interviews sometimes confirmed our own lines of enquiry, but also opened new ones. With their permission, we have included quotes from some of these individuals, since their own words often best described the features or problems of the process. In order to hide their identity, these individuals are referred to as Persons A–G. However, we owe a great debt of gratitude to *all* those whom we interviewed.

Section 13.2 will describe the process of how tax policy is made in the UK and how this has changed since the Meade Report was published. It will also compare the process with how tax policy is made in other countries, such as the USA and Germany, with different institutional frameworks. The main point to emphasize here will be the dominance of the executive over tax policy, particularly HM Treasury. Section 13.3 will discuss in turn interesting developments—from the point of view of political economy—in income tax, indirect taxation, corporate tax, and other forms of taxation in the UK, and beyond. It will also set the scene for more detailed analysis later on in the chapter.

With these observations in mind, we will move on towards using the theory of political economy to explain them. Section 13.4 will begin by seeing if the trends in income taxation can be explained through an examination of electoral interests and voter behaviour. This will encompass discussion

of empirical information on voters' opinions and behaviour, the classical Meltzer–Richard model—where the position of the median voter is seen as crucial—and more recent developments in the field. Section 13.5 will then move on to discuss the nature of interest-group politics in the UK through a case-study of the R&D tax credit.

Section 13.6 will examine the level of transparency and accountability in the UK tax policy process. Section 13.7 will conclude by summarizing the chapter, discussing the implications of our conclusions for potential tax reformers, and presenting our recommendations for how the tax policy process could be changed for the better.

13.2. THE UK TAX PROCESS

13.2.1. Description and comparison of institutional frameworks

Exactly *how* is tax policy made in the UK? What follows is a concise overview of this process and how it differs from the experience in other countries.

We begin by selectively illustrating the specific UK political institutions relevant to tax policy. The first-past-the-post electoral system used for the House of Commons usually allows single parties to govern with significant legislative majorities. Ministers responsible for tax policy (those at the Treasury) will be selected from the ranks of the governing party's MPs by the Prime Minister. This power of patronage is a major reason why these large legislative majorities also tend to be cohesive, with government bills almost always being passed by a subservient House of Commons. One should also note that the British tax system is exceptionally centralized by international standards: little actual discretionary power is located anywhere outside central government. In 2003, over 95% of UK tax revenues were raised by central government—amongst major OECD countries, only Ireland had a greater share of tax revenues accruing to central government.

The key point is that Britain has a narrow base from which policy initiatives can be made: the only body that can put forward tax policy proposals to Parliament is the Treasury.² This is a tremendous advantage to the government and empowers ministers to propose tax measures in the annual Finance Bill following the Budget—a major event in the parliamentary calendar. The unelected House of Lords has no power to block finance bills. Council tax

² Very occasionally a tax-related provision turns up in some other bill (e.g. partnership law) but it would have to be cleared with the Treasury (Person A interview).

rates are set locally, and the Scottish Parliament can change the basic rate of income tax in Scotland by up to 3p, but the power to alter the tax system remains overwhelmingly the prerogative of central government.

It is hard to over-play the dominance of the executive over tax policy, the Treasury in particular. This is because as well as enormous agenda-setting powers, the resources available to the Treasury are vast when compared with those of most MPs. The Treasury can draw on much policy and practical expertise, as well as analysis conducted by HM Revenue and Customs (HMRC). MPs have many fewer resources at their command throughout the year. When discussing the annual Finance Bill, they must generally rely on outside organizations for advice. Parliament thus finds it difficult to provide effective scrutiny of tax measures, and measures are nearly always enacted unchanged in the annual Finance Bill that follows the Budget. As Person A put it,

Debate on the Finance Bill is poorer because there is no expert support available to MPs. Typically an Opposition MP will be briefed by an accounting firm and will have a question to ask during the committee stage, the minister has been briefed by officials and gives an answer, but the individual MP is unable to evaluate the response and cannot pursue a sensible discussion. So debate is utterly meaningless.³

Such criticisms could be made of parliamentary scrutiny of other areas of policy, with executive dominance evident in many others areas of public policy. However, in contrast to other areas of policy, the House of Lords cannot amend the Finance Bill and therefore has limited powers of scrutiny. It is also the case that tax measures receive far less pre-legislative scrutiny than other areas of policy. This is because most departments first announce policy in White Papers, or produce consultation documents called Green Papers discussing policy options. White Papers and Green Papers tend to receive much scrutiny in and outside Parliament. The effectiveness of this scrutiny is another question, but tax policy doesn't even receive this level of pre-legislative scrutiny. However, it does have to be said that pre-legislative consultation of tax professionals is widespread and has become more so in recent years, which should surely help in the development of good tax policy.

The lack of effective parliamentary scrutiny could be a problem for many reasons. First, it may be a problem in its own right, since the House of Commons has a constitutional responsibility to provide effective scrutiny of tax measures, which it is clearly failing to do at present. Secondly,

³ Person A interview. In fact, 'It has happened that the Minister picks the wrong answer off the list, but the MP doesn't know and is satisfied with the answer.'

effective scrutiny may prevent policy-makers from making policy mistakes, and improve the tax system.

What are the direct sources of ideas for tax policy reforms within the executive branch? The first source will be proposals from civil servants within the Treasury, crafted to meet particular ministerial objectives. These ministerial objectives could be quite narrow and particular, for example, Nigel Lawson's main aim was widely seen to be promoting tax neutrality. Or they could be more general and wide-ranging, such as Gordon Brown's stated agenda of organizing public finances 'to encourage work, savings, investment and fairness'.⁴ How these goals are defined varies from minister to minister. They could be personal views or they could be crafted for manifestos to achieve maximum electoral support. Clearly external influences—such as think tanks, tax practitioners, and the media—could persuade politicians of suitable ministerial objectives for a tax system, but there is also room for external influences in generating tax policy ideas that meet given ministerial objectives.

A second source of tax policy proposals concerns measures to prevent tax avoidance. In administering the tax system, staff in HMRC are able to identify loopholes in the tax system that allow agents to avoid paying tax. They are then able to propose ways to close such loopholes, or other ways to protect revenues. There is also a clear opportunity here for other specialist tax practitioners to suggest ways to reduce tax avoidance.

A third source of tax policy is more political, that made directly by ministers and advisors. This could come from election manifesto promises implemented soon after election, like the windfall tax on privatized utilities in 1997, or the cutting of top marginal rates of income tax in 1979. It could also be tax policy made between elections directly by ministers and their advisors, with or against the advice of tax policy officials.

The way tax policy is made in the UK is very different to the situation in many other European countries, particularly those with systems of proportional representation and powerful veto players. For instance, in Italy where coalition governments are the norm, tax policy is made as a result of negotiations within coalitions, and third parties, such as trade unions, are often consulted much more than in the UK. A good recent example from Italy is the cut in income tax enacted by Silvio Berlusconi in 2004. Before this became possible, agreement was required between all members of the governing coalition, who sometimes had quite different priorities. For instance, the far-right National Alliance wanted more to be spent on the south

⁴ Pre-Budget Report 1997.

of Italy, whilst the Christian Democrats were keen to protect the privileges of public sector workers.

The cuts in corporate and incomes tax undertaken by Gerhard Schroeder's government, starting in 2001, are an example from Germany which shows how important are veto players. Ganghof (2008) shows that despite an apparent preference for the introduction of a dual-income tax system over across the board cuts in corporate and income tax rates, the latter was instituted instead. The dual-income tax system was primarily a non-starter in Germany because the constitutional court had already let it be known that differential tax treatment of income and capital would most probably be ruled unconstitutional.

Steinmo (1996) has already identified the role of committees and legislative bargaining as being crucial to understanding how US tax policy has evolved over time. In comparison with the US, Michael Keen wrote:

To the outsider, the most obvious contrast is in the degree of consultation in the formation of tax policy. In the United States, major tax policy initiatives are developed, marketed, analyzed, and negotiated . . . In the United Kingdom, they are commonly announced.⁵

Put another way, in the UK the processes of analysis, negotiation, and marketing take place much more within the executive branch than in the legislature, or indeed in politicians' campaigns for election. The executive has extensive agenda power, and government proposals are rarely subject to significant amendment, let alone veto.⁶ The centralization of revenues, lack of information and expertise in Parliament, rarity of coalition bargaining, and absence of any powers of initiative and referendum reinforces the familiar executive dominance of British politics.

It should be noted that such arrangements do have some benefits, particularly with regard to levels of government debt. By international standards (based on OECD and IMF data reviewed in Alt and Lassen (2006)) Britain has a relatively transparent budget process, which weakens political incentives to manipulate revenues (and spending) for purposes of electoral gain. At the same time, Britain only very infrequently has coalition governments, which have higher debt levels at least in bad economic times, due to the relative

⁵ Keen (1999).

⁶ A rare example of Parliament significantly affecting the course of tax legislation is the so-called Rooker–Wise Amendment, introduced in the 1977 Finance Bill Committee by two Labour backbenchers. This ensures that an Act of Parliament is required in order to increase income tax allowances by less than the increase in RPI, which means that the default option is that they be uprated in line with RPI. Note that this amendment was introduced at a time when the governing Labour Party did not have a majority.

inability of multiparty coalition governments to respond quickly to economic shocks (Roubini and Sachs (1989)). In part at least for these reasons, Britain has had a comparatively low level of debt for most of the period since Meade.

13.2.2. Changes in executive process since Meade

This section will discuss changes in the executive process since the Meade Report was published, together with a short introduction to the fiscal rules that were introduced ten years ago.

The classical view of how executive goals evolve into policy sees civil servants producing tax policy recommendations that seek to achieve these policy goals; the more visible a politician's policy goals are to civil servants, the better they can respond. The classical view prevailed into the 1990s, but the last decade saw significant changes: a comprehensive reorganization of policy development in the Treasury, a major increase in the importance of political special advisors, and the adoption of some fiscal rules.

First and foremost, the organization of policy planning in HM Treasury (HMT) and HMRC has changed dramatically. Previously, according to Person B, in HM Treasury during the early 1990s,

There was one 'team' for fiscal policy with three branches: taxes, indirect taxes, and budget coordination, with at most 2–3 people per branch. It was a big challenge to get anything done. Revenue and Customs produced material that was very technically phrased, but HMT was deeply dependent on the others for input.⁷

Now, by contrast, following the O'Donnell Review (O'Donnell, 2004) which proposed the merger of the Inland Revenue and Customs and Excise to create HMRC, the heart of policy development is in HMT, and new ideas could even come from policy teams there.

Policy teams reflect ideas from outside. The organization of teams is formally structured. There are three subdirectorates and 19 teams: 2 for strategy, 1 for budget delivery, but the other 16 are policy teams, organized either by tax (for example, corporate) or labour market or sector (property tax). The idea is to have any policy proposal contained within a team but real policy is too wide, so there is typically Department for Work and Pensions (DWP) involvement and also across other directorates.

The consequences are not all benign according to Person A:

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

⁷ Person B interview.

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.⁸

These organizational changes have thus increased the power of the Treasury over tax policy, which were already quite substantial, at the expense of HMRC. But it does have another very important consequence. Sometimes the teams are deliberately used in a competitive environment, to get different people giving different views. For instance, as the R&D tax credit was shepherded through the institutional process, the input from multiple departments:

gives ministers broader choice. It works well if the three have equal power. Revenue controls costings; Productivity team ... had the eyes and ears of Special Advisers and Ministers because innovation was valued; Tax Policy sat in the middle with the scorecard trying to balance; each had its own focus. No-one has to tell HMT to get lined up with Enterprise [productivity] and Policy [tax] because you need them to fight for you.⁹

Second, partly as a consequence of the first set of changes, the process is now far more 'political' than before, at the special adviser and ministerial level. Special advisers were a feature of the political process even at the time of the Meade Report, however, they have become more important over time, especially during the past ten years. As Person C described the process during Brown's Chancellorship:

you had enfranchisement of political advisors far deeper than would have been the case before ... Special advisors were the real motive forces. Some are brought in because they have specialist knowledge of a topic, acting as a key expert witness within HMT. In HMT they were far more part of the day-to-day work, and, while they couldn't instruct anyone in the Civil Service, given that they talked to ministers all the time, they were often considered to be the mouthpiece of the minister. One always wanted to talk to the Special Advisor to figure out where the minister was coming from¹⁰ and you might have four meetings with a Special Adviser, then one with the Chancellor. The result was that you would get much clearer policy direction much earlier.

⁸ Person A interview.

⁹ Person C interview.

¹⁰ Person C interview. This point applies equally to representatives of outside interests and to those within HMT crafting policy proposals.

This change has created a systematic demand for information that can only be provided by outside organizations. For example, in the case of the R&D Tax Credit that we examine below,

HMT at the time was trying to build more direct contact with business. Previously, all contact had been via the Inland Revenue and the Department for Trade and Industry (DTI) . . . and Treasury wanted to have direct company input in order to resist its intentions being constantly trumped by ‘this won’t work’ statements from the others who had such direct contact. Furthermore, the Inland Revenue suffered from a negative external reputation as the tax collector and HMT had the advantage that it was seen by business as a policy group, not just the people who take your money.

Finally, the direct access to company ideas meant that the ideas were delivered ‘unwashed’ to special advisors, rather than being ‘normalized’ through the Budget process. This led to a large initial set of vibrant ideas, with special advisers being involved in the weeding out process.¹¹

The period we review, and specifically Brown’s Chancellorship, may have been the peak of special advisers’ importance in tax policy-making. According to Person E:

Nearly a year after the move of Gordon Brown from the Treasury it is clear that special advisers are no longer the absolutely key element in the policy making process that they were between 1997 and 2007.

Nevertheless, tax policy is more ‘political’ than it used to be, with a greater role for special advisers than at the time of the Meade Report. Partly as a result of this, there has also been a fusion of tax policy goals with other political goals. The fusion of legislative input with the desire for social engineering is usually used to explain why the US tax code is so much more complicated than the UK code:

The British example shows that the American tax code could be much simpler if Americans were willing to reduce the extent to which [they] tried to administer social policy through the tax code (Gale (1999)).

However, as already stated, this difference may be eroding:

Mr. Brown’s penchant for fine-tuning taxes has doubled the size of the tax code to 8,300 pages . . . the second-longest in the world’s 20 top economies, after India. (*Wall Street Journal*, 3/21/07, p. 1)¹²

Increased fusion of tax policy with other political goals, Treasury assuming responsibility for tax policy input, and the increased politicization of the

¹¹ Person C interview.

¹² Citing a report by the World Bank and PriceWaterhouseCoopers.

whole tax policy process mark significant recent, though by no means certainly permanent, changes in the British tax policy process.

Finally, another important institutional innovation in the past thirty years is the introduction of the fiscal rules. The Labour government chose to impose two fiscal rules in 1998. The first was known as the ‘golden rule’ which demanded that the current budget be balanced over an economic cycle. The second rule was known as the ‘sustainable investment’ or ‘net debt’ rule. This said that net debt should remain at ‘a stable and prudent level’, which the government chose to define as below 40% of GDP. These rules were instituted in order that there be transparent public finance goals to which the government could be held to account, thereby ensuring responsible management of the public finances. We do not discuss the fiscal rules in much more detail since they relate more to the difference between levels of public spending and taxation, rather than levels of taxation.

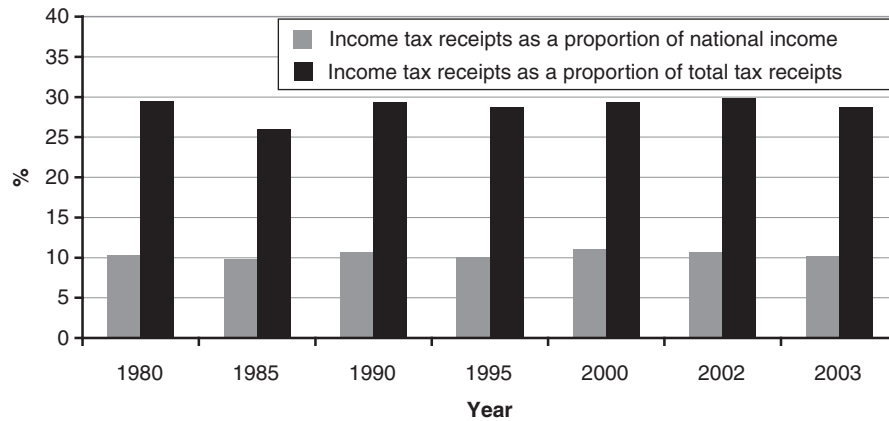
13.3. TAX POLICY IN PRACTICE

This section describes how tax systems have been reformed over the past thirty years in five broad areas—income, social security contributions, indirect, corporate, and property taxes. It will concentrate on drawing out which political forces and ideas have driven the process, with a particular focus on the UK, though also contrasting and comparing the cross-country experience.

13.3.1. Income tax

One of the main headline changes of the last thirty years has been the fall in statutory marginal tax rates, with the top rate falling by the most. In the UK, following their election victory in 1979, the Conservatives cut the top rate on earned income from 83% to 60%, and the basic rate from 33% to 30%. Over the 1980s, these continued to be cut, with the top rate falling to 40% in 1988.

The Labour Party opposed these cuts throughout the 1980s, stating in its 1987 general election manifesto that, ‘We will reverse the extra tax cuts which the richest 5 per cent have received from the Tory government and allocate that money instead to the most needy.’ However, by 1997 the Labour Party under Tony Blair had changed its tune, with its general election manifesto stating that, ‘There will be no increase in the basic or top rates of income tax.’



Source: OECD Revenue Statistics.

Figure 13.1. Income tax receipts as a proportion of GDP and total tax receipts

Drawing out the political reasons behind why statutory rates fell during the 1980s will be a key question for this chapter, as will why there has been a convergence on the status quo amongst the main political parties in recent years. We will attempt to answer these questions in Section 13.4 through an examination of voter preferences and models of political economy.

In contrast to the decline in statutory rates, it seems clear from Figure 13.1 that the overall burden of income tax—as measured by income tax receipts as a proportion of national income—has changed little over the past thirty years. This is because whilst statutory rates have been cut, thresholds and allowances have tended to rise in line with inflation, whilst earnings have risen more quickly, leading the number of higher rate tax-payers to grow from 674,000 in 1979–80 to 3.3 million in 2006–07—this process is known as ‘bracket creep’ or ‘fiscal drag’. Moreover, certain major tax expenditures, such as mortgage interest tax relief, have been withdrawn, leading to a broadening of the income tax base. It is worth noting that ‘fiscal drag’ does not just affect income tax, it affects all taxes where the tax base grows faster than allowances and thresholds used for that tax. In fact, the Treasury estimates that ‘fiscal drag’ on all taxes contributes an additional 0.2% of national income to tax revenues every year.¹³

Looking at this from a political economy standpoint, it is odd how important the statutory rate has been in political debate relative to thresholds, given their joint importance in determining the tax burden. Income tax ‘cuts’

¹³ Paragraph A24 of HM Treasury, *End of Year Fiscal Report*, December 2003 <http://www.hm-treasury.gov.uk/media/324/70/end_of_year_352%5B1%5D.pdf>.

appeared to be quite popular in the 1980s and how much you pay in income tax is quite observable and transparent. Yet the overall burden of income tax has hardly budged. This observation also raises the question of fiscal illusion—the idea that voters systematically underestimate the amount they are paying in tax. We will discuss how well informed the public are about the tax system in Section 13.6, together with a discussion of overall levels of transparency and accountability.

13.3.2. National Insurance contributions

The other major tax that is levied on earned income in the UK is National Insurance contributions (NICs). Over time the main NIC rates have risen for both employees and employers, rising from 6.5% in 1979–80 to 11% in 2006–07 for employee contributions (10% to 12.8% for employer contributions).

It is not clear that NICs should be treated as conceptually different from income tax, and whether a comparison with other countries' social security contributions is a valid one. This is because there is only a weak connection between contributions made and entitlement in the UK, compared with a much stronger one in other countries, particularly those in continental Europe. Moreover, in contrast to other countries where social security contributions are often earmarked for specific areas of public expenditure—a process known as hypothecation—NICs are not hypothecated in any meaningful sense. These two points suggest only minimal differences between paying income tax and NICs, something further underlined by a gradual alignment of their respective schedules.

Despite this, the fact that NICs and marginal rates of income tax have followed different trends over the past thirty years suggests that raising NICs is more politically acceptable than is raising income tax. Section 13.6 will discuss this issue further in the context of models of political economy where voters are imperfectly informed.

13.3.3. Indirect taxation

When VAT replaced purchase tax in 1973, it was not particularly controversial though it was considered complex and some believed it to be a source of price inflation. However, its structure has been a source of controversy, for instance, such controversy forced Labour to derogate from the EEC 6th VAT Directive in 1977 to maintain a zero rate for children's clothing.

Since 1979, the main rate was increased twice by the Conservatives: in 1979, from a two-tier system of 8% and 12.5% to a single higher rate of 15%, to help pay for lower statutory rates of income tax; and then again in 1991, from 15% to 17.5%, to help pay for reductions in the poll tax. Partly as a result of these changes, the proportion of GDP taken up by indirect tax receipts rose from 8.3% in 1979 to reach 11.2% by 2005. This overall change in the burden of indirect taxes does not tell us much about the change in its composition. There has in fact been a shift away from specific taxes on goods and excise duties towards the broadly based and uniform VAT. (More specific details can be found in Chapter 1 (Adam, Browne, and Heady).)

As already stated, the structure of VAT has been a more pertinent political issue than the main rate. All parties have attached a high salience to the zero-rating of children's clothing, food, and other items. Demonstrating this is the fact that the Labour Party has included a pledge in all of its recent general election manifestos: pledges along the lines of 'We renew our pledge not to extend VAT to food, children's clothes, books and newspapers and public transport fares' (taken from the 1997 Labour manifesto).

Similarly, the Labour Party made much political capital from the Conservatives' imposition of VAT on domestic energy at 8% in 1994, and from their role in preventing the Conservatives increasing this to 17.5% in 1995, as was the original intention. Labour then symbolically cut the rate to 5% in the summer budget of 1997, the first budget after the new Labour government had been elected. The taxation of petrol was, however, to prove even more costly for Labour. In response to high levels of tax on petrol, protests in September 2001 almost brought the country to a standstill and caused Labour to lose its lead in the polls for the first time since it was elected in 1997.

In our analysis of the role of interest groups in Section 13.5, we discuss how and why certain elements of indirect taxes have proved to be so politically controversial. Our discussion will emphasize the role that analysing individual taxes on their own rather than as part of the tax system has played in making these issues so controversial and reform so difficult. We will also extend this discussion to the present debate on council tax.

Coming back to this issue of why steady rises in the overall rate of VAT have proven to be politically sustainable, perhaps this is because it helped to pay for things voters valued more, such as lower rates of income tax or a lower poll tax. However, it is impossible to discuss VAT without reference to the increasing role played by the EU in this area. In fact we see that many current

members of the EU have increased or introduced VAT over the past twenty-five years. This list includes founder members such as France, Germany, Italy, but also includes newer members such as Spain, Greece, and most of the former communist countries of Central and Eastern Europe. From Chapter 1 by Adam, Browne, and Heady, we also know that it is EU countries who raise relatively high proportions of revenue from indirect taxation. This is particularly the case when comparing major EU countries, such as Germany and France, with other major OECD economies, such as Japan and the USA.

In stark contrast to the largely uncontroversial raising of VAT in the EU, Canada, Australia, and Japan have all introduced a Goods and Services Tax (GST) or consumption tax over the past thirty years amid a wave of political controversy. One reason for the relatively controversial introduction of indirect taxes in Canada, Australia, and Japan could be the administrative differences between the operation of their indirect taxes and VAT in the EU.¹⁴ More important though may be the increasing role of the EU in VAT policy, which has largely been to aid the creation of the Single Market. The 6th VAT Directive of the EU, introduced in 1977 (amended in various years and complemented by other directives since then), states that all EU countries must have a VAT rate above 15%, which goods can be granted reduced-rate status and that new exemptions for goods and services must be agreed to by the EU. This means that voters in current or aspirant members of the EU have to weigh the benefits of membership of the EU and the single market against any reservations about being forced to increase/introduce VAT. The intertwining of the issue of VAT with the issue of EU membership may thus largely defuse the introduction/extension of VAT as a potential political concern in a large number of European countries.

13.3.4. Corporation tax

Almost all major OECD countries show a very similar pattern in the timing and nature of reforms to their corporate taxation systems. One phrase can sum it up: 'Gradual cuts in the statutory rate of corporation tax, combined with base-broadening measures.' This has occurred across almost all

¹⁴ Note that there has never even been a serious political attempt to implement a VAT in the US, where 90% of the states have retail sales taxes, a majority dating from the Depression. Exemptions and allowances vary widely across states. Increases in sales taxes are controversial, often occurring in response to fiscal crises, when it is often expedient to label them as temporary. For instance, Rhode Island's current 7% sales tax rate was raised 'temporarily' from 1 to 6% in the 1970s, and again 'temporarily' from 6 to 7% in the early 1990s to bail out the state's failed credit unions.

countries, no matter the political persuasion of governing parties nor the institutional setting. Moreover, there is little evidence to suggest that corporation tax has been a major issue in elections in any of these countries. Corporate tax receipts as a proportion of GDP have remained fairly constant in all major OECD countries. Base-broadening measures have largely offset the effect of falling statutory rates (see the chapters on taxing corporate income by Auerbach, Devereux, and Simpson, Chapter 9, and international capital taxation by Griffith, Hines, and Sørensen, Chapter 10, for more details).

The structure of corporation tax is complicated the world over. Cross-country comparisons are best illustrated in the separate chapters focusing on corporate tax and on international issues. However, in order to examine the role of interest groups in the development of corporate tax policy, we have chosen to conduct a detailed case-study of the development of the R&D tax credit in the UK (Section 13.5). Therefore, it is important to note the following facts.

First and foremost, the fact that Britain now has an R&D tax credit is not particularly surprising. Many governments offer R&D tax incentives to firms in research-intensive industries as part of a strategy to promote domestic innovation and competitiveness. As of 2006, R&D tax incentives are available in 18 of the 30 OECD countries, up from 12 countries in 1996.¹⁵ These R&D incentives usually take the form of a tax relief, with the amount provided being determined by the extent of R&D activity undertaken.

Britain established a relatively generous credit by international standards. Billings and Paschke (2003)¹⁶ confirm that the US provides one of the lowest incentives in the world for R&D. However, in a series of interviews, senior managers at leading pharmaceutical firms confirmed that from an investment perspective, the US continues to be the most attractive location; when asked to name potential future challenges to US leadership, not a single interviewee mentioned tax incentives as a significant consideration (Xu (2007)). Sedgley (2006) presents data that disputes any simple correlation between a country's share of OECD R&D spending and the generosity of its tax incentives (France and Germany, for instance, have less generous R&D tax incentives but higher shares of R&D than the UK). On the other hand, Berger (1993), Hall (1993), and Bloom, Griffith, and Van Reenen (2002) all present evidence that such credits can lead to increases in R&D.

It is also notable that international bodies have become increasingly important in the development of corporate tax policy, including the OECD and the

¹⁵ Sedgley (2006), p. 42.

¹⁶ Calculation methods are published in a paper in *Tax Notes International* in 2003.

EU. We note this fact, but leave it to Chapters 9 and 10 (Auerbach, Devereux, and Simpson; Griffith, Hines, and Sørensen) to discuss it in more detail.

13.3.5. Property and local taxation

The years since Meade saw one major attempt at innovation in property taxation. As already highlighted, less than 5% of total tax revenue is raised locally. Over recent history, practically all of this has been through various kinds of property taxes. As a result, it is thus quite difficult to separate out issues relating to property taxes and the degree of centralization in tax setting powers.

Up to and including the 1980s, local authorities funded part of their spending through a system called domestic rates. Every property had a 'rateable value', which was then multiplied by a tax rate called the 'rate poundage' set by each local authority to calculate the amount of domestic rates payable by residential households. There were rate rebates for poorer households. A similar scheme of rates also existed for business properties. The rest of local authority spending was funded through grants from central government, which were adjusted in order to equalize tax raising powers across local authorities.

By the late 1980s, 'rateable values' had not been adjusted since 1973 and thus were out of line with current patterns of property values. Domestic rates were also unpopular as some low-income households faced high rates bills, but had fairly modest incomes, for example, single pensioners. The unpopularity of rates can also be seen in the numerous instances of 'rate capping' during the 1980s, whereby the government prevented councils raising rates by more than a given amount.

The government also argued that this system was detrimental to local political accountability as

All too often this accountability is blurred by the complexities of the national grant system and by the fact that differences arise among those who vote for, those who pay for and those who receive local government services.

In place of domestic rates, the government proposed to introduce a flat-rate charge for each adult in a household (with a few exemptions and rebates).¹⁷ This charge was officially known as the community charge, but became known as the 'poll tax'. The intent of these proposals was to create

¹⁷ Regarding non-domestic rates, they proposed equalizing rates on business properties across the country combined with a centralization of revenue collection. It also proposed replacing the scheme that equalized resources to correct for an uneven distribution of rateable values with a need-based assessment of spending requirements.

a system whereby each extra pound of local spending had to be funded through the poll tax rather than central government grants, with a view to increasing local political accountability by linking local government spending and local election voting. As well as improving political accountability, it was also argued that the community charge would be more equitable, since it would ensure that everyone contributed something to the provision of local services.

These proposals were included in the Conservative Party's general election manifesto in 1987. However, the Labour Party remained largely silent on the poll tax during the campaign in order to avoid reminding voters of the perceived profligacy of so-called 'loony Left' councils. Despite the opposition of the Chancellor at the time, Nigel Lawson, and an attempt by the Conservative MP Michael Mates to make the poll tax dependent on banded household income, the proposals were enacted and came into effect on 1 April 1990 (they came into effect one year earlier in Scotland). However, the poll tax proved to be very unpopular: there were riots in central London and many individuals were sent to court for refusing to pay the 'unfair' poll tax. The unpopularity of the poll tax is widely seen as a major contributory factor of the downfall of Margaret Thatcher that would follow later that year.

Why it was controversial is not that hard to explain. Most people felt its level and structure were deeply unfair, with many people being worse off by relatively large amounts. Many voters in social and economic groups C1 and C2 expected to be worst hit by the new poll tax (according to a poll conducted by NOP for the *Local Government Chronicle*). Moreover, the riots in Trafalgar Square were attended not just by the 'usual suspects', but also by these middle-income voters who expected to lose relatively large amounts from the poll tax. Therefore it is not surprising that many Conservative MPs felt their seats threatened. This fear almost certainly motivated many of them to vote for Michael Heseltine (who promised to get rid of the poll tax) against Margaret Thatcher in a leadership election in November 1990, resulting in her downfall.

What is surprising is how such a policy was even contemplated, let alone proposed and implemented. According to Butler, Adonis, and Travers (1994), it was a natural result of the set-up of British political institutions and nothing has changed to prevent such a blunder from happening again. According to them, apart from the already mentioned circumstance that Labour was unable to oppose the poll tax proposals effectively during the 1987 general election, the electoral system still guarantees safe legislative majorities,

especially when the Opposition seems incapable of forming a government. Governing parties are still able to come up with policies without consulting outside the party or cabinet. Frequent cabinet shuffles still prevent most ministers from looking at policies from a considered long-term point of view. Governing parties are still largely able to force legislation through the Commons, even if their own backbenchers oppose it, through the promise of patronage. Finally, the House of Lords is still heavily restricted in its ability to scrutinize tax policy changes.

The experience of the poll tax thus provides very useful lessons for potential tax reformers. The UK institutional set-up permits a huge freedom of action for policymakers, with little effective scrutiny of tax policy after it has been announced. This may seem to be a blessing for a policymaker keen on reforming the tax system in a particular direction. However, insulation from effective scrutiny may allow them to implement deeply unpopular policies, resulting in severe punishment from a disgruntled public. For example, a brief legislative defeat over the poll tax might have been preferable to the rioting in Trafalgar Square. We will discuss measures that could improve effective scrutiny in Section 13.6 and in our final section on policy recommendations for the institutional process.

The poll tax was gradually unwound from 1991 onwards, with an increase in VAT in Budget 1991 paying for a reduction in average poll tax levels. The poll tax was then replaced with the council tax in 1993, which is not that dissimilar from the old domestic rates system though there are some important differences: council tax is calculated according to banded property values and there is relief for single occupants. Council taxes were originally set at a lower level than domestic rates, and now provide barely one-sixth of local authority expenditure. The net result of the poll tax experiment and changes to non-domestic rates has been a greater centralization of tax revenues. There is just as much uncertainty as to how increases in local taxation translate into greater local spending and, consequently, just as little local political accountability over local spending levels.

The council tax seems to be just as unpopular as domestic rates. For instance, when a YouGov poll for the Taxpayer's Alliance in August 2007 asked respondents which out of a set of potential tax reforms they favoured, the most popular was lower levels of council tax. Why council tax might be so unpopular will be discussed in relation to interest-group theory in Section 13.5, and with relation to voters' understanding of the tax system in Section 13.6 where we will also explore measures that could improve central and local political accountability.

13.4. INCOME TAXATION AND ELECTORAL INTERESTS: A CASE STUDY

Although personal taxes as a share of national income have remained at about the same level, a main headline change of the period since Meade has been the fall in statutory marginal tax rates in Britain (and elsewhere). This has happened over a period of rising and increasingly unequal pre-tax incomes in Britain. Nevertheless this increase in pre-tax income inequality has not been met by an increasingly progressive income tax structure. (See Adam, Browne, and Heady, Chapter 1). This is potentially puzzling to both political economists and optimum tax theorists: under fairly straightforward assumptions, in a system in which taxes and transfers are either chosen by a majority of rational self-interested voters or set by a benevolent social welfare maximizer, an increase in pre-tax income inequality would usually be offset by changes in taxation. The fact that this did not happen—and has frequently been observed not to happen in other contexts—suggests that we should look closely at the information, beliefs, and attitudes of voters. For example, did top rates come down and stay down because people changed their minds about the desirability of redistribution? We also need to consider how closely the politics of tax policy choice approximate majority voting. Political economists take note of wide institutional variation in how elections are conducted: majoritarian versus proportional representation is an aspect of this, along with the nature of parliamentary authority, accountability of the executive, whether politicians are term-limited, and whether there is scope for direct democracy.

Lowered top and basic income tax rates in Britain have proved politically sustainable for some time. In this section, we discuss this within the context of a fairly generalized model of political economy, relating changes in top and basic income tax rates to evidence and theory on voters, electoral interests and political parties. It is a case study: we discuss issues of theory and modelling at a fairly general level and tie this back to the policy and institutional issues in the UK. We stress the significance of voter loyalties to polarized parties, how the parties' manifesto pledges in turn affect voters' choices, and how voters connect the desirability of redistribution to their confidence in the government as their agent for public provision.

For this purpose we draw on the best source of consistent and reliable data on the evolution of attitudes in the UK, which is the British Social Attitudes survey. Since 1984 this has provided evidence on social attitudes of nationally representative samples of British residents and

questions asked include several pertinent to the level and structure of taxation.

13.4.1. What taxes do voters want?

The standard model

Analysis of determination of tax rates under democracy begins with analysis of voter preferences. The standard model here proceeds from the same fundamentals as the optimum income tax literature. Voters like private consumption—and possibly also publicly provided goods—but not work. Taxation (interpreted broadly) determines individuals' private budget constraints linking the two and individual hours' choices then link tax schedules to realized utility at differing wage rates. The issue for political economy, as in the optimum income tax literature, is to study determination of the tax function from within some feasible set, restricted to satisfy the public sector budget constraint and possibly other administrative requirements.

Consider individual preferences over tax schedules. Self-interested individuals prefer tax schedules which maximize their own utility subject to the government budget constraint. Let us suppose for the moment (as in Romer (1975), Roberts (1977), and Meltzer and Richard (1981) for example) that the tax functions under comparison are linear and there are no publicly provided goods. We can think of there being two effects to positive tax rates. First, income is redistributed from the better off to the worse off and secondly, hours' choices are distorted and resources wasted in collection, creating a deadweight loss. The latter effect benefits no one but the former is to the advantage of those below mean pre-tax income¹⁸ at the expense of those above it. Individuals whose wages are such that incomes would fall above the mean in the absence of taxes therefore favour zero taxes whereas those with lower wages are prepared to trade off the efficiency costs against the redistributive gains and therefore favour positive rates. Meltzer and Richard (1981) argue that desired tax rates will increase as one moves down the wage distribution. Eventually one reaches wage levels at which individuals would choose not to work at their desired tax rate and for all such individuals the best tax rate is simply that which maximizes the revenue available to fund

¹⁸ Since the tax is linear and there is no other form of public spending, the government budget constraint requires the individual with mean pre-tax income to pay zero tax.

their government-provided post-tax income, a tax rate nonetheless less than 100% because of the incentive effects of taxation.¹⁹

With a linear tax schedule and a government budget constraint there is only one degree of freedom in tax setting and individuals are restricted to comparing taxes simply along the single dimension of the marginal tax rate. With more flexibility in feasible tax schedules the scope for individuals to design tax schedules which benefit them while placing the burden on others is increased. In particular, if we were to allow for, say, systems with two marginal rates then those on lower wages would be able to choose systems which have lower rates of tax on their own incomes but which make up revenue through higher rates on those on higher wages.

Some of the starker predictions of this sort of theorizing about individual preferences over tax setting—for example, no support for taxation at all from those above mean income—arise from a particularly crude assumption of self-interestedness. Even without our assuming altruism, the rich may believe that high levels of inequality would cause problems of crime and social unrest which would make their lives uncomfortable. If we allow for the possibility of altruistic concern as a complementary motivation then support for redistribution from better-off individuals becomes even less surprising. If we suppose, say, that individuals choose tax rates which maximize some weighted average of their own and other's utilities then a desire for positive tax rates will be present even at high incomes. The extent of altruism may differ between societies—and it has been argued, for example by Alesina, Glaeser, and Sacerdote (2001), that it is promoted by factors such as social and racial homogeneity—in which case the steepness with which desired tax rates decline with income should be greater in societies less disposed to altruism. Georgiadis and Manning (2007) point out that uncertainty about future income may have implications somewhat similar to altruism in inducing concern about tax rates at other points in the distribution. We return to discussion of the insurance role of taxation below.

Beliefs and attitudes on the distribution of income

The foregoing analysis suggests that support for taxation and redistribution should be related to position in the income distribution. For evidence

¹⁹ These observations essentially all apply in the simplified model used by Bolton and Roland (1997) and subsequently by McCarty, Poole, and Rosenthal (2006) in which voters are interested solely in post-tax income, the redistributive gain is linear and there is a deadweight loss which is quadratic in the tax rate. The latter effect is therefore small relative to the former for small tax rates but becomes increasingly important for larger tax rates.

on this we turn to the BSA which has contained information on household income and on attitudes to redistribution throughout its duration. Information on income is banded and bands change with time but we can construct a measure of income position which is reasonably comparable across years by calculating for each respondent the number of other respondents placing themselves in lower income bands in the same year.²⁰

One might worry, before using this measure, as to the extent to which individuals perceive their position in the distribution accurately. The BSA in 2004 asked respondents specifically what proportion of the population they believed to be less well off than themselves (Sefton (2005)) and it is interesting to compare this to actual position. Figure 13.2 shows that perception is strongly positively related to true position²¹ though there is some evidence that those at the top underestimate how well off they are and those at the bottom underestimate how badly off they are²² (in line with the observations of Taylor-Gooby, Hastie, and Bromley (2003) and Evans and Kelley (2004)) with the result that the perceived income distribution is a good deal flatter than the true distribution. We have checked using the 2004 data to see whether relating other survey responses to actual income position gives a misleading impression of relation to perceived position and there seems little evidence that this is an important issue.

BSA has asked a number of questions about support for income redistribution as an objective of government and we base analysis on the most consistent and longstanding of these.²³ Figure 13.3 shows how support for redistribution has evolved over time and also how it varies across the income

²⁰ As a measure of household living standard this is only rough since there are obvious arguments for adjusting for needs as reflected in household size and composition. Our measure of position is based crudely on gross household income without any such adjustment. It is questionable whether such an adjustment is needed in the current context anyway since it is position in the distribution of tax payments that matters and not position in the distribution of living standards. Since survey responses rates are known to vary with income we are careful to use weighting factors appropriately. Respondents in the same income band are assumed, for simplicity, to be half at higher incomes and half at lower.

²¹ The figure shows a non-parametric regression of perceived position on the truth. Imprecision in measurement of true position means we should not expect a 45 degree line even if individuals knew the truth, but the deviation is sufficiently large to think there may well be considerable misperception.

²² Hall and Preston (2000) present evidence from an earlier year's BSA showing that perception of hypothetical income-related tax payments is also reasonably accurate.

²³ Respondents are asked to place themselves on a scale from strong agreement to strong disagreement with the statement that 'government should redistribute from the better-off to those that are less well-off'. We create a binary variable whereby those 'agreeing' or 'strongly agreeing' are counted as approving redistribution.

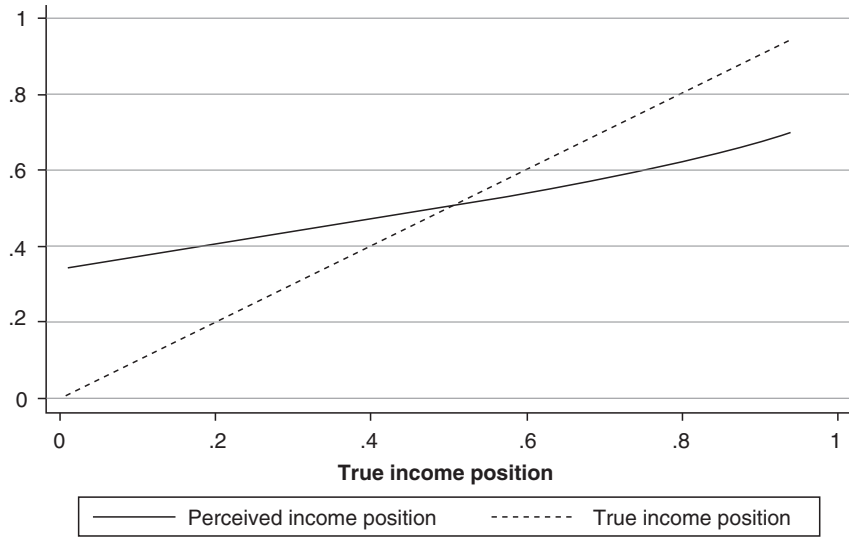


Figure 13.2. Income distribution: Perception and reality (BSA, 2004)

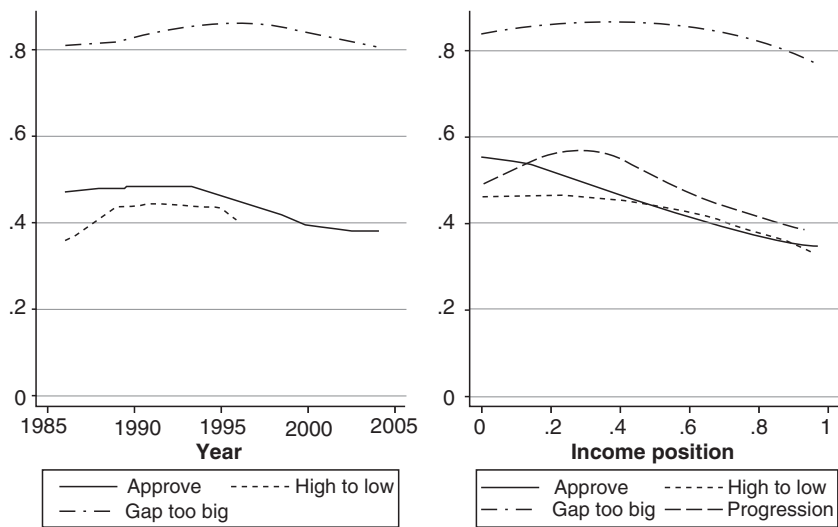


Figure 13.3. Support for redistribution (BSA, 1986–2004)

distribution.²⁴ The line in question is the unbroken line labelled 'Approve'. Approval close to 50% through the late 1980s and early 1990s drops somewhat in the mid-1990s but remains at over a third.²⁵ Georgiadis and Manning (2007) link this data to similar questions in British Election Surveys from ten years earlier, suggesting that support for redistribution was then considerably higher so that the decline is long term. They suggest that the decline over time can be linked to 'changing views about the workings of the economy, both in terms of the importance of incentives and the justness of the pre-tax distribution of resources' (p. 32), though cautioning that directions of causation between different attitudes are highly problematic to identify. Hills (2002) and Svallfors (1997) argue that declining support for redistribution may be a case of attitudes following policy making.

Sefton (2005) and Orton and Rowlingson (2007) point out that the proportion of the population expressing themselves as in support of government redistribution is consistently considerably smaller than the proportion who declare themselves in the same survey to view the gap between incomes of rich and poor as too large (labelled 'Gap too big'), which remains over 75% throughout the period. Plainly many individuals think either that governments should reduce the gap by other means (such as education policy or wage controls, say) or that ameliorating the gap is not the business of government.

The relationship to income is very clearly declining as one would expect, though it is notable that, even at the top end of the distribution, agreement with redistribution as an appropriate activity for government is, on average over the period, as high as a third of the population. Georgiadis and Manning (2007) point to correlations of attitudes with several other household characteristics—men, those in the middle years of life, those unmarried, and those without children and ethnic minorities, for example, are all more favourable than others to redistribution.

Beliefs and attitudes on taxation

Questions on the structure of taxation have not been asked in a consistent fashion over the entire period. An interesting set of questions, enquiring

²⁴ In this, as in similar figures below, the relationships are smoothed by taking running means. The relationship with year shows the evolution of the unconditional mean, whereas the relationship with income is taken after subtraction of year effects.

²⁵ By comparison the percentage disapproving of redistribution is typically between a quarter and a third over the period covered (though it exceeds the percentage approving for the first time in the final year).

Table 13.1. Opinions on taxes by self-assessed income group

Self-assessed income	No of respondents	Taxes on					
		High incomes		Medium incomes		Low incomes	
		Too high	Too low	Too high	Too low	Too high	Too low
High	460	36.8	19.1	37.8	5.5	71.0	1.5
Medium	8,472	17.5	44.6	33.9	4.0	78.2	2.2
Low	8,003	14.6	52.9	29.5	8.1	82.9	2.6

Table 13.2. Opinions on redistribution by self-assessed income group

Self-assessed income	No of respondents	Redistribute from		
		High to low	High to medium	Medium to low
High	460	16.1	3.0	4.2
Medium	8,472	37.8	9.0	2.8
Low	8,003	47.6	8.9	6.6

whether tax rates²⁶ on high, medium, and low incomes were too high, about right or too low, were asked in several years up to the mid-1990s. Individuals were also asked at the same time to assess their own income relative to these categories allowing us to draw inferences about how individuals saw their own tax rates. As Table 13.1 shows, not many individuals saw themselves as having a ‘high’ income but those that did were much less likely to see taxes on high incomes as too low—a rather popular view in the rest of the population. Those seeing their own incomes either as ‘medium’ or as ‘low’ were least likely also to see taxes on their own income group as too low, albeit that neither of these views was well supported in general.

Table 13.2 reports on the results of combining answers to different questions to draw inferences about attitudes to redistribution through taxes. If someone declares both that they believe taxes on high incomes are too low and that taxes on low incomes are too high it seems reasonable to think that they would support, at least to some extent, redistribution from high to low incomes²⁷—we call this attitude ‘High to Low’. Such individuals are more and

²⁶ The question is not specific as to whether it concerns average or marginal rates.

²⁷ The reverse opinion is too rare to be worth investigating. Although an appreciable number of individuals regard taxes as too high at the top end, these same individuals seldom regard low incomes as taxed too little.

more common the lower one looks in the self-assessed distribution. (Redistribution from high to medium incomes and from medium to low incomes also turn out to be most popular with recipients and least popular with those being taxed.) Figure 13.3 shows also that this alternatively defined measure of support for redistribution (labelled 'High to Low') varies negatively with actual position in the income distribution—in particular, that it declines sharply at high incomes. Tracking over time, we see that this view gained support in the mid-1980s—probably not coincidentally as marginal tax rates on high incomes were cut—but then showed hints of a decline (similar to that for the other measure considered earlier) in the mid-1990s at which point the question ceased to be asked.

Finally, a question asked only once, in 2004, offered respondents the alternative of funding a hypothetical increase in government spending by a flat additional tax payment, a proportional increase in taxes, or a progressive increase. Sefton (2005) reports that about half the population agreed with progression as an appropriate structure. The final line on Figure 13.3 shows that support for progression as indicated in responses to this question tended also to decline with income.

Altogether the clear income gradient in answers to these questions suggests that at least some of the preference for redistribution is linked, consciously or not, to self interest though the support for redistribution evident even in the richest groups of the population surveyed shows this is less than the whole of the picture.

Redistribution of pre-tax incomes earned with certainty is only one view of the purpose of progressive taxation and state welfare. Another view sees the goal of redistributive policy as providing insurance against uncertainty in incomes or in employment rather than or in addition to redistribution. Introducing such uncertainty raises new issues, for example as to how income risk and risk attitudes vary with income. Moene and Wallerstein (2001, 2003) show that self-interested support for state-provided insurance might in principle rise with income under reasonable assumptions about risk aversion. On the other hand, unemployment risk might be felt to decline with income, giving the well-off less reason to support welfare state redistribution. Indeed, Cusack et al. (2006) find that the demand for redistribution is related to exposure to labour market risk. Fong (2001) emphasizes the importance of beliefs about effort, luck, and opportunity of the less well advantaged in determining support for redistribution. Extending the Meltzer–Richard framework to a model in which taxed wage earners receive publicly provided goods but also face risks of temporarily joining a class of permanently unemployed in receipt of state benefits, Moene and Wallerstein (2001) demonstrate that how

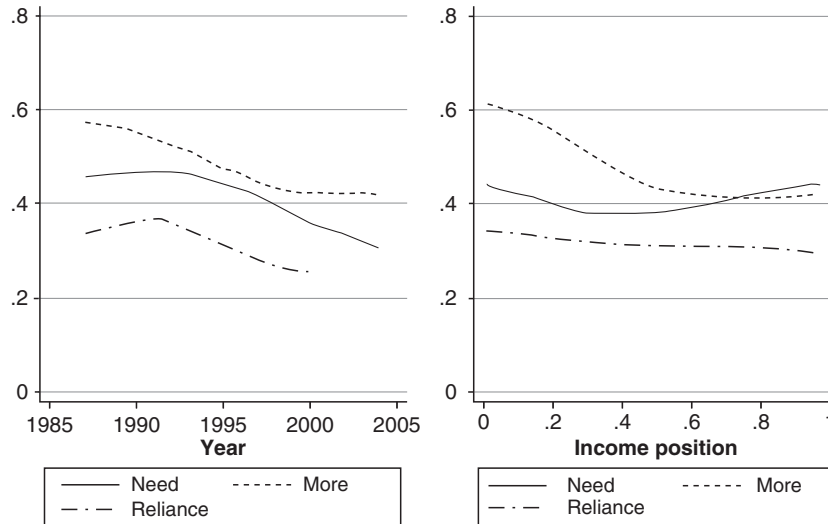


Figure 13.4. Support for social insurance (BSA, 1986–2004)

support for taxation varies with income depends upon assumptions made about the pattern of state spending.

Figure 13.4 presents a little more detail on attitudes within the BSA to welfare payments to the poor. While the evidence above suggests support for that aspect of redistribution which involves taking from the relatively rich, that need not mean comparable popularity for the distribution of funds through welfare spending to the relatively poor. The dashed line labelled ‘More’ shows support for increased payments to the poor.²⁸ This has fallen over time and is markedly lower among those with above average incomes. The other two lines are concerned with beliefs about the deservingness of the poor—that labelled ‘Need’ regards beliefs that the poor genuinely need the help given²⁹ and that labelled ‘Reliance’ regards the belief that self-reliance is not undermined by welfare state payments.³⁰ Again these views have become more negative over time though there is little evidence of any clear relationship to income within periods.³¹

²⁸ Specifically the question asks for agreement or disagreement with the opinion that ‘the government should spend more money in welfare benefits for the poor, even if it leads to higher taxes’.

²⁹ Specifically the question asks for agreement or disagreement with the opinion that ‘many people who get social security don’t really deserve any help’.

³⁰ Specifically the question asks for agreement or disagreement with the opinion that ‘the welfare state nowadays makes people less willing to look after themselves’.

³¹ There are other questions in BSA relating social security to lack of self-reliance. Georgiadis and Manning (2007) draw attention to the association between these beliefs and support for

If we introduce expenditure on public provision of goods as another potential outlay of public funds then the demand for the goods provided becomes an issue in how voter attitudes differ. If taxes are raised proportionally to income and publicly provided goods are income elastic then this may be a reason for better-off voters to demand higher *levels* of taxes, for example. If there are different types of expenditure then not only will the composition of public spending be a source of political contention but expectations about how that contention is resolved will affect support for taxes and the way in which this varies with household characteristics.³²

One question asked in almost every year of the BSA concerns whether or not the respondent would support an increase in the level of taxes and spending on health, education, and social benefits. For these particular items of spending, responses to this question provide the best long-term evidence on preferences regarding the size of the public sector and associated level of taxation. Figure 13.5 plots the proportion of respondents expressing themselves to be in favour of such a change over the period from 1986 to 2004. Those favouring an increase consistently exceed half of respondents and are at their highest, exceeding 60%, over the 1990s. There is little cross-sectional association with income, which may well be a consequence of the question grouping together goods of rather different income elasticities.

Given the apparent strength of support for increases in public spending over this period it is worth asking why politicians showed such reluctance to be seen favouring the associated increases in taxation. If the public doubts the likelihood of funds raised being spent as desired then this will obviously dampen support for tax increases. Hypothecation of tax revenues may be seen as a potential solution to the agency problem involved here but the essential fungibility of public funds makes credibility problems with any attempted promise to direct particular resources to particular uses inescapable. Even in a purely redistributive setting, there is the possibility that 'a fraction of total tax revenue that passes through the government's hands on the way from one set of citizen's to another is "lost" . . . either through incompetence or venality' (Georgiadis and Manning (2007)). In the terms used earlier, such losses

redistribution and the apparently increasing strength of opinion that social security encourages dependence as evidence that declining support for redistribution is driven partly by changing views on incentive effects of the tax and welfare system. Unfortunately, BSA has little evidence regarding views on the incentive effects on high earners.

³² Several papers, surveyed for example in Rubinfeld (1987), have sought to estimate demands for locally publicly provided goods using variation across localities in levels of provision and tax prices. Hall and Preston (2000) report on a largely unsuccessful attempt to separate tax price effects from income-dependent variation in demand for national public goods by randomization of tax instruments in questions in the BSA.

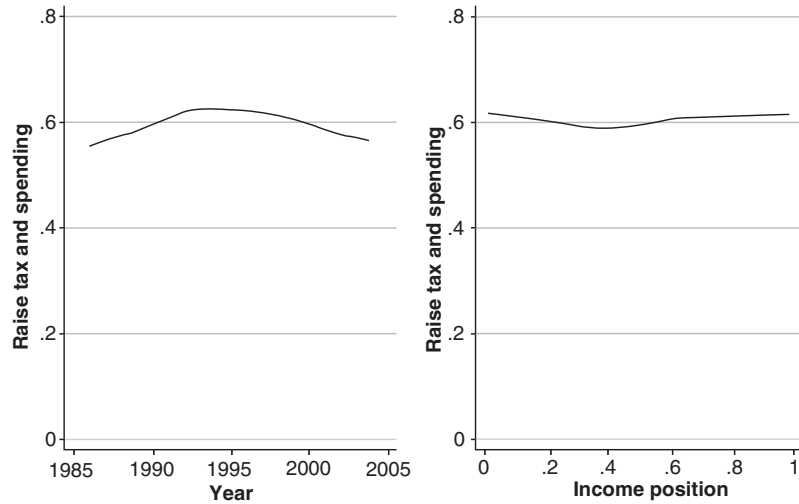


Figure 13.5. Support for public spending (BSA, 1986–2004)

would be viewed as another aspect of deadweight costs and declining trust in government competence or integrity interpreted as a perceived increase in those costs.

Unfortunately BSA asks no question addressing directly the issue of how effective the government is believed to be in directing public funds to desired uses but there are questions on trust. Specifically, for example, there is a question on whether the respondent trusts the party in government to put the interests of the country before those of the party.³³ Figure 13.6 shows a sharp and continuing decline in such trust, particularly over the 1980s and early 1990s. If this is reflective of a general erosion of confidence in government to use public money to deliver the public services demanded by voters then it may help explain why raising the headline rate of income tax is so politically difficult.

So what taxes do voters want?

Generally speaking, individuals favour redistribution, particularly that from 'high' to 'low' incomes. They also favour increases in public spending, and

³³ Specifically the question asks 'how much do you trust British governments of any party to place the needs of the nation above the interests of their political party'. We count someone as usually trusting government if they answer 'just about always' or 'most of the time' rather than 'only some of the time' or 'almost never'.

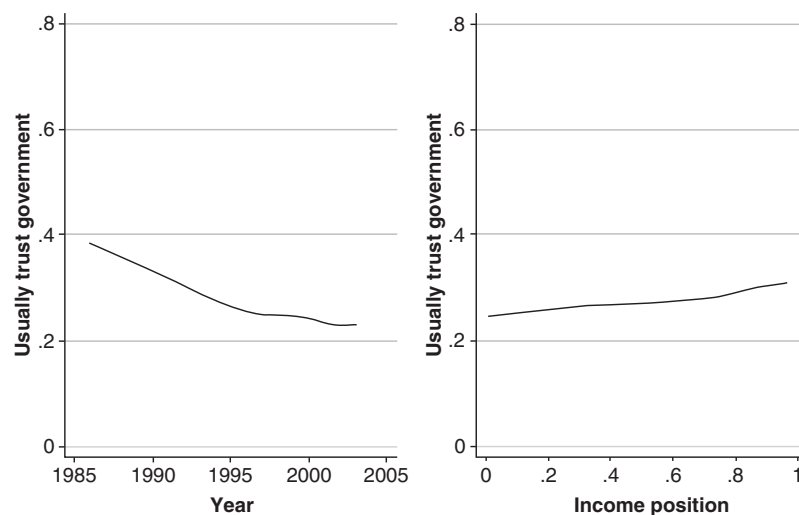


Figure 13.6. Trust in government (BSA, 1986–2004)

would like it to be funded on a progressive basis. It is also clear that preferences for redistribution decrease with income, as one might expect. However, it is also clear that preferences for redistribution have declined over the past twenty to thirty years.

We have already posited that declining levels of trust might explain why politicians have been reluctant to promise higher levels of public spending through increased levels of taxation, despite apparent public preference for such a policy. But we must ask other questions, such as why there were cuts in statutory marginal rates of income tax during the 1980s, a time when attitudes towards redistribution were at their most favourable. We attempt to answer this question through an examination of what we might expect politics to deliver, given different models of political economy. This involves consideration of the electoral system, party preferences, and the inherent multi-dimensionality of politics.

13.4.2. What taxes does politics deliver?

The foregoing analysis on individual preferences could serve as precursor to a standard treatment of the optimum income tax literature. Dependence of individual utilities on tax schedules is precisely the information needed for a hypothetical benevolent dictator to choose the tax schedule maximizing social welfare conceived as an appropriate aggregate of those individual utilities. In a general setting observations follow about the optimum structure

of taxes and if we restrict ourselves to linear taxes we can compare optimum tax rates under different assumptions about the economy. Tuomala (1990), for instance, makes many comparisons of this type. Typically it seems true to say that optimum tax rates rise with the inequality of wages (as the case for redistributive correction becomes more pressing) and that optimum tax rates fall with responsiveness of labour supply to wages (as efficiency costs of redistribution become more acute).

The political economy literature seeks to investigate how tax rates arise from the political process. Since tax setting in democracies should be responsive to individual preferences it is not surprising that qualitative conclusions, at least of the simplest models, nonetheless have much in common with those regarding optimum tax setting.

Median voter models

The canonical model of political representation that has dominated political economy for fifty years is the case of two parties competing by announcing election strategies that they will carry out if they win office. The most stylized version of this model has no role for post-election politics with announcements being carried out after the election and parties whose sole motivation is to win. This approach was applied most influentially to the political economy of tax policy in Meltzer and Richard (1981), building on earlier work by Foley (1967), Romer (1975), and Roberts (1977).

The approach focuses on the rate of income tax as a single dimension of conflict between citizens who differ in their pre-tax incomes, as outlined above, the proceeds of taxation being spent on goods and services or income transfers which accrue uniformly to the citizens. As long as preferences are appropriately 'single-peaked', then competition between two parties, each of which cares only about winning, will result in the tax rate being chosen to suit the voter with median income. One simplistic interpretation of this is that we should expect the middle classes to have most political weight in determining tax policy outcomes.

The level of taxation, and thus the amount of redistribution, chosen by the median voter is determined by two things: (i) the distance between the median and mean income, and (ii) the extent to which increases in income taxation reduce pre-tax labour earnings through distortion of labour supply. To the extent that the difference between median and mean income can be regarded as indicative of the degree of inequality—as it is, for example, for a lognormal distribution—then these determinants are strikingly similar, at least qualitatively, to those that would determine optimum tax rates.

Another key implication of the theory which bears emphasizing is that both parties who compete to offer tax packages will offer the same policy. This is characteristic of the Downsian class of models in which this is based. There are periods in the UK in which such policy convergence seems plausible and there are clearly some important issues of tax policy where this is the case. For example, Labour in 1997 was committed to maintaining the 40% top rate of tax introduced by the Conservative Party in 1988. Likewise the Conservative Party in 2007 indicated a commitment to maintain Labour's spending plans (even before knowing what they were). But as a general proposition, there are sufficient differences in policy between parties—even in two-party systems—to make this a questionable intellectual foundation for studying political economy issues. We will discuss this further below.

This approach is hard to take to the data directly. First, the kind of tax system that it describes does not correspond very well to what we see in reality. Second, measuring the extent to which pre-tax income distributions are right skewed across countries on a consistent basis over time is also difficult. Most empirical work has tended to look across countries where it is difficult to believe that factors determining income distribution are not correlated with those affecting political choice over tax rates so that causation from the former to the latter is extraordinarily difficult to isolate. Moreover, the basic institutional structure which is needed to yield the median voter prediction—two vote seeking parties in a majoritarian system—seems implausible for many countries.

In any case the popularity of the model was never matched by the success of its empirical prediction that more pre-tax inequality should go hand in hand with more income-targeted redistribution (Perotti (1996)), even if there are historical instances where such a description might fit. Consequently, a significant literature extends the basic framework in a number of directions. For example Snyder and Kramer (1988) investigated voting on a progressive income tax in the presence of an untaxed alternative economy, but found difficulties in showing the existence of equilibrium. Voting behaviour in a Meltzer–Richard model also changes in the presence of social divisions including religion (Scheve and Stasavage (2006)), moral values (Roemer (1998)), Benabou and Tirole (2006)), race (Alesina and Glaeser (2004)), and the quality of jobs (Austen-Smith and Wallerstein (2006)).

Extending the median voter model to contexts in which tax and public spending choice acquire multiple dimensions requires heavy and unreasonable restrictions on voter preferences, on the nature of choice or on the political process. Moene and Wallerstein (2001) consider choice over both tax

rates and targeting of benefits, demonstrating that equilibria may be found if one assumes issue-by-issue voting, for example, or party competition of a particularly restrictive kind. Bergstrom and Goodman (1973) discuss issues in public spending choice. However, existence of equilibrium is, in general, a challenging issue.

Hettich and Winer (1988, 1999) adopt a 'probabilistic voting' model to study tax policy. Here governments seek to maximize 'expected support' where the probability of any voter supporting them depends upon the difference between the value of benefits received and the costliness of taxes paid. More broadly we can interpret weight given to different voters' interest as reflecting 'relative political influence' (1988, p. 702), an idea underlying the treatment also in Georgiadis and Manning (2007). Models of this sort are notable for their explanation of income tax system complexity, with multiple brackets targeting particular constituencies being a prominent feature. While the ability to handle multidimensional issues in tax setting can be seen as an advantage, the extent to which this is achieved in this strand of literature by 'bypassing questions concerning the existence and stability of political equilibrium and the explicit derivation of government objective functions in a game-theoretic context' (Hettich and Winer (1988), p. 702) means important questions are left unresolved.

Party preferences and swing voters: passively moving rightwards

A weakness of the models considered so far is their treatment of parties as disinterested vote chasers. Iversen and Soskice (2006) show how recognizing parties as run by actors with specific interests can change conclusions. They present a model in which parties are tied to class interests, describing a world in which there are three classes but majoritarian political competition restricts the number of parties to two (according to Duverger's law). Median voters located in the middle class are forced to choose between parties representing coalitions of middle and lower class interests or middle and upper class interests. They vote for the latter because, uncertain about the class leanings of party leaders, they are more scared of lower class than upper class domination. The asymmetry arises because the middle class can ally with the lower class to defend itself against upper class expropriation but would stand alone defenceless against expropriation by the poor. There is an inherent tendency in their view for majoritarian systems, such as that of the UK, to deliver the median voter with less redistribution than they would prefer and less than would be delivered under alternative systems based on proportional representation.

Recognition that parties can represent particular interests, in some respects unconnected to issues of taxation, also opens up new perspectives on electoral competition over taxes. We can suppose that voters differ in their loyalties to the parties: some are more likely than others always to support the same party, while others can be persuaded by appropriately targeted policies. One useful way to think of this in a UK context is to maintain the idea that political competition is broadly organized between three main parties. These parties have core supporters who will be loyal to the parties under most circumstances. However, there are also groups of 'swing voters' who will vote for whichever party has a better policy stance on issues that it views to be salient. Some subset of these swing voters may view some kind of tax policy as being a salient issue. A party that has a large advantage over the other parties for non-tax reasons will find it less necessary to make tax promises that are designed to appeal to politically decisive voters. Such policies will be more important when there is a larger politically decisive group that is not loyal to one party.

Then there is the electoral system: we should also factor in that swing voters belong to Parliamentary constituencies. Some are safe in the sense that the outcome is determined by loyal voters while others are marginal in the sense of being potentially winnable by either main party. To win a majority in the House of Commons, electoral strategy will involve trying to appeal to swing voters in marginal seats. These will be the decisive voters in the sense that Meltzer and Richard cast the median voter as decisive, but the decisive voter will have to choose between alternatives proposed by the competing parties. These alternatives may or may not converge.

So are swing voters distinctive? BSA also collects data on party identification allowing us to separate out attitudes among those uncommitted to particular parties, who constitute about half of respondents, a proportion which has grown slightly over the period observed.³⁴ Figure 13.7 picks out attitudes on two of the dimensions discussed above. Generally speaking, trends in attitudes over time among both swing voters and party identifiers tend to move in very similar directions with attitudes of swing voters on most questions lying between Labour and Conservative identifiers in predictable ways. Attitudes to redistribution typify this, with swing voters less inclined to approve redistribution than either Labour or Liberal Democrat supporters but more so than the Conservatives and showing a time path of mean opinion very similar to that already seen for the overall population. Of all aspects

³⁴ Clearly, it would be interesting to analyse the opinions of uncommitted voters in marginal constituencies.

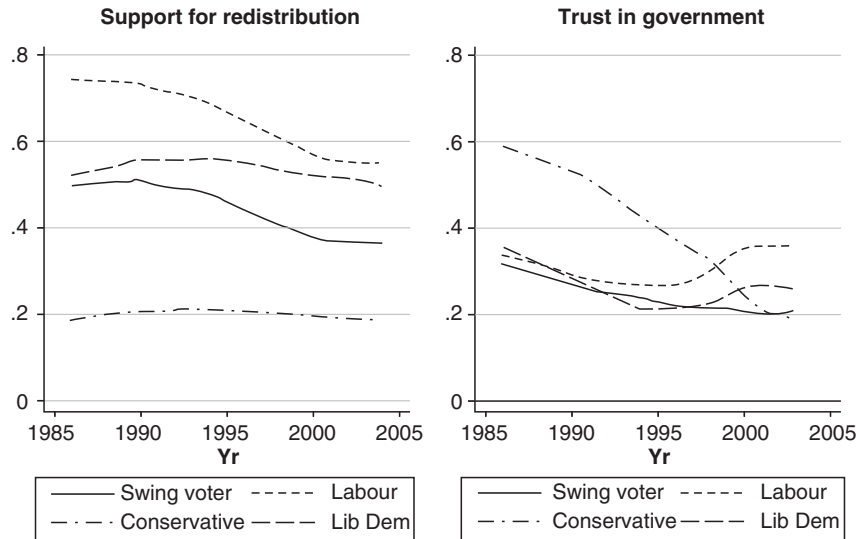


Figure 13.7. Opinions by party support (BSA, 1986–2004)

to attitudes considered above, the one exception to this rule, interestingly, is trust in government which is consistently weakest, and declining, among swing voters. Among committed voters, average trust in government appears to be driven largely by the identity of the party in power.

How will parties come up with their proposals in such a model? Parties will be reluctant to give election promises that compromise their core values if they can find something else that appeals to swing voters. As the electoral compromises reached will differ between parties we should not expect parties to converge on common tax policies and, even if voter opinions do not polarize, elites (parties) can, so the divergence between them may vary over time.

Table 13.3 summarizes each of the main parties' manifesto proposals on the basic and top rates of income tax at elections between 1979 and 2005. Where parties specified an exact value in their manifesto, we report this value; where they only give a preferred direction of change, we report whether this is less or more than the current value. If there is no evidence of a preference for change in either direction we report NC (for No Change).

Combining the information on party positions with the parties' shares of the votes allows us to construct a vote-weighted median position for each of the top and basic rates of tax by using weights equal to vote shares. If the tax issue in question were the sole issue on which voters decided then we could think of this as the position of the median voter. In practice, of course, there are many issues and the voter may have to make the best of

Table 13.3. Party position on income tax

	Actual	Labour	Lib Dem	Conservative	Other	Vote-weighted median
1979 vote shares		36.9	13.8	43.9	5.4	
Basic rate	33	NC	<33	<33		<33
Top rate	83	NC	50	<83		<83
1983 vote shares		27.6	25.4	42.4	4.6	
Basic rate	30	NC	NC	<30		30
Top rate	60	>60	>60	<60		>60
1987 vote shares		30.8	22.6	42.2	4.4	
Basic rate	27	29	NC	25		27
Top rate	60	>60	NC	<60		60
1992 vote shares		34.4	17.8	41.4	6.4	
Basic rate	25	25	>25	20		25
Top rate	40	50	>40	NC		>40
1997 vote shares		43.2	16.8	30.7	9.3	
Basic rate	23	23	24	20		23
Top rate	40	40	50	40		40
2001 vote shares		40.7	18.3	30.7	10.3	
Basic rate	22	22	23	<22		22
Top rate	40	40	50	<40		40
2005 vote shares		35.3	22.1	32.3	10.3	
Basic rate	22	22	22	NC		22
Top rate	40	40	50	NC		40

Source: Various manifestos 1979–2005, authors' calculations.

a bad job, choosing the most appealing of divergent party promises, so any such identification would be tenuous but the vote-weighted median remains an interesting indicator of where parties chose to stand on tax questions. So, for instance, in 1979, Labour proposed no change in the basic rate, but both the Conservative and Liberal parties favoured a cut. More than 50% of voters voted for the latter two parties, so the median voter in the pure tax policy dimension voted for a cut in the basic rate. Alternatively in 1992, the Labour party proposed a top rate of 50%, the Liberal Democrats a top rate higher than the current rate of 40% and the Conservatives proposed no change. Given that a majority of the population voted for either Labour or the Liberal Democrats, we know that the median voter in a pure tax policy dimension voted on this occasion for a rate higher than 40%.

What do we observe over time? First, it is worth noting that a non-median position has won the election on taxes quite a few times, something that is perhaps unsurprising under the UK's combination of three-party politics and plurality-based electoral system, demonstrating that the median voter is not necessarily the pivotal voter.

Secondly, one notes in Table 13.3 that the divergence in party tax proposals is also not constant over time. Although there has been policy divergence over the top rate in every election, disagreement over the basic rate was at its highest in the late 1980s and early 1990s, when tax policy was at its most salient as an electoral issue, but has declined since and more or less disappeared in the most recent election. There are circumstances under which this policy divergence or polarization advantages the right. In general how it affects the strengths of competing parties depends in a subtle way on how deadweight costs vary with tax rates.³⁵

Thirdly, however, it is also the case that the median position has drifted rightwards over time so that parties in later years tend to compete in proposals centred around lower marginal tax rates. Moreover, the question of whom declining average tax proposals benefit is far clearer than that of whom declining polarization benefits: there seems to be good reason to think that they will be helpful to more left wing parties.³⁶ Finally, we note that Kim and Fording (1998, 2003) present evidence, based on expert analysis of party positions on taxing and spending, to suggest that the rightwards drift of the median that we observe in Britain since the 1970s has actually been OECD-wide.³⁷

13.4.3. Summing up electoral interests and the representation problem

In summary, we have found some evidence of declining support for redistribution and social insurance, though on the whole attitudes towards redistribution, though declining, are still fairly positive and a majority of individuals favour higher top rates of tax. It is noteworthy that there is some evidence of a strong and ongoing decline in the number of people who place their

³⁵ In the linear-quadratic model, drawn from McCarty, Poole, and Rosenthal (2006) and discussed above, partisan advantage depends only upon the average tax rate offered. Polarization in tax proposals around an unchanging average offer polarizes party support in the sense that each party's supporters become more committed but doesn't lead anyone to switch sides. In a model where *marginal* deadweight costs were convex however, one would find greater polarization advantaging the right.

³⁶ If voters decide between competing tax proposals by balancing the redistributive gains (if below mean income) against deadweight costs (which harm everyone) and if marginal deadweight costs are increasing in tax rates whereas marginal redistributive gains or losses are not (as in the models of Bolton and Roland (1997) or McCarty, Poole, and Rosenthal (2006)) then differences in deadweight costs will assume more and more importance the higher is the average of the marginal tax rates offered by the parties, to the detriment of those proposing higher taxes.

³⁷ The Kim–Fording data also suggest two OECD-wide swings leftwards: an earlier one from 1950 to 1975 and recently from about 1990 to 2000. Their expert data is also consistent with our treatment of polarization in tax policy proposals, above.

trust in government, which may somewhat undermine support for taxation. It nonetheless seems difficult to claim that the trend towards lower statutory rates of income tax has been the result of a groundswell of support for such a policy.

Marginal tax rates proposed by the main parties at elections have evidently drifted downward in recent years and divergence between party proposals has recently declined markedly from a period of more intense competition over tax rates in the 1980s and early 1990s.

When we introduce the idea that voters are imperfectly informed about the tax system and party preferences, things naturally become more complicated, and we will discuss this more in Section 13.6. However, we speculate that the combination of a policy divergence from majority opinion and a lack of trust in politicians is a vicious circle, especially if voters are ill-informed about the tax system and true party preferences.

13.5. INTEREST GROUP POLITICS: A CASE OF POLICY PERSISTENCE AND DRIFT

Unlike the personal income tax, corporate taxation is not typically electorally salient. Perhaps the many who work for large corporations feel a (class) conflict with their employers or, as in the US, 'large corporations have not yet found any effective narrative for attacking corporate taxes' (Graetz and Shapiro (2005), p. 272). Perhaps corporate tax usually involves technical or complex aspects that elude public understanding.³⁸ Whatever the reason, the lack of an electoral connection opens the door to lobbying by special interests, often for closely targeted benefits. Nor does this happen just in the US:

[A contrast with Britain] is the apparently greater vulnerability of tax policymaking in America to lobbying by special interest groups . . . evident in the notoriously wide range of provisions favoring special groups that have typically characterized the US Tax Code . . . But British tax policy is not immune to special pleading; the 1997 Budget brought special tax breaks for the film industry. (Michael Keen, 'A British Perspective on Tax Policy in the United States', in Slemrod (1999), pp. 505–6.)

³⁸ When the costs of a policy, though small, are easy enough to observe, then mixing even small but well-financed or organized groups with extensive media coverage can result in mobilizing the otherwise unorganized. This gives the issue increased potential electoral salience: this is the essence of Graetz and Shapiro's (2005) account of the evolution of support for estate tax repeal in the US. In the UK, the case of fuel tax protests makes a similar point.

We analyse the case of Labour's R&D tax credit to reveal both the opportunities for and limits on lobbying by special interests for favourable tax treatment in the UK. The R&D tax credit purports to support a socially desirable goal: its origin was a government intent on promoting innovation, to some extent initially impressed by the way this was done elsewhere. Any benefits of increasing aggregate innovation or investment are imperceptible to voters but larger to those firms actively involved in research and development. However, this policy does not appear to be the direct result of lobbying by concentrated, organized interest groups. The effects of lobbying appear to be more subtle. Development of policy subsequent to its introduction reveals important political forces, including *ex post* lobbying and provision of information by the industry, with the programme drifting and growing beyond the original intent and justifications that were offered for it.

We use a blend of quantitative, documentary, and interview evidence³⁹ that focuses particularly on the political behaviour of large firms and the transition of the R&D credit (initially predominantly aimed at and economically justified for small firms) from an SME credit to a larger programme of large company credits. How it happened, why it happened, what the politics of various decisions were is the substance. Nevertheless, puzzles remain. For instance, will the policy prove to be politically unsustainable, however good the original intentions?⁴⁰

Section 13.5.1 provides a stylized model of policy persistence as a result of *ex post* lobbying (the full technical detail of which is not crucial for non-technical readers) and Section 13.5.2 provides the case study of the R&D tax credit. Section 13.5.3 provides examples of interest-group politics outside corporation tax, the zero-rating of children's clothing in VAT, together with one where the 'unorganized' suddenly became very organized and very vocal—the fuel tax protests in 2001.

13.5.1. The political economy of interest groups

The standard interest-group explanation of policy is that groups representing net beneficiaries of a policy form to advocate and/or defend it.

³⁹ As stated in the Introduction, we conducted a number of interviews with individuals involved in the tax policy process over the past thirty years. These interviews are an important source of information for our case study of the R&D tax credit. Although these individuals are not named in the case study, we do indicate which quotes came from the same people and the nature of their involvement in the tax policy process.

⁴⁰ Should they take power, the Conservatives appear likely to propose a scheme whereby businesses would be willing to give up the credit in exchange for a lower rate of corporation tax, an exchange several executives we interviewed indicated they would be happy enough to make.

Concentrated, organized groups have an advantage over unorganized interests (Olson (1965)) and a disproportionate advantage in seeking policies whose benefits are concentrated and costs widely dispersed (Wilson (1989)) because it is unlikely that those bearing the costs will find it worthwhile or possible to organize collectively to oppose the policy. This is the usual explanation for the success of special interests in seeking trade protection and subsidies as well as favourable regulation and tax treatment, in Britain as well as elsewhere.⁴¹

However, Noll and Cohen (1983) pointed out over two decades ago that firms affected by a regulation also frequently adjust to become its greatest defenders, even if they were not originally advocates. So far the R&D credit is a textbook case: frequently changed, with its tax cost rapidly growing in the years since it was introduced. Moreover, its principal beneficiaries were not active proponents of the credit before it began, and though they are quick to claim that it doesn't make a significant difference to their investment decisions,⁴² they continue to be willing to suggest further extensions to the credit.

There is a puzzle here, which is this: if an interest group had the capacity and incentives to lobby to maintain a subsidy, for instance, they presumably would have the capacity and incentives to lobby to introduce such subsidies, so the existence of such subsidies cannot be used to explain their persistence. Coate and Morris (1999) describe the political economy conventional wisdom that once an economic policy is introduced, it is hard to remove, even if its original rationale no longer applies or is invalid.⁴³ Asking how policy introduction alters incentives in the political process for maintaining the new status quo, they write:

[T]he mechanism by which the introduction of the policy alters incentives in the political process in favor of the new status quo . . . [is that when] an economic policy

⁴¹ For instance, Person F (interview) noted how lobbying for a special regime for shipping to encourage and retain UK ship-owners became the Tonnage Tax in Finance Act 2000. 'This was a result of direct lobbying by the industry. It benefited Greek ship-owners based in London, who also benefit from the personal tax rules for those not domiciled in the UK, as they only pay tax on money they bring into the country. A long running review on domicile by the then Inland Revenue never came to any conclusion, in part because of the perceived economic damage to the UK if such non-domiciliaries were to leave the country. Similar arguments have also been used, and widely reported, to criticize proposed changes to the rules governing non-domiciliaries from 2008 onwards—another good example of focused lobbying, by a special interest group.'

⁴² Of course, a credit that works at the margin of choice can have real effects even if decision-makers are unconscious of its effects.

⁴³ Here Coate and Morris note that the standard explanation, which they regard as inadequate, is that 'interest groups representing net beneficiaries form to defend policies' (footnote added to quotation).

is introduced, agents will often respond by undertaking actions in order to benefit from it . . . increas[ing] their willingness to pay for the policy in the future.

This extra willingness to pay will be translated into political pressure to retain the policy and this means it is more likely to be operative in the future. We present a simple dynamic model which . . . combines an agency style model of political competition of the type pioneered by Robert Barro (1973) and John Ferejohn (1986), with a lobbying model of the form made popular by the recent work of Gene M. Grossman and Helpman (1994) . . . to point out that policy persistence . . . can be Pareto dominated . . . because voters forgo support for policies which provide temporary efficiency benefits, anticipating that they will persist once they have been implemented. (Coate and Morris (1999), p. 1327.)

The model's equilibrium sequence has policy first created without the support of the affected interest (in our case, the large firms did not lobby for the creation of the R&D tax credit), but once the policy exists, affected interests lobby and politicians respond by maintaining the policy in every period, even after the rationale for the original policy has disappeared.

The model combines agency and lobbying in an optimizing framework with political implications.⁴⁴ Politicians value re-election to a point, but firms' contributions can persuade politicians to do other things than carry out voters' most-preferred policy. In equilibrium, policies are either never implemented, or, if implemented, they persist, even if dominated by sequences (in the public, or voters' interest) in which a policy is implemented and then removed. However, the latter does not arise in equilibrium as long as voters have partial control, because firms, even if they did not contribute to creating the policy, adjust their behaviour so as to become willing to contribute enough to persuade politicians to maintain policy. If there are synergies between policies, so that firms can contribute to other policies favoured by the government, the policy in question may even expand. That is how some policies that favour a sector but are costly to citizens at large persist, indeed, even grow.

13.5.2. Policy evolution: the R&D tax credit

Tax incentives can potentially increase innovation by attracting investment by new firms, either by convincing large multi-national enterprises (MNEs) looking to expand globally to invest R&D resources or by helping small firms to emerge and establish themselves as business entities. Alternatively,

⁴⁴ In particular it lacks parties as well as the uncertainty about the results of elections that might make the implementation of post-election policy unpredictable *ex ante*.

tax incentives can fuel greater innovation by leading existing investors to increase their level of spending. In any case, R&D tax incentives provide tax relief to research-intensive companies for undertaking R&D, defined for tax purposes as projects that '[seek] to achieve an advance in overall knowledge or capability in a field of science or technology, not a company's own state of knowledge or capability'.⁴⁵

Origins

Everyone seems to agree that the R&D tax credit was 'not something industry was lobbying for'.⁴⁶ New Labour came to power in 1997 with a Chancellor who believed that tax is a tool of social and economic policy.⁴⁷ His 1998 Budget speech announced that since '[e]ncouraging greater R&D investment is . . . crucial to higher productivity' the government would begin the consultations that by 1999 resulted in a small-company credit, seen as a measure 'to facilitate and directly influence the demand to innovate and undertake R&D' (p. 15). This measure was introduced in the 2000 Budget at an estimated cost of £100 million in 2001–02 and £150 million in 2002–03,⁴⁸ which compare with an initial cost estimate of £50 million per year.⁴⁹

At the time, some believed there was observable evidence of an 'innovation deficit' in the UK. Griffith et al. (2006) show that in the 1990s affiliates of UK firms were disproportionately likely to place R&D in the US, in comparison with firms from Japan or Germany. Moreover, between 1987 and 1996 nearly half of the European Patent Office filings by the largest UK-based pharmaceutical firms were based on research conducted in the US, while 'for all other countries with major pharmaceutical industries . . . the large majority of patents came from the home country' (Gambardella et al. (2000), p. 42). Economic arguments for subsidizing R&D focus on externality issues associated with the inappropriability of technological spillover benefits from research and the inadequacy of other interventions, such as patenting legislation, fully to address the problem (see, for example, Griffith, Sandler, and Van Reenen (1996)).

At the same time it was also (and in many quarters continues to be) widely accepted that research supported the government's belief in the effectiveness of R&D tax credits (see Hall and Van Reenen (1999)), at least in the case

⁴⁵ As defined by HM Revenue and Customs in reference to DTI (now DBERR) Guidelines.

⁴⁶ Person F interview.

⁴⁷ Person C interview citing RedBook 7/97 sections 1.66–1.72 (HMT archive).

⁴⁸ See Budget 2000 Scorecard.

⁴⁹ Recollection of Person F (interview) confirmed by Person A (interview) and other decision participants.

of smaller firms that may be financially constrained and thus particularly unable to capture the economic returns that their research activities produce. Berger (1993) and Hall (1993) estimated that tax credits reducing the after-tax cost of R&D by 10% could increase R&D by 10–15%. Bloom, Griffith, and Van Reenen (2002) placed the long-run increase in R&D at 10% from a 10% reduction in costs, based on a study of several countries from 1979 to 1997, and noted that the benefits of such a tax credit increase from the short to the long run.⁵⁰

Person A describes the sources of the R&D tax credit, including evidence surrounding the effectiveness of R&D tax credit in other countries:

The source of the RDTC was atypical, it came from productivity policy built on work done at IFS, then it found favour with some advisors, who believed the benefits. It looked like a logical step to improve innovation and creativity . . . but [some] doubted it would work in the world. There was a need to understand whether firms will change their behaviour, and it was not convincing that firms would do R&D just because it is a bit cheaper. Firms do R&D because they need it for their business, not because it is a little cheaper. There were both formal and informal discussions, informal mostly with those with large R&D, aerospace and pharma, aerospace self-selected as leaders of the discussion; also informal (led by CBI) discussions with smaller firms.

Apart from a host of technical issues, the government faced two core choices. One was whether the basis of credit should be new increments of R&D spending or the total volume of spending. The other was what size companies would be eligible, since ‘Increasing Innovation’, the Budget 2001 consultation, specifically concentrated on the economic analysis of ‘the difficulties that smaller companies have in accessing capital for R&D investment’ (p. 19),⁵¹ but while that case can be made for small firms, it is less clear for big.

But the goal of the policy was innovation, and R&D was to be substantially increased: later a 40% increase came to be the public target. Of course, big firms do most of the R&D. The 1999 BERD Survey shows that of the £8+ billion in current, private R&D expenditure undertaken in the UK in 1999, SMEs⁵² did maybe 10% (Dilnot et al. (2002)). The other 90%, done by non-SMEs, was an attractive target for a government determined to do something

⁵⁰ Griffith, Redding, and Van Reenen (2001) provided further support. However, note that firms do not perceive financing, high costs, or appropriability problems to be more significant barriers to innovation in the UK than in the US (Abramovsky, Griffith, Harrison (2005b)). See also comments in *Supporting Growth in Innovation*.

⁵¹ It also noted that the UK goes further and allows companies to write off immediately all R&D capital expenditure, including plant and machinery and scientific buildings but excluding land and dwelling houses.

⁵² Throughout this discussion, as in eligibility for the credit itself, the definition of small and medium sized enterprises (SMEs) as having less than 250 employees follows EU concepts.

to encourage innovation. Since their contemplated scale of change would require an unimaginable fourfold increase in SME R&D, it would have to be done by larger firms.

In 2000, EU countries established the Lisbon Agenda to make the EU ‘the most competitive and dynamic knowledge-driven economy by 2010’.⁵³ The Treasury’s consultation paper, ‘Increasing Innovation’, came out shortly after in 2001, committed to

Encouraging innovation ... a vital component of the Government’s strategy for improving the UK’s productivity performance and competitiveness ... The Government can help by ... giving business the platform from which to innovate. (p. x)

It proposed to extend the credit to larger firms, believing that of several available options, this one was ‘the most appropriate instrument for helping boost the demand of businesses to innovate and undertake R&D’ (p. 2) hoping to ‘bring about a step change in the level of R&D and innovation’ (p. 24).

Therefore, we see that the origins of the R&D tax credit seem to be a desire to raise levels of innovation and increase productivity. Moreover, the policy seems to have been based on evidence found in economic research. Its introduction was certainly not a case of industry lobbying for more generous tax treatment. We now move to discuss what informed the government’s choice of a volume-based credit, and the decision to extend the credit to larger firms.

Volume versus incremental credits: an informed choice

Originally the intent was to introduce the credit in incremental form: this had the strong support of the DTI and influential figures in government. The incremental form was modelled on the US tax credit, first introduced in July 1981 as part of the Economic Recovery Tax Act and later renewed in the Tax Reform Act of 1986.⁵⁴ The US tax credit is administered on the incremental basis, rewarding relative increases in, rather than absolute levels of, R&D spending.⁵⁵

⁵³ <<http://www.euractive.com/en/agenda2004/lisbon-agenda/article-117510>>.

⁵⁴ TRA86 made the significant change of incorporating it into the General Business Credit and removing it as a separate statistical line item. See Bronwyn Hall, ‘Effectiveness of Research and Experimentation Tax Credits: Critical Literature Review and Research Design’, Report prepared for the Office of Technology Assessment, Congress of the United States, 15 June 1995, p. 4. Over the next ten years, it continued to be renewed on a short-term basis, mostly through yearly Omnibus Budget Reconciliation Acts.

⁵⁵ Although the US is not the only country to use this system—France, Japan, and Korea have also implemented incremental schemes—it is nevertheless noteworthy as a contrast to the volume-based

The incremental system has been argued to distort dynamic incentives because companies have to invest more and more in R&D each year just to receive the same, or less, credit. They thus have less incentive to invest early in large quantities in R&D, because doing so will simply raise the base from which the incremental credit is calculated in subsequent years. It appears to have been clear already (see Griffith, Redding, and Van Reenen (2001) commenting on the 1999 consultations) that it was doubtful that the credit (which was announced in incremental form) would be cost-effective in the short run, though it always was in the long run. The volume-based system is intended to reward companies that show a long commitment to R&D and innovation.

In the end, the government chose to introduce a volume-based system, on the basis of internal discussions and on the advice of industry. Interviewees frequently cited similar economic logic as described above for why the government made this choice. Below Person A describes some of the reasoning behind why the government eventually chose the volume-based system.

[Initially] HMT favoured an incremental credit over volume: in a simple model with one decision-maker, incremental looks better, but outside the one company model life is more complicated. The incremental approach takes away all the certainty with regard to the credit, where companies are linked they may take offsetting decisions by mistake. Business saw this as a problem too. Incremental had supporters, but not many in complex businesses.⁵⁶

From Person D's point of view the R&D tax credit was born out of a broader agenda of putting the intellectual property tax regime right and agreed that industry certainly favoured the volume-based system:

[We] heard Gordon Brown say 'Innovations are key to a knowledge-based economy, therefore, we need to incentivize the creation of knowledge', so they decided to introduce the R&D tax credit. In June 1998 came the Budget 98 document 'Innovating for the Future'. The government consulted the Intellectual Property Institute and business to discuss the position regarding all types of protected intellectual property: copyright, patents trademarks, know-how, etc., in order to understand the tax treatment in each case. They found that the tax treatment was inconsistent,

systems of other countries, including the UK. Because of their incremental nature, tax credits bear only a fraction of their face value. This is because each time they increase their spending, the base that they must spend to earn the same amount of credit increases. Based on some simple calculations, (Brown (1984), p. 3) concludes that 'the incentive is not the \$25 face value of the credit, but just the value of getting \$25 now rather than later. Assuming an interest rate of 10 percent, the discounted value of the credit is not \$25, but only \$4.29.'

⁵⁶ Person A interview.

incomplete, and ambiguous and the cause of many disputes between taxpayers and the authorities. Company A was involved in the very thorough consultation, and favoured reform of the tax treatment of all intellectual property as well as a volume-based R&D tax credit.

Therefore, while some still favour an incremental system, we find it difficult to fault the government's choice of a volume-based system after both weighing up the economic arguments and listening to the advice of industry.

The large firms extension: policy drift and 'policy creep'

In 2002, the tax incentive was expanded to include a credit for large firms; this provided a 125% allowance but did not offer a cash repayment option. The allowance provides deductions from taxable income based on the actual expenditure amount. The large company scheme also allowed otherwise ineligible SMEs to claim under the large company scheme for qualifying expenditure where they act as subcontractor to a large company.

This did represent, in the eyes of people responsible for framing policy, a fundamental shift. According to Person C:

policy had always been talked about as restricted to SMEs, though the DTI was heavily pushing to include large firms, so there was a political aspect to decisions. The SMEs was a generous policy, but the government was unlikely to meet its targets through just SMEs. It was not exactly the targets that drove the decision to extend RDTTC to large companies, but aggregate investment was a concern and the SMEs were not big enough. The Engineers' Employers Federation was key to the political push, with their continual focus and their power increasing over time. They definitely caused a sea change in the views of large company desirability.

The arguments put forward for large company R&D were more practical than economic—that the existence of a tax credit would 'get the UK onto the shortlist' and that, without a tax credit, we would not be getting our fair share of R&D. We needed to have special incentives for R&D when firms considered location. Pfizer can put its lab in Kent or Hannover, it won't even look at you if you can't check off the 'incentive' box on page 1.

Despite the practical nature of the arguments for the existence of the credit, the detailed discussion was still dominated by the externalities at the Research end of R&D. However, once the policy was in place, we saw a gradual erosion of this and a further shift in focus ('policy creep') onto Development, with people saying that, since this credit is practical in origin, we could easily alter the position to cover additional expenditure.

However, this extension was again not something that all industries were lobbying for. Recalling a meeting in June 2001 attended by representatives

of ICI, AstraZeneca, BT, Reuters (for their IT-proprietary software), Logica, and Laporte, among others, Person D comments:

[I] think the government was determined to bring in RDTC for large companies . . . There are many drivers of R&D investment decisions that come before tax efficiency. This was communicated to the government at the time and it was suggested that they could take the money available for the credit and invest it in science education instead for similar or greater impact. It was also suggested that securing contracts for UK based researchers would be more valuable as we were losing researchers to the US because of poor pay and unstable career prospects.

There can be no doubt that the government also attempted to tie any proposed broad-based tax credits to receiving assurances from industry that new incentives would be matched by new activity. In June 2001 Company A submitted that a volume-based system would be better for large firms. The firm also participates in a scheme to invest in research into disease areas that affect the developing world. In parallel there was growing political pressure for pharma to provide access to existing therapies to those poorest countries. Noting that this ‘was a passion to a number of ministers’, Person D remarks:

A key aim for any government is to generate and conserve UK jobs. However, the vaccine credit can be obtained from qualifying investment located anywhere. To focus on a disease, companies need to access locations and people with the disease. The vaccine credit receives widespread political support, as part of the worldwide effort to provide access to improved therapies to developing nations. However, there is the complicating factor of security in pricing in developed markets and the effects of parallel trading.⁵⁷

Therefore, the extension of the RDTC to large companies raises many issues. First, it reveals policy drifting from its predominant original justification, that is, boosting R&D through relieving small companies of credit constraints, in an attempt to meet a quantitative R&D target. This is not to say that such a change could not have been justified in terms of the general spillover benefits from R&D even in larger firms but just to note that there was an unmistakable shift in the nature of the policy. It also shows how even though no one really lobbied for the RDTC in the first place, once it was in place there was certainly lobbying for its extension to large firms from the DTI and some in industry like the EEF. So the extension to large firms is both an example of quantitative targets distorting policy—what one may call policy drift—and lobbying once the initial SME credit was in place—or as person C described it ‘policy creep’.

⁵⁷ Person D interview. Documents in the file indicate that Company B also welcomed the Vaccine Credit, believing it should be more than 50% deductible against UK tax.

Policy operation: soliciting information and policy change

Securing information about company operations was always a problem for official assessment of the operation of the policy, though not because information was not being shared. People involved suggested that a greater problem was the need to make heroic assumptions about behavioural change while lacking information on bedrock R&D within companies. They found it very difficult to get a sense of the ratio of deadweight cost to RDTC spending. According to Person C:

The Inland Revenue has a significant amount of information, some of which is electronic, but tax returns are always a year behind, which doesn't help. Furthermore, the bulk of the information is in hard copy and was only really accessible as case studies of the largest companies. In addition, since HMT has no right of access to specific taxpayer data, the Inland Revenue needed to adopt strong precautions to make sure HMT couldn't identify individual companies.

So, although the Inland Revenue is a rich source, information was often not readily available. In cases like finance or shipping the clear way to get information is to go to the relevant tax inspector because the industry is regionally concentrated. The Inland Revenue was able to go back to companies to get a realistic amount of expenditure: very much on a case study plus estimate basis, not data for the whole population. For the SMEs, it was more of the same, but even more of a challenge since they publish less. That's why it was so important to talk to the companies.

Almost before the credit got out of the door, the government was thinking about altering it, and solicited firms' comments on its operations. As HMIR, 'R&D Tax Credits: responses to "Defining Innovation"', 12/2003, p. 1, put it, the respondents (virtually all larger firms or associations of firms) 'gave strong support for the R&D tax credit schemes and provided valuable insight into . . . how it might be improved'.

The UK government commissioned two consultation documents on the R&D tax credit, collecting feedback from firms and associations in order to assess the experiences of companies currently claiming the tax credit. However, even before reaching the document stage there were informal discussions involving CFOs about their business priorities and trying out ideas, mostly led by lower officials in HMT.

Almost exclusively large firms respond to the written consultations, because small firms cannot afford someone on the payroll to look after lobbying. The firms that do send in materials sometimes argue that policy as designed makes no difference to their behaviour, even while trying to tailor policy to their needs. The overall message that emerged from corporate responses was that, owing to a combination of unsatisfactory content and

poor implementation, the tax credit was not substantively affecting their R&D investment decisions.

Why was this so? A variety of firms' responses argued, perhaps unsurprisingly, that the actual rate of the UK tax credit was not high enough. For example, the large-firm credit, designed to provide a 7.5% reduction, in practice covers only 60% of R&D expenditures. This really represents a 5% rate of relief which, according to the Confederation of British Industry, falls within the range of insignificant 'background noise'. Hence, Pfizer and GlaxoSmithKline (GSK), the world's leaders in pharmaceutical R&D, were sceptical that the tax credit offered any real incentive. GSK remarked:

If the goal of the credit is to increase UK-based R&D expenditure, rather than maintain it, *the government should consider increasing the rate of relief*. This would then place the UK in a more competitive situation.⁵⁸ (Emphasis added.)

Pfizer stated:

If the Government wishes the UK's tax credit system to act as a headline incentive for greater R&D investment in the UK, it needs to become more prominent in management's planning. *The current rate of the R&D tax credit is only at the margins of significance for our decisions on new investment and maintenance*. To become more prominent, significant increases in the current rate—doubling or tripling—would be required.⁵⁹ (Emphasis added.)

The Chemical Industries Association (CIA) further contends that the lack of a clear financial support and credit structure is symptomatic of a larger lack of clearly defined purpose and scope that plagues the UK government's actions with regard to innovation incentives:

[A]re the tax credits meant to promote a 'new' culture within UK companies to invest more in R&D activities? If so, the current level of R&D tax credit that a company can gain is not seen as a real incentive to do more R&D. A rate of return greater than 5% is required if the credits are to have any meaningful impact within commercial enterprises.⁶⁰

If the government's goal was to increase R&D spending in the UK, they certainly heard the opinion of affected parties that they would have to do more.

Virtually every company surveyed also argued that subjective and arbitrary application of policies resulted in a highly restrictive interpretation of the tax credit policy, contrary to the policy's original intent. AstraZeneca, for

⁵⁸ 'Supporting growth in innovation: Enhancing the R&D tax credit'. Comments from GlaxoSmithKline on the July 2005 consultation paper.

⁵⁹ 'Supporting Growth in Innovation.' Response dated 12 October 2005.

⁶⁰ CIA response to 'Defining Innovation' dated 14 October 2003.

example, claimed that the Inland Revenue's narrow interpretation of the term 'consumable stores' resulted in over-restriction of the definition of qualifying expenditures and the exclusion of expenditures that were clearly relevant to R&D.

Another alleged problem was limited accessibility: a combination of low awareness, ignorance of various benefits of submitting claims, complicated eligibility requirements, the possibility that credits would be temporary, and the costs and difficulty of the application process,⁶¹ though a report prepared by the British Market Research Bureau for HMRC implied that the problem was not lack of familiarity.

There were other complaints about administration. The Cox Review (ch. 5: 'Providing Support and Incentive', p. 7) took very much a position frequently argued to us by firms' spokespersons. Cox suggested that 'Tax inspectors need to recognise that this is an incentive scheme to be encouraged, not an avoidance scheme to be policed.' Cox also felt that 'the UK continues to lag in international terms' and, echoing a view debated at the outset, that an incremental scheme would provide more incentive. Nevertheless, the credit seems to have flourished: Cox cites the 16,000 claims for the R&D Tax Credit 2000–01 to 2004–05 as 'above the original projection made by the Inland Revenue'.

So, the government also heard that they would have to change the definitions of what counted as R&D and they would have to improve the administration.

By and large, lobbying firms got nearly all of what they wanted, though many still want more. Significant changes include revised definitions broadening allowable costs of staff, consumables, and even clinical trials.⁶² However, it would be inappropriate to characterize the entire consultation and policy refinement process as one of firms lobbying for more generous tax treatment. The consultation process is also one of policy improvement, as was the case with the choice of the volume-based system. However, over time the situation has changed from one where the R&D tax credit was 'not something industry was really lobbying for' to one where much of the affected industry is lobbying for quite specific changes to the credit. This is exactly what the Coate and Morris model predicts. The government when creating a tax credit also created an interest group, whose voice became louder over time.

⁶¹ See, for example, the BAE response to 'Defining Innovation' dated 9 October 2003.

⁶² For a time line and list of changes see HMRC's CIR98900—R&D tax relief: legislative structure and time line.

The result and its implications

Those concerned with crafting sustainable policies can anticipate and take account of sources of policy drift that the R&D tax credit illustrates. Good intentions and even possible economic justifications are not enough. The case illustrates the ways that government goals interact in the process of policy formation and evolution. The need for information gives advantages to those who provide it, in ways that affect both the direction and details of policy. Sometimes, as with the vaccine credit, new activities that help achieve other government goals can be traded for policy benefits. Down the road, the supporting coalition for a policy can come to look quite different from the enacting coalition, even without anyone discovering they were wrong about anything. Nevertheless, the shape and size of policy may come eventually to bear little resemblance to what was on the table when the original justifications were argued out and beneficiaries chosen. It may well be that in British tax politics, in comparison with those at least in some other countries like the US, special interest politics are less important. Nevertheless, they may be growing in importance, and with consequences that a political economy analysis helps explain.

On goals, the government are on record as hoping that the R&D tax credit would raise Business Enterprise R&D by at least 40–50% (HM Treasury et al. (2004)), though this has not been achieved.⁶³ Sources converge in suggesting that at least three-quarters of the credit goes to large firms, and that this share is growing. ‘Defining Innovation’, the July 2003 consultative document (table 2.1, p. 6) appears to forecast about £600 million a year recurring cost for the credit (the last round of refinements may put the price up further) which is already a dozen times the size that participants recall being discussed when the first consultations were held.⁶⁴ The R&D tax credit certainly grew.

Did it achieve its objectives? That depends on a number of factors. It appears to be universally acknowledged that relieving financial constraints on research activity of small firms was a major initial goal, and indeed more than 90% of paid small-firm tax credit claims in the UK are in the form of cash repayment. But this is a small part of the actual credit. Arguments can be and are made for a general R&D credit to firms of all sizes, on grounds of addressing general externalities. Interviews with policy makers and industrialists revealed little evidence that such arguments had any prominence at

⁶³ See ‘Science and Innovation Investment Framework 2004–2014’ (HMT, DTI, DfES 7/2004) and Abramovsky et al. (2005a, 2005b).

⁶⁴ Echoing this, the July 2005 HMT/DTI/HMRC consultative document ‘Supporting Growth in Innovation’ mentions that in 2003–04 over 4,500 SME companies and almost 1,000 large companies claimed the credit, at just under £550 million in all (p. 13).

the time of the policy's introduction. Such arguments presuppose anyway that firms' behaviour is influenced by the credit and we found this idea to be treated with scepticism within large affected firms. For instance, Person F indicated that tax credits essentially represent 'free money', which firms will not turn down. Summing this up, Person D said that the large-firm credit

was welcomed in the pharma community at large. For small firms [the SME credit] may be a competitive necessity. It's also good for levelling the playing field, and the UK is recognized as very competitive in this regard. But generally large firms will spend where they perceive they can gain in productivity and in high quality, innovative outputs and the tax incentive may or may not fit with that.

Against this, certainly taxes affect some decisions.⁶⁵ Defenders can also argue that decision-makers may not always be aware of the marginal influences affecting their choices or be best placed to evaluate comparison between policy regimes. Careful econometric observation of actual R&D outcomes should be a more reliable indicator. Indeed, the research that spawned the credit suggested that its main effects come very slowly, so it may be too soon to tell. So there is mixed evidence: the Cox Review on innovation was still a firm believer in the efficacy of the credits.

Finally, it also depends on whether the goal of policy was to encourage geographically specific R&D. If it concerned actual people doing research at actual seats in actual British workplaces, the case for the credit may be weaker. As Person D, the same person who recalled putting the case five years earlier that science-based contracts would have been a more powerful tool of policy, put it:

If I were to ask the head of research about location decisions, he'd say: 'where are the best people?' It's not about labour and consumable costs, it's about intellectual power, scientific knowledge and innovation.

Abramovsky et al. (2007) provide evidence for co-location of pharmaceutical R&D labs and university research departments in Great Britain. The paramount importance of the quality of the scientific community in R&D location decisions features prominently in our interviews and those of Xu (2007). At the same time, Griffith et al. (2006) show that locating R&D in the US has a big productivity pay-off for UK firms. That result is consistent with two important ideas that affect evaluation of the R&D tax credit: first, that the main benefit of R&D is to create knowledge externalities which cross borders between countries and maybe companies, and second, that the very

⁶⁵ Person F, formerly Tax Director at Company B, did mention that he funded actual R&D in low tax jurisdictions.

nature of transmitting externalities means that the benefits of any investment decision may come through very slowly. But if the externalities are the benefit of R&D, and are biggest when the R&D is undertaken in the most advanced location, then indeed a good policy may be what Person D reports long advocating:

We ask for the broadest definitions, because so much activity is on a global scale, we want to capture the entire investment made anywhere in the world.

The UK government has resisted this all along. The headline quality of giving tax credits in the UK to MNEs for their spending in other countries might just prove politically costly, even if the economic case for it can be made.

13.5.3. Lobbying outside corporate taxation

The costs of the R&D credit to the taxpayer are small, widely dispersed, and very hard to observe. Those facts alone help explain why the politics took the form they did. However, there is more to say about interest groups than that. When the costs of a policy, though small, are easy enough to observe, extensive media coverage can result in mobilizing the otherwise unorganized 'cause' groups, which are becoming increasingly prominent as a form of participation in British politics.⁶⁶ This gives an issue increased electoral salience, as the recent case of fuel tax protests shows. Moreover, in other cases the link between ideology and party politics creates circumstances in which the interests of unorganized groups are anticipated and represented by parties even without the galvanizing effect of mass protests. Zero-rating VAT on children's clothing and food is such a case. These two cases deserve a brief comment.

Between 1993 and 1999 excise duties on petrol were increased by a fixed proportion above inflation year on year by both Labour and Conservative governments in the name of reducing congestion and pollution. However, in September 2000, with unleaded pump prices at about 80p per litre and fuel duty at about 49p per litre,⁶⁷ protestors (mainly hauliers) who objected to this historic high in fuel duty blockaded petrol refineries. This caused nationwide petrol shortages, with many petrol stations running out, partly as a result of panic-buying. Eventually, the blockades ended with greater police protection for lorries leaving refineries, as the costs and inconvenience of shortages became more evident. Even though the fuel duty escalator had

⁶⁶ The poll tax case, mentioned above, also exemplifies this.

⁶⁷ <<http://www.dtistats.net/energystats/qep411.xls>>.

been halted before the protests, the government bore the brunt: this was the only time during Labour's first term that they fell behind the Conservatives in the polls.

Observing that this was an issue that threatened to change voting intentions quite strongly, the government reduced fuel duty in its Budget of 2001, just before the general election of that year. Since then it has been increased in nominal terms only four times: as a result it is much lower in real terms compared with the level in 2000. Why? Even if the economics of the issue are unchanged, if more voters are aware of the fuel duty, it is easier to mobilize their preconceptions than to create them in the first place,⁶⁸ and the reaction of 'swing' voters to higher levels of fuel duty could be highly costly in terms of public support.

Maintaining VAT exemptions for food and children's clothing has been an untouchable commitment of all major parties for many years. The commitment is usually justified on redistributive grounds: because these goods are perceived as essential items for poorer families with children taxing them would unfairly hit a deserving group in the population.

However, VAT is an *ad valorem* tax, so the main beneficiaries in absolute terms are those with higher absolute spending on these goods. The exemption subsidizes the rich parent buying designer clothes for their child as much as it does the poor family buying necessary items. If one really wanted to address redistributive concerns, it would make sense to end zero-rating of these goods and at the same time put the money 'saved' (the extra revenue collected) into increasing child benefits. This would benefit all families with the same number of children equally in absolute terms, but would benefit poorer households more in proportionate terms.

More generally, while it is clearly desirable that redistributing income taking account of needs should be one among several objectives met by the *overall* tax system it is not sensible to try to make every element of the system meet every objective.

Yet neither Labour, usually thought the most redistributive of the major parties, nor any of its rivals supports the change. Of course, one reason might be that the status quo is genuinely redistributive in relative terms when viewed in isolation. Perception of this may prevent voters from supporting more redistributive reforms that could be achieved with the same money. Second, eliminating zero-rating would be costly in a way immediately

⁶⁸ Graetz and Shapiro (2005) show that it is more expensive for ideologically motivated groups to frame the issue (in their case, abolition of the estate tax in the US) in the first place, but given sufficient resources (and perhaps a few lucky coincidences), large numbers of people can be persuaded to support a tax from which they derive no benefit.

apparent to a lot of people, even if the increase in child benefit were enacted simultaneously.⁶⁹

Earlier we remarked that keeping the focus on an element of the tax system was also a key strategic element in the campaign organized by interest groups in the US that led to the abolition of the estate tax (the US equivalent of inheritance tax).⁷⁰ Keeping the focus on an element of the tax system viewed in isolation prevented voters from making many relevant comparisons. The recent skirmish over inheritance tax in Britain resembles some of the origins in that case:

After a decade in which the threshold for inheritance tax rose at half the rate of house prices, stories began to appear (usually based on ‘research’ by banks) speculating about the number of home-owning families that would owe estate tax. This began modestly: ‘A further 22% rise to 37,000 is expected by 2007, according to Halifax’ (4 Aug 2005) but inflated rapidly when ‘Halifax . . . said “house price rises meant the tax would be payable on 2.1 million homes”’ (19 Nov 2005). Within months one could read that ‘One in three UK homeowners will now be subject to a 40% inheritance tax, . . . a recent survey by Scottish Widows shows.’ (16 Feb. 2006)⁷¹

At this point in the American case the Graetz–Shapiro analysis of careful, patient lobbying by groups shows how swing voters in the US were mobilized to the cause, to the point where even raised allowances eliminating 99% of citizens from the estate tax could not win in the legislature. The response by the UK Chancellor (an adjustment of thresholds which appeared to defuse the issue) reflects the lack of development of a comparable lobbying organization on the issue, perhaps because there have been no consultations to mobilize it. The inheritance tax also reflects the importance of insulation and centralization in British policy-making. One Chancellor can deflect lobbying; the next might change policy completely, just as a small, determined group of ministers were able to force through the poll tax.

13.5.4. What have we learned?

So what does our study of interest groups and taxation show? Its primary lesson is that enacting tax policy can create interest groups and constituencies for that policy. Even when they did not lobby for the policy in the

⁶⁹ If the changes are separated, questions about policy commitment could arise.

⁷⁰ See note 38 above. The estate tax was in fact not completely abolished, and will return after 2010 absent legislative action.

⁷¹ All quotations taken from <<http://news.bbc.co.uk>>.

first place, they will lobby both for persistence and extensions that allow policy to drift from its original motivation. This is exactly what we see with the R&D tax credit. Lobbying for policy persistence from existing beneficiaries of a tax policy is a generalization of the widely understood phenomenon that losers from a reform are more vociferous than potential winners.

Outside corporation tax, we can see that the role of framing tax policy can be crucial. Framing the zero-rating of children's clothing in isolation has helped maintain it; framing the estate tax in isolation also helped those lobbying for the end of estate tax in the US. The lessons from the fuel tax protests are more difficult to generalize, but if anything we see that media attention can make the 'unorganized' very vocal indeed. One could also argue that focusing on the effects of the tax in isolation helped crystallize protest.

13.6. TRANSPARENCY AND ACCOUNTABILITY IN TAX SETTING

'Good' tax policy could be said to encompass a number of features: the ideal mix between different sources of taxation; the optimal size of government; and minimum wastage or misappropriation of public revenues. It is widely acknowledged that the making of good public policy in all areas of government—tax policy included—partly rests on the existence of a well-informed electorate that can hold the government to account. However, it is frequently claimed that the electorate is poorly informed about most areas of public policy, and that they are thus restricted in their ability to hold the government to account. This may allow politicians to follow their own agendas on tax policy, be this in terms of the overall size of government or the composition of tax revenues. For instance, one of the stated reasons for introducing the poll tax was to ensure profligate councils were held to account by local citizens. The 1987 Conservative general election manifesto stated that:

We will reform local government finance to strengthen local democracy and accountability. Local electors must be able to decide the level of service they want and how much they are prepared to pay for it.

From a theoretical perspective, unlike redistributive taxation, it is harder to isolate a canonical model to represent the conflict of interest between

politicians and voters. A related tradition in political economy that puts direct emphasis on elections is due to Barro (1973). He considers a world in which the promise of re-election can lead politicians to implement policies favoured by citizens. Thus, the problem of excessive taxation is held in check by the fact that political office is contestable. In effect political parties and/or politicians develop reputations that they lose if they do not fulfil them. Politicians who renege on their tax promises risk being voted out of office in this kind of framework. The models have found empirical support in evidence that some fraction of voters does appear to vote retrospectively, that is, looking at the records of incumbents on taxation and spending—see Paldam and Nannestad (1994) for a review of the literature. There is also evidence, consistent with these models, that politicians that are in the last period in office and hence cannot be re-elected behave differently in setting tax and spending policies compared to those who can run again—see, for example, Besley and Case (1995b).

Accountability models focus for the main part on debates about what drives the size of government rather than the composition of taxation. However, one key feature of the approach which does have implications for tax structures takes the information foundations of agency models more directly to heart. One of the reasons why politicians are able to run their own agendas which may not be in line with what voters want is based on the idea that voters are imperfectly informed. This builds on the quite reasonable fact that few voters are expert economists and, even if they were, they would lack the information needed to assess the incidence of many tax policies. Moreover, some forms of taxation may be less visible than other forms. This is important because Mani and Mukand (2007) show that public expenditure on public goods can suffer from a ‘visibility effect’. This causes public expenditure to be distorted towards more visible forms of public goods, despite less visible public goods being of considerable public benefit. One could imagine a converse argument applying to taxation, such that less visible forms of taxation are over-used relative to the optimal tax structure.

Section 13.6.1 will discuss the implications of imperfect information, both in terms of voters’ knowledge about the tax system, and in terms of the visibility of different elements of the tax system. Section 13.6.2 will discuss the role that political institutions and policy rules have played in terms of holding the government of the day to account: this will include a discussion of the role played by Parliament, fiscal rules, and external bodies. Section 13.6.3 concludes.

13.6.1. Role of information and transparency in shaping tax structures

Public understanding and hypothecation

It is unreasonable to expect voters fully to understand the tax system and its first- or second-order effects: that is, after all, what economists and accountants are employed for. However, a lack of understanding of the tax system and its elements may play a significant role in the shape the system takes. This is best understood when looking at the example of National Insurance contributions (NICs) and income tax.

Income tax and employee NICs (referred to as just NICs until we come to discuss employer NICs later in this section) are highly similar in their operation, such that NICs have increasingly come to resemble just another income tax over the years. They both tax earned income—though income tax also taxes savings and pension income. They are both withheld at source for employees (i.e. deducted from pay cheques), though collected via different administrative systems. There are some differences in that NICs are levied on weekly earnings, whilst income tax is levied upon annual income, and there are some other important differences for the self-employed. However, there is a common belief that there is a strong connection between NICs paid and state benefits, and that NICs pay for the NHS, making NICs distinct from income tax. Neither of these perceptions is based very convincingly on the reality.

In the UK, there has always been a weak connection between benefits and contributions. Furthermore, this connection has been weakened by a gradual alignment of the NIC schedule with the income tax schedule and the removal of the ceiling on NICs, such that NICs increasingly resemble just another income tax. Moreover, there is actually no meaningful connection between how much is spent on contributory state benefits or the NHS, and how much revenue is raised via NICs. Despite this there appears to be a general misperception that the NHS is funded via NICs (see Stafford (1998)).

Having first accepted the idea that NICs and income tax are highly similar, it may seem surprising that income tax rates and NICs have followed different trajectories over the past thirty years. This might not be so surprising if there are widespread misperceptions regarding the degree of hypothecation and the connection between contributions paid. This is because such misperceptions may make NICs more politically acceptable, since they are wrongly perceived to pay for things voters like and may benefit from later on in life.

However, as NICs only tax earned income, rather than that from savings and pensions, only the working-age population is likely to pay significant amounts. This means that rises in NICs, as opposed to income tax, exempts pensioners—a group that has a relatively high likelihood to vote in a general election. So, the greater relative reliance on NICs could also be the result of baser political motivations to tax relatively lightly a group in society with increasing political weight—pensioners.

Still, a situation where the public falsely believes that NICs are meaningfully hypothecated towards the funding of the NHS and contributory benefits is far from conducive to accountability. Whether a better situation is one with meaningful hypothecation is doubtful. Transparency might be enhanced but linking the revenue from particular tax instruments to spending on particular items would unhelpfully reduce discretion over the composition of public expenditure and unnecessarily complicate the tax system. An improvement in public information with respect to the current arrangements would improve transparency and accountability without these drawbacks.

Visibility

As already indicated, it seems like a reasonable conjecture that politicians that view voters as averse to increased taxation will tend to pick forms of taxation that are less visible to the decisive voters whose votes they care about. In the UK, this chimes with discussions about ‘stealth taxation’, the idea being that there has been a tendency in the last two administrations to pick low visibility forms of tax increase. Unfortunately, it is quite hard to assess the exact empirical validity of this proposition, in part because the effects of transparency are not quite as simple as ‘more is better.’⁷² However, we can point to some specific large-scale examples.

Examples of less visible forms of taxation would include most indirect taxes since they are typically not separated in prices perceived by consumers.⁷³ By contrast, pay slips are typically quite explicit about deductions for taxes and National Insurance. Things are more complicated, however, when the ultimate incidence of a tax is unclear. Consider, for example, employers’ National Insurance contributions. In a competitive labour market, these will be borne by workers. However, few workers observe directly what is being paid by their employer and are likely to set aside the possibility that it is actually coming

⁷² Partial transparency can create distortionary incentives in a variety of ways. For an example of a case where more transparency is not actually welfare-enhancing, see Besley (2006), ch. 3.

⁷³ This compared with most states sales taxes in the US, which are not included in the prices perceived by most consumers and are instead only included when consumers pay for their goods.

out of their pay packet since this requires an economic analysis of the market equilibrium.

An example of a relatively visible tax would be income tax paid by the self-employed, which has to be directly remitted by these individuals. Another would be council tax, which has to be paid by individuals directly, after the bill lands on their doorstep, ensuring maximum visibility. This could be a source of its public disfavour. However, unpopularity of the council tax may owe more to observed gaps between property values and property taxes due to infrequent revaluation as well as the opaqueness of the formulae under which local authorities receive grants from central government, both of which produce a disconnect between payment of taxes and receipt of services. Ironically, one of the arguments made in favour of the poll tax was that its transparent visibility would enhance accountability. However, as we discussed above, the policy was not sustainable in the face of public opposition, and the long-term consequence of the poll tax experiment turned out to be even greater centralization and further obscuring of the cost of local services.

Moreover, the way changes to taxation are perceived by the public or reported by the media may be important. Revenues from some taxes, such as income tax and VAT, keep pace with inflation as earnings and sales increase with inflation. However, excise duties and council tax must be ‘raised’ each year in line with inflation in order to prevent the revenues from being eroded by inflation. There is thus an incentive to place greater reliance on taxes that need not be ‘raised’ each year, which is exactly what we see in the UK, with relatively less reliance on specific indirect taxes over the past thirty years.

Similarly, governments of all stripes have partly relied on fiscal drag—or ‘bracket creep’—over the past thirty years for growth in income tax revenues. If the government raised the top or basic rate of income tax, the effects are likely to be quite transparent and widely reported. However, it is not quite so obvious how much extra tax you pay when your earnings increase just enough to push you into the top income bracket because the government only increases the income tax threshold with prices, as opposed to earnings.

With all this in mind, we see that UK governments over the past thirty years have benefited from the growth in revenues associated with taxes (or elements of them) whose effects are not that transparent or well-understood—for example, rising rates of VAT, fiscal drag, and both employer and employee NICs. They have relied less on taxes whose effects are transparent or which require ‘increases’ each year to maintain their real value, for example, specific excise duties and top or basic rates of income tax. See Chapter 1, Figure 1.3 for trends in the composition of tax revenue over time.

13.6.2. Institutional constraints

We have speculated that the public is far from perfectly informed in matters of taxation and so cannot hold the government fully to account. Research conducted by Torsten Persson, Gerard Roland, and Guido Tabellini argues that some forms of institutional structures can improve the quality of governmental response to problems of imperfect information. For instance, Persson and Tabellini (2003) argue that presidential forms of government create a greater level of individual accountability. Obviously, the UK is not a presidential system and no such fundamental political change is under serious consideration, but are there other constraints on the executive that ensure accountability? We shall begin this section by discussing whether fiscal constitutions, such as fiscal rules, ensure greater levels of accountability. We will then move on to discuss the role played by Parliament and external bodies.

Fiscal rules

Scholars of political economy have put a lot of store by fiscal rules for governing the public finances. Among Public Choice scholars, like Brennan and Buchanan (1980), this is based on a belief that electoral mechanisms are insufficient by themselves to restrain government's power to tax. They advocate adopting a 'fiscal constitution' where governments are explicitly constrained.

In a broad sense, the need for explicit fiscal rules can be thought of as responding to explicit failures in governmental decision-making. Rules that govern macro-economic aspects of the public finances are usually motivated by the idea that voters are poorly informed about the true state of public finances. In principle, fiscal rules could also encompass specific tax measures—such as the tax base or the rate of income tax. However, while these are often the subject of electoral pledges, they are rarely embodied in rules. Most fiscal rules relate to the overall size of government.

The UK public finances are governed by the Code for Fiscal Stability, which says that the government must announce their fiscal objectives, and if they have any rules, how these will be defined. In 1998, the Labour government chose to impose two fiscal rules, neither of which related to the size of the state—instead they focused on measures of borrowing and debt. The first was known as the 'golden rule', which demanded that the current budget be at least in balance over an economic cycle. The second rule was known as the 'sustainable investment' or 'net debt' rule. This said that net debt should

remain at 'a stable and prudent level', which the government chose to define as not more than 40% of GDP.

These are self-proclaimed rules and have no legal force. They also require the government to define important concepts, such as the dates of the economics cycle, and could thus be subject to manipulation. Nevertheless, according to Person E:

However much mistrust there may be in the precise definition of the Golden Rule, there is no doubt that it played a very real role in constraining Gordon Brown as Chancellor. It set parameters around what was allowable, and by and large these parameters restricted and genuinely constrained policy.

Furthermore, the Labour government's decision to abandon these fiscal rules, when faced with a banking crisis in late 2008 and a large increase in the level of government borrowing, proved to be politically embarrassing. Such a situation added weight to the accusations from both main opposition parties that the government had been fiscally irresponsible.

Other countries have also adopted fiscal rules. For example, some states have adopted balanced budget rules that restrict the extent to which states can run budget deficits, which are easily verifiable but do restrict a state's ability to smooth tax and spending over the ups-and-downs of the cycle. There is also the Stability and Growth Pact, which forbids signatories from running budget deficits in excess of 3% of GDP except in exceptional circumstances. However, this has proven difficult to enforce in practice, especially in a context where it is fellow European leaders who decide on any possible sanctions.

Parliament

Going back as far as the thirteenth century, Parliament has had the constitutional responsibility of approving new taxes. How is it placed to hold the executive to account and perform scrutiny of tax policy in the twenty-first century?

Parliament has a number of routes through which it can scrutinize the government's tax policy. First, the Chancellor often comes before the Treasury Select Committee soon after the Budget and Pre-Budget Report. This gives members of the Treasury Select Committee the chance to ask the Chancellor questions about the announcements he or she has made about tax policy. There is also an opportunity for MPs to scrutinize tax legislation during debates on the Finance Act in the House of Commons and during the committee stage. However, the effectiveness of this scrutiny is questionable since MPs have few resources to draw upon, as we have already observed.

The House of Lords provides some scrutiny of the detail of tax policy, however its role is restricted as it cannot vote on money bills.

Neither is there any pre-legislative scrutiny, which is important to note given that tax reforms announced in the Budget, or Pre-Budget Report, are more often than not just enacted as announced. Therefore, since there is precious little evidence that Parliament is taking up the strain in terms of holding the government to account, do external bodies do the job any better?

External scrutiny

What roles do external bodies play in scrutinizing tax policy? One important source of scrutiny comes from tax professionals. HMRC regularly consults tax professionals before enacting legislation, either via formal consultations or informal approaches. The degree to which HMRC does this has also increased over the past thirty years. This has certainly helped improve the quality of tax legislation and more of the same could further improve matters. However, there is little explicit pre-legislative scrutiny from external economists.

Most of the external scrutiny from economists is provided immediately after tax policy announcements in the Budget or Pre-Budget Report. An important source of such scrutiny comes from pressure groups, accountancy analysts, and—excusing the authors' natural bias—the Institute for Fiscal Studies (IFS). The briefings provided by the IFS, for example, the day after Budget or Pre-Budget Report, have become a staple for economic journalists and the analysis of tax policy proposals is widely reported. Although such scrutiny rarely leads to changes in tax policy proposals, the knowledge that bodies like the IFS will provide detailed and careful analysis certainly provides strong incentives for the government to make sure the full implications of any proposal are fully thought through before they are announced.

However, such external scrutiny is limited by the availability of data. For instance, publishing more of the assumptions behind the fiscal forecasts would enable better external scrutiny and ensure greater credibility for the fiscal rules.

13.6.3. Summary

There is a limit to how well-informed the electorate can be expected to be for the purpose of holding the government to account and ensuring good quality tax policy. Nonetheless, the extent to which we observe government making increasing use of tax policy instruments that are either ill-understood

by voters—as in the case of employer or employee NICs—or those that are less visible or transparent to voters—such as VAT or fiscal drag—should be seen as unwelcome.

Do other institutions pick up the accountability baton where the electorate leaves off? Parliament plays some role, but lacks the informational resources to play much of a role, and is hardly involved at all in the crucial pre-legislative stage. The fiscal rules appear to have lost credibility due to perceived fudging of the rules by government and little external scrutiny of assumptions. On a more positive note, external organizations do provide some level of scrutiny and accountability, ensuring improved tax legislation and that the economic impact of proposals is fully thought through.

Transparency is now part of the motherhood and apple pie of government policy making. Moreover, greater freedom of information and public discussion of these issues has certainly resulted in significant moves in this direction in recent years. We take it as a goal of transparent tax policy to make the analysis and data that is provided for debates about tax reform even more available to citizens.

13.7. CONCLUSIONS AND POLICY RECOMMENDATIONS

Following his attempts to create a fairer tax system, Jean-Baptiste Colbert, the French Minister of Finance under Louis XIV, observed that:

The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least possible amount of hissing.

This quote neatly summarizes the conflicts inherent in tax design from both an economic and a political perspective, that is, we wish both to create a tax system that minimizes economic costs, such as deadweight loss, but also to create one that is politically sustainable within the machinery of government and society.

We conclude by summarizing the key themes our analysis has highlighted: a ‘passive’ movement to the right; policy drift as a result of lobbying; disconnected tax debates; the effect of an ill-informed electorate and minimal transparency; and finally we present our proposal to improve scrutiny and parliamentary accountability. Before we begin, it should be noted that many of the problems we identify are not unique to taxation, and neither are the solutions we recommend. Our recommendations should thus be seen in a wider context of the overall UK political process.

13.7.1. A 'passive' movement to the right

This chapter analyses whether changes in voter preferences and strategic party positioning could explain declines in statutory rates of income tax. What we discover is that electoral support has moved to the right, though voters seem to have followed rather than led the changing content of party manifestos. Voters have always favoured redistribution, particularly from those with the highest incomes to those with the lowest incomes. Whilst preferences for redistribution have been declining over time, it is notable that the large cuts in statutory rates of income tax took place at a time when attitudes to redistribution were at their most favourable, and when a majority of voters voted for parties who did not favour these cuts. Whether this move to the right will persist and to what extent it is now a fact of political life is hard to say.

13.7.2. Policy drift and persistence

Our case study of the R&D tax credit provides a number of lessons, the primary one being that enacting tax policy can create interest groups and constituencies in favour of that policy. Even when they did not lobby for the policy in the first place, like the large firms in our study, they will lobby both for persistence and extensions that allow policy to drift from its original motivation. Therefore, any potential tax reformer should remember that any new allowances enacted or favourable tax treatments provided to particular groups could prove difficult to remove and may be distorted into something different over time.

While the example of the R&D tax credit vividly illustrates policy persistence as well as drift, the past thirty years has seen other areas of specific tax privilege phased out, most notably the married couples allowance and mortgage interest tax relief. The timing of these reforms suggest that it is helpful to phase out changes gradually and during a period when it can plausibly be claimed that other taxes are being cut or rationalized.

13.7.3. Disconnected tax debates

The framing of tax policy debates can be crucial. Framing the VAT zero-rating of children's clothing in isolation has helped maintain it; framing the estate tax in isolation also helped those lobbying for its abolition in the US. Such

framing could easily result from a lack of public understanding about the interconnectedness of the tax system.

However, in order to pursue sensible tax policy it is essential to see the tax system as a system rather than to consider its different elements in isolation. So disconnected tax debates may be particularly counter-productive for tax policy as compared with other areas of public policy. This has a lesson for the Mirrlees Review, which may need to combine tax reforms in different areas to provide a broad-based set of reform measures, making clear that there is give and take across different population groups.

13.7.4. Transparency and accountability

There is a limit to how well-informed the electorate can be expected to be for the purpose of holding the government to account and ensuring good quality tax policy. However, institutional reforms which improve transparency and public understanding would help avoid situations where government can make increasing use of tax policy instruments that are either ill-understood by voters—as in the case of the relationship between National Insurance contributions, NHS spending, and state benefit spending—or those that are less visible or transparent to voters—such as VAT or fiscal drag.

Other institutions like Parliament can have an accountability role, but as noted above limited information and pre-legislative involvement make it a small one. At the same time external organizations provide some level of scrutiny and accountability, which improves tax legislation and economic analysis of proposals. However, to the extent these are also interested parties, the costs of policy persistence and drift (analysed above in Section 13.5) have to be set against this.

13.7.5. A proposal to improve scrutiny

We are not the first to identify this lack of parliamentary accountability as a problem. In 2003, a Tax Law Review Committee working party chaired by Sir Alan Budd produced a report called 'Making Tax Law'. This report stated that,

In the case of taxation, the unfortunate reality is that the House of Commons fails to scrutinise the rules (if not the levels) of taxation in any real sense at all. 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.

A degree of parliamentary accountability through greater levels of pre-legislative scrutiny of tax policy would be highly desirable. Of course, a lack of effective parliamentary accountability extends to other areas of policy, beyond taxation, and is a general political concern. However, the degree of pre-legislative parliamentary scrutiny is even weaker for tax policy, since in other areas policy proposals are regularly published in White Papers or Green Papers. Although there is pre-legislative scrutiny of draft tax proposals by tax professionals and other interested parties, Parliament is rarely involved in this process.

The best vehicle for pre-legislative scrutiny is the select committee system. We leave it as an open question whether scrutiny of tax policy is best undertaken by the existing Treasury Select Committee or by a new select committee on taxation. But it is clear to us that ensuring higher levels of pre-legislative scrutiny should be a priority for government.

Alongside this, in order to undertake effective pre-legislative scrutiny, MPs require more resources. At present, much advice and support comes through external organizations, and this could be extended. However, another possibility is a formal in-house service akin to the Congressional Budget Office in the US, which could be explicitly charged with providing analysis of tax policy for MPs.

More broadly, we believe that serious thought should be given to instituting a body to oversee the public finances. A group of experts with genuine knowledge of the operation of tax systems could be put in place to offer advice and to audit revenue and spending figures. This body could be accessible and accountable to Parliament as well as to the executive with appointments appropriately scrutinized. As well as scrutinizing government plans, the body could offer advice to all parties, particularly around election times. To provide meaningful scrutiny and advice, any such body would require access to more data than is currently provided to Parliament. As well as providing more data to this body, providing more data to the public could improve external scrutiny, for example, by publishing all assumptions behind fiscal forecasts.

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Commentary by Peter Riddell

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The Alt, Preston, and Sibieta chapter has too much flimsy political science and not enough well-founded history. Its discussion of the political influences on tax policymaking would have been more convincing if the authors had examined what had happened rather than tested, and partly found wanting, some tendentious theoretical models. There are virtually no references to what Geoffrey Howe, Nigel Lawson, Kenneth Clarke, and Gordon Brown said, thought, and did. We do not have to speculate on why various tax decisions were made. There is ample evidence in what politicians said at the time, especially about what they believed (rightly or wrongly) about the attitudes of voters, and in more immediate, and extensive, opinion research by polling organizations, rather than just the British Social Attitudes Survey (valuable though that is). There have been two long periods of one-party rule in Britain, from 1979 to 1997 under the Conservatives, and since 1997 under Labour, when broadly consistent tax policies were followed (with notable exceptions, of course, such as the introduction and then abolition of the poll tax or community charge). This historical approach provides greater insights into the pressures to reduce marginal tax rates during the 1980s, then not to raise them again from the 1990s onwards, until the banking and financial crisis of 2008 onwards. Such an analysis would also place much greater emphasis on international influences on tax policy, especially during Labour's period in power, than this chapter does.

A major reservation about the chapter is over the discussion of voter preferences and median voter models. Their usefulness is limited because votes in

general elections are not solely or even primarily determined by the public's views just on taxes and on the parties' tax policies. The pattern is, in practice, more complicated, because as the authors concede, public knowledge is imperfect, while attitudes on taxation form part of a much broader range of attitudes towards a governing party's competence in managing the economy. For instance, Gordon Brown's repeated emphasis, both before and after the 1997 election, on not raising the basic and higher rates of income tax was only partially about tax policy as such—and only a limited guide to the trend of the tax burden, as the chapter recognizes—and much more about convincing voters that it was safe for them to have, and then retain, a Labour government. The authors correctly link support for taxes to levels of public spending. But it is more a question of whether voters think their tax money is being well spent. The chapter says (on page 1236) that the BSA asks no question addressing directly the issue of how effective the government is believed to have been in directing public funds to desired uses. But this question has been asked frequently by the main polling organizations, such as ICM, Populus, and YouGov (all of whose work is readily accessible on their websites). This shows a consistent decline over the past five years in the number believing the increase in taxes has been well or efficiently spent. The trust question asked in the BSA, as mentioned in the chapter, is only a rough-and-ready proxy for this more specific question which is the key to attitudes to taxation. In this context, as discussed below, it is astonishing that this chapter does not discuss Gordon Brown's decision in 2002 to raise employer and employee National Insurance contributions specifically to finance a big increase in spending on the NHS.

1. THE CONSERVATIVE YEARS

The Conservatives came to power in May 1979 with a clear tax objective. As Margaret Thatcher (1993) put in her memoirs (p. 42): 'Lower income tax combined with a shift from taxation on earnings to taxation on spending, would increase incentives.' There was no dispute on this goal. Promises to cut taxation had featured prominently in Conservative campaigning and in its manifesto, cutting the top rate of income from 83 to 60% (the then European average) and also the basic rate, while undertaking an unspecified switch from direct to indirect taxation. Tory strategists believed that not just the wealthy but also skilled manual workers felt they were paying too much in direct taxes. As Professor Ivor Crewe pointed out (in Penniman (1981),

pp. 284–97), taxes came third on the list of issues which members of the public said influenced their voting decisions (behind prices and unemployment). Moreover, amongst those saying the issue was important, the Conservatives enjoyed a lead of plus 61 points. The Tories' edge here and on law and order offset Labour's advantages on prices and unemployment. Moreover, crucially, voters believed that a Conservative government would succeed in achieving its promise to reduce income tax—by a margin of plus 49 points saying it would rather than would not. Tax, Crewe argued, was different from other economic questions.

To promise a reduction in the income tax, as the Conservatives repeatedly did, is as clear, tangible, and accountable a campaign commitment as a party can make. The electorate felt that something ought to be done about process, jobs, strikes, crime and taxes, and on the first two it was marginally more inclined to put its trust in Labour; but only on taxes did the voters also believe that something could and would be done—and that it was the Conservatives who would do the doing.

Taxation was the most helpful issue for the party.

A year before the election the Conservatives' lead over Labour as 'the better party to reduce taxation' was a mere two percentage points; by polling day, the Conservatives' lead was 42 percentage points. On no other issue did public concern and party popularity move so decisively—and swiftly—in the Conservative party's favour.

So the Conservative leadership regarded honouring the tax promise as a top priority, both because it was right and to show that their election manifesto was being implemented. The Howe–Lawson team never signed up in full to the theories of Art Laffer that cutting income tax would not reduce the tax yield, and might increase it as a result of stimulating economic activity. This was one of the main contrasts between the economic policies of the Thatcher and at least the first-term Reagan administration. While the Thatcherites agreed that, over the long term, cuts in marginal tax rates would raise incentives and activity, they thought the positive effects would take time to work through and would not immediately offset the revenue lost from any reduction in the basic rate or from raising thresholds. The sole exception was in cutting the previously very high top rate of 83% to 60%, which they believed would have favourable effects on revenue, not least through a reduction in tax evasions and avoidance. This positive effect would not, however, apply in the short term to a cut in the basic rate of income tax, which Howe believed, had to be from 33p to 30p in the pound. Howe (1994, p. 129) argued that:

the level of income tax payable by the average taxpayer had to be reduced substantially. Not just because his or her income was more highly taxed than that of most of our overseas competitors. Not just because he or she felt demotivated. But, most important of all, because it would be politically impossible to make the large cuts in top rates that were necessary without achieving some comparable reduction in the direct tax burden of the average citizen.

So with tax thresholds and allowances rising above the cost of inflation, the Treasury would have to find at least £4.25 billion from indirect taxes, notably by replacing the previous two rates of Value Added Tax of 8 and 12.5% by a unified one of 15%. The main downside of this big tax switch was in raising retail prices and on the retail prices index which, in turn, would affect the level of pay claims, especially at a time of double-digit inflation.

The intellectual and political drive for the tax change came from the Conservative Treasury team. But such a big change naturally also involved the Prime Minister. Howe noted (1994, p. 130):

the ambivalence which Margaret often showed when the time came to move from the level of high principle and evangelism to practical politics . . . now that we had come to the point of decision, she expressed herself anxious, understandably, about the possible RPI effects. At our first bilateral meeting, on 22 May, she was inclined to stick at a VAT flat rate of 12.5 per cent. I argued that our first Budget provided 'our only opportunity to make a radical switch from direct to indirect taxation and thus honour the commitment on which our credibility depends.'

At a second meeting, two days later, the scale of the shift was agreed, with a later compromise on excise duties. Thatcher herself recalled (1993, p. 43): 'Income tax cuts were vital, even if they had to be paid for by raising Value Added Tax (VAT) in this large leap. The decisive argument was that such a controversial increase in indirect taxes could only be made at the beginning of a parliament, when our mandate was fresh.'

Important political influences were notable by their absence from this discussion. First, public opinion only played a background role: being seen to support the general proposition that income tax should be cut but no more. There were guesses about the impact of the direct to indirect tax shift but no more sophisticated assessment of public preferences. Second, there were no worries about the attitude of MPs or Parliament. It was assumed that even such a controversial package would be approved by MPs, as, indeed, it was later that summer. The key decisions were taken by only a small group of senior politicians and advisers, all committed Thatcherites, as shown by the dismay of some of what were then called 'wets', dissenters in the Cabinet such as James Prior and Sir Ian Gilmour: doubts shared by quite a number

of civil servants and economists. The June 1979 Budget was essentially an ideological statement, underlined by the decisions to raise the tax burden in the spring 1981 Budget in order to reduce public borrowing and facilitate a cut in interest rates.

The second phase of the Thatcher era came with the appointment of Nigel Lawson as Chancellor in June 1983. He pursued the tax-cutting agenda, notably by slashing the top rate of income tax to 40% in his 1988 Budget and with further cuts in the basic rate. But the most striking aspect of his period as Chancellor was the priority he gave to tax simplification and neutrality. In his memoirs, the most comprehensive account of his period at the Treasury by any Chancellor, Lawson (1992, pp. 338–46) set out his broad approach:

1. To leave people more of their own money so that they could choose for themselves what to do with it.
2. So far as was practical, to reduce marginal tax rates, so that an extra pound of earnings or profits was really worth having.
3. To see that, as a general rule, people's choices were distorted as little as possible through the tax system.
4. But to be prepared, when it was sensible to do so, to promote tax reliefs designed to make the economy work better.
5. To ensure, so far as possible, that the tax system was both simple and acceptable (not least to married women).
6. To adopt an economic rather than a social approach.

Among the changes which Lawson introduced, or extended from the Howe years, were the abolition of the National Insurance surcharge on employers and the reduction of the bias against jobs in the corporation tax system, while savings were encouraged by the abolition of the investment income surcharge, the replacement of capital transfer tax by inheritance tax, and the launch of Personal Equity Plans.

Most of the Lawson era changes originated in the Treasury, in the mind of Lawson and his close advisers. Thatcher (1993, pp. 672–3) conceded that 'Nigel's Budgets were . . . essentially his'. She added: 'We had some differences—not least about mortgage tax relief which he would probably have liked to abolish and whose threshold I would certainly have liked to raise. But Nigel did not generally like to seek or take advice. Doubtless he felt he did not need to. He was precisely the opposite of the collegiate style which Geoffrey Howe before him practised.' In the Lawson memoirs, there is virtually no mention of Cabinet colleagues on Budget decision-making and

none of Parliament. His 1988 Budget caused considerable controversy in the Commons on the day, but his proposals were passed into law pretty smoothly despite the worries of some about fuelling an already strengthening consumer boom. This is leaving aside the battles between the Treasury and Thatcher over the replacement of domestic rates by the community charge, or poll tax, a rare occasion of a new tax being introduced despite the opposition of the Chancellor of the day.

The focus in this section of the commentary has been on marginal tax rates when as Alt, Preston, and Sibieta rightly point out, the trends in the tax burden are often very different and less spectacular. The tax share of national income rose by a couple of points during the Thatcher era, though it fell marginally during Lawson's time as Chancellor. Marginal tax rates for the average taxpayer fell by about 5 percentage points during the Howe and Lawson decade to 34%. The contrast with the smaller change in the relative tax share is not only because of the shift to VAT but also because of fiscal drag.

In the final phase of the Conservative years, from November 1990 until May 1997, there was much less emphasis on tax reform or simplification and much more on stabilization in response to the inflation, exchange rate, and fiscal crisis of 1991–93, which required substantial tax increases. The political and economic pressures were different from those of the Thatcher decade, not least because after the 1992 general election, the Major government had a precarious, and then non-existent, majority in the House of Commons. The relative freedom which Howe and Lawson enjoyed, at least in retrospect, was not shared by either Norman Lamont or, after May 1993, Kenneth Clarke. Even though the economy recovered steadily after Black Wednesday, the tax increases proved to be highly unpopular and were seen as breaking the 1992 election pledge, as the Labour opposition continually argued. Indeed, the gradual disappearance of the Conservatives' Commons majority, coupled with a rebellion by a number of euro-sceptic MPs led to the defeat in December 1994 of the government's proposal to raise VAT on domestic fuel from 8 to 17.5%. This was a very rare example of a government being defeated in the Commons on a Budgetary measure, but memories of the event acted as a constraint on what Clarke could do in his remaining period as Chancellor.

2. THE GORDON BROWN DECADE

The approach of Gordon Brown and New Labour to tax policy was a mirror image of the Tories' problems and loss of trust on economic competence

and taxation from 1992 onwards. Brown, Tony Blair, and their key advisers were convinced that Labour's ambiguous message on taxation had been a major factor in their fourth successive election defeat in 1992. Philip Gould (1998, pp. 117–30) recorded the damaging impact of tax for Labour ahead of the 1992 election. A presentation he made in autumn 1991 showed that tax was the top reason for not voting Labour, with nearly two-thirds of voters agreeing that the party would raise taxes for everyone. The percentage was even higher amongst C2 skilled workers, reflecting their aspirations as much as their current position. Gould recorded that the presentation made the politicians angry. 'Tony Blair and Gordon Brown were frustrated that we were in a position where our policy was both untenable and highly unpopular; John Smith [then Shadow Chancellor], knowing what we said was all true, simply walked out.' Gould and other New Labour strategists believed that suspicions over Labour's tax plans had lost them the support of the key group of 'aspirational' voters, Middle England or Middle Britain if you like.

Tax, therefore, played a key part in the creation of New Labour. Gould recorded (1998, pp. 283–4) that

Tax was central to our strategy of reassurance. If the election campaign had one crucial battle, one defining fight, it was over tax. We lost the 1992 election and won the 1997 one in large part because of tax. Tony Blair and Gordon Brown both believed the shadow Budget in 1992 had been a mistake: it revealed our hand and raised taxes for middle-income earners . . . Blair and Brown had a gut feeling that hard-working families paid enough tax; why should they pay any more?

So, both before and after Tony Blair became party leader in July 1994, Brown followed a double track approach: attacking the Tories for breaking their pledges by raising taxes and trying to reassure voters that Labour could be trusted on the economy, and particularly on taxation. This was not just about taxation but also involved taking a very tough line against new public spending commitments.

The key symbolic argument was about whether to introduce a new top rate of income tax. Blair and Gould were hostile, fearing that it would be seen as merely the start of higher taxes and would undermine voters' attitudes towards New Labour on taxation generally. Seeing it from the perspective of the Brown camp, and particularly that of Ed Balls, Brown's long-term economic adviser, Robert Peston described Brown's attitude (2005, pp. 253–4): 'The danger he foresaw of giving in to the party's opinion poll pundits—such as Gould—by closing down this tax option was that over time he would be forced to abandon his ability as a future Chancellor to raise any taxes, simply for fear of upsetting potential voters. He would be a neutered Chancellor.'

In the event, Brown was persuaded to announce in January 1997, only a few months before the last possible election date, that a Labour government would not increase the top rate of income tax for the next parliament. This was coupled with a promise not to raise the basic rate or broaden the scope of VAT.

This approach worked electorally. As Anthony King (1998, pp. 194–5) showed, nearly a half of ‘lost’ Tories, those who previously supported the party, said a reason for no longer supporting the party was because it promised to keep taxes down but had instead increased them. Similarly, Butler and Kavanagh (1997, p. 130) noted the view of Tory polling advisers that tax no longer worked as an issue to help them and to damage Labour because of Blair’s successful campaign of reassurance.

Some of Labour’s worries may have been exaggerated since, as King quoted (1998, p. 200), a big majority of voters polled by Gallup (72%) believed that government services such as health, education, and welfare should be extended, even if it meant some increases in taxes. This was up from 66% in 1992, and 61% in 1987. But the 1997 level was more than double the 34% of 1979, when 34% believed that taxes should be cut, even if it meant some reduction in government services such as health, education, and welfare. That figure had fallen to just 7% by 1997. These figures both explain the Thatcher opportunity in 1979 and underline the New Labour dilemma in 1997. Blair and his advisers were so scarred by the party’s four election defeats that they may have been unnecessarily cautious in 1997. They were, however, sceptical about findings such as these and those in the BSA surveys, believing that voters were, in reality, much more worried about higher taxes.

In office, Gordon Brown addressed this dilemma by eventually both raising the growth of public spending, especially after 2000, and by increasing taxes. Throughout, Mr Brown honoured, and extended at both the 2001 and 2005 general elections, his 1997 pledge on not raising the higher rate of income tax or the basic rate (which was cut). Yet the tax burden rose steadily over the period, by more than three percentage points overall. This was partly as a result of what the Conservatives described, in their only effective slogan of the period, as ‘stealth taxes’. These ranged from the high profile one-off windfall levy on privatized utilities and the lasting, and more damaging, changes to the tax treatment of dividends received by pension funds to various new charges on insurance premiums and airline flights. (For more details of these and other tax changes see both Peston (2005) and Robinson (2000).) But, for most of the time, Brown was reluctant to be seen as a tax raiser. He was, however, a substantial tax innovator, notably via the creation, and later extension, of

tax credits, meant to reduce poverty among households with young children, and pensioners.

The big exception was the decision announced in the spring Budget in 2002, though taking effect a year later, to raise the National Insurance contributions paid by both employers and employees. This amounted to a substantial rise in taxes and, for employees, had the same effect as an increase in the basic rate of income tax. Blair and Brown were evasive on this issue during the 2001 election. But Brown announced the increase specifically to pay for an increase in the NHS Budget which he claimed was justified by a report by Sir Derek Wanless, a former chief executive of NatWest, which pointed to a large funding gap and ruled out alternative methods of funding health. It was only this specific link to the NHS that enabled Brown to announce the increase in tax. As Robert Peston (2005, p. 274) noted, the move would

challenge one of the great givens of British politics since the advent of Margaret Thatcher in 1979, that direct taxes could not be increased in an explicit way without wreaking huge damage to the governing party (although they could be raised in inconspicuous 'stealthy' ways, by abolishing allowances or failing to raise thresholds). It was the first proper test of whether voters now had confidence in a British Government to spend their money wisely and Labour's sustained lead in opinion polls suggests they did (and do) have that confidence.

The key issue is not about taxation as such but about whether the public believes that the money is being well spent. That was the initial, favourable public response to the 2002 announcement and the 2003 tax increase. Tax was a neutral issue for Labour at the 2005 general election, partly also because voters did not believe Tory tax promises. However, voters became increasingly sceptical about whether the rise in taxes was being well spent. So, as repeated polls showed after 2005, there were increasing doubts about the effectiveness of the increased public spending, and complaints about waste and so on, and these affected attitudes to taxation as more people felt that taxes were too high. The crucial relationship was from attitudes to spending to views on taxation. One consequence was that the Tories recovered a lead, for the first time since 1992, as the best party on taxation.

In marked contrast to the situation in the Thatcher years, international influences had a much greater, and growing, impact on tax decisions by Brown. Howe and Lawson had often referred to international comparisons of tax rates, largely to justify cuts in the top rate down to European levels. But there were not specific international pressures, as there have been since 1997. First, these have appeared in EU pressures to harmonize tax policies as part of the single market. Brown has strongly resisted extensions of EU

competence over taxation, whether corporate or over savings (the latter involving a long battle over withholding taxes). Second, Brown believed that taxation was an important part of competitiveness in a globalized world of mobility not only of capital but also of skilled workers, entrepreneurs, and investors. This applied particularly to Britain in view of the growing success, and importance to the Treasury and the economy, of financial services and the City. Hence, Brown became sensitive to arguments that measures might encourage bankers to leave Britain and invest elsewhere. These international pressures affected both higher rates of taxation and measures particularly affecting the City and foreign workers and investors. This was seen during the winter of 2007–08 in the arguments over the taxation of non-domiciled individuals, foreigners who worked in Britain but who could avoid tax on their foreign income and gains despite being resident in the UK (in some cases for many years).

3. THE TREASURY

Throughout the Brown decade, the key decisions were made in the Treasury, and generally only amongst a small circle of advisers and officials around Mr Brown himself. For much of the time there was little communication with 10 Downing Street, let alone the rest of the Cabinet, or with parliament, despite some moves towards greater openness noted below. At times, Blair acted as a voice of business arguing against measures that might deter investors and in so doing reinforced Brown's instinctive resistance to raising taxes.

These episodes underline not only the importance of the executive/Treasury, as argued in the Alt, Preston, and Sibieta chapter (though with qualifications noted below), but also the significance of the tax–public spending interaction. It has not just been the public's views of taxation, but more important has been the view of how money is being spent. This chapter's description of a dominant Treasury has largely been correct. What a Chancellor of the Exchequer wants, he can usually get. But a number of important qualifications need to be made. First, it should not always, or automatically, be assumed that the Treasury and the executive are the same. It is impossible to discuss this subject without, as noted above, considering the role of particular Prime Ministers and Chancellors. As I have argued, these relationships substantially affect the making of tax policy: for instance, the retention of mortgage tax relief throughout the Thatcher years; and her insistence, against

the wishes of the Treasury, in pressing ahead with the replacement of rates by the poll tax. In the New Labour decade, Gordon Brown had virtual, but never entire, control over tax policy.

Moreover, it is misleading to brush aside the role of Parliament. The sentence on page 1210, 'this power of patronage is a major reason why these large legislative majorities also tend to be cohesive, with government bills almost always being passed by a subservient House of Commons', is an over-simplification. The role of Parliament on tax policy is unquestionably secondary, but it is not entirely insignificant. Parliamentary majorities are more cohesive than in a federal system, notably the USA with its formal separation of powers between the executive and the legislature. But this is as much because of party and ideological loyalties as because of the power of patronage. The collective self-discipline of party, and agreement with the thrust of most measures proposed by the government, is why the MPs of the ruling party vote for budgets and finance bills. However, as Professor Philip Cowley has shown, the image of a 'subservient' Commons is now out of date as both the frequency and scale of revolts by government backbenchers has increased sharply over the past decade, though admittedly less on tax than on other measures (see <<http://www.revolts.co.uk>>). Moreover, internal pressures within the ruling party can lead to changes, as happened in spring 2008 when protests by Labour MPs against the failure to compensate fully for the abolition of the 10p tax band forced £2.7 billion of tax relief.

Moreover, the assertion, on page 1211 of the chapter, that 'Parliament thus finds it difficult to provide effective scrutiny of tax measures, and measures are nearly always enacted unchanged in the annual Finance Bill that follows the Budget' is inaccurate. The proposals announced in a Budget in March are often amended by the time the subsequent Finance Bill becomes law the following July, and even on occasion between publication of the bill and its enactment. This is, admittedly, very seldom because of pressure from MPs or the Opposition as such, and is mainly because of broader political pressures or representations by specific interest groups to the Treasury or HM Revenue and Customs. In most cases, the result is detailed amendments, rather than major changes, or the abandonment of a measure. The committee and report stages of the annual Finance Bill are the occasion for such amendments, seldom the cause of them.

The main omissions in the institutional discussion are about the role of the Pre-Budget Report, the subsequent inquiries by the Treasury Select Committee of the Commons; the post-Budget investigations by the House of Lords Committee on Economic Affairs; and the many inquiries by the Treasury

Committee and the Public Accounts Committee of the Commons into the administration of the tax system, and particularly the serious difficulties with tax credits.

The Pre-Budget Report in the autumn, initially often dubbed the green budget, has been intended not just as a half-yearly review of the state of the economy and an updating of economic forecasts, but also as an opportunity to consult on proposed changes to the tax system. Consultative papers would be produced, and at times draft clauses, ahead of the annual spring Budget. For instance, the Commons Treasury Committee, in its report of January 2007 (House of Commons paper 115, session 2006–07), discussed not only the broad outlook for the economy and for public finances, but also delays to improvements in the tax credits regimes, climate change and environmental taxation, missing trader intra-community fraud, and taxation of alternatively secured pensions, amongst other taxation issues. The committee noted, however, that ‘it is important that the Pre-Budget Report retains a focus on consultation on fiscal measures that may be included in the forthcoming Budget. Although the 2006 Report is accompanied by a considerable volume of material on technical tax changes, there is less discussion on more substantive tax measures under consideration in the Budget.’ The Treasury Committee’s report on the 2007 Pre-Budget Report in late November 2007 (House of Commons paper 54, session 2007–08) contained lengthy discussion of the many taxation proposals which had been announced, notably the proposed major reforms to capital tax, the changes to inheritance tax thresholds, and the new rules for non-domiciled taxpayers. There was lively, and lengthy, debate in the Commons on each of these major tax changes, even though the objections and concerns of outside business and industrial bodies carried more weight in Whitehall, as noted above.

The role of the Lords Committee on Economic Affairs has been controversial. The Treasury has resisted the incursion by the Lords into issues traditionally the prerogative of the Commons, especially when a sub-committee was set up in 2003 to cover technical issues of tax administration, clarification, and simplification, but specifically not rates or incidence of taxation. This was intended to avoid encroaching on the financial privileges of the Commons. The Lords contains a number of experts in these areas and its reports are timed to appear before the report stage of the Finance Bill in the Commons, allowing amendments to be tabled. This has, however, proved to be a hurried and unsatisfactory process. The Treasury has at times resisted questioning by the committee on the grounds that ministers are accountable to the House of Commons where the substantive provisions are debated. (The Lords holds a formal debate on the Finance Bill but cannot amend it.)

Parliament is more effective in examining the implementation of policies. There have been several inquiries by the Public Accounts and Treasury committees of the Commons into the working, and many administrative failures, involved in the tax credit system, notably the repeated over-payments and therefore cost overruns.

However, the overall inadequacies of current parliamentary procedures for scrutinizing financial proposals, both on the expenditure and taxation side, were authoritatively examined in a report by the Hansard Society (Brazier and Ram (2006)). This report followed lengthy consultations both within Parliament and with practitioners. Amongst its main conclusions on the taxation side were that

- in the period between the Pre-Budget and the main Budget, parliamentary committees should take expert and public evidence on the government's plans, make a case for the priorities it wishes government to consider, and ensure the government provides full information and explanation for its proposals;
- the entire Finance Bill should be subject to pre-legislative scrutiny by a parliamentary committee;
- alternative options for reform include: the establishment of separate Tax Administrative or Taxation Committees in the House of Commons or a Joint Committee on Tax Administration. In addition, a Tax Law Commission could be established to overview the effectiveness of tax legislation and make proposals for change.

Many of these proposals have been echoed by George Osborne, the Shadow Chancellor, who has urged the publication of more information on technical tax changes at the time of the Pre-Budget report in the autumn, as well as allowing time for greater scrutiny by a new parliamentary committee which would hear evidence from tax specialists. This is among the ideas being examined in detail by a group headed by Geoffrey Howe, in turn echoing a speech along similar lines he made as Shadow Chancellor in the late 1970s.

4. CONCLUSIONS

Nonetheless, the Alt, Preston, and Sibieta chapter is substantially correct about the institutional balance in tax policymaking; and about the disconnected nature of the tax debate. The focus on headline rates of income tax

has both obscured rational discussion of tax options and distracted attention from other tax changes, and the steady rise in the tax burden since the early 1990s. My qualification is over the chapter's discussion of a 'passive' movement to the right which is based too much on thin survey evidence and does not take sufficient, or even much, account of what has actually happened. This chapter's solutions are a mixture of the sensible on parliamentary scrutiny (reflecting those already made by a wide range of bodies inside and outside Parliament itself) to the slightly naive, about establishing 'a body to oversee the public finances' directly accountable both to Parliament and the executive. The authors do not consider whether there is a conflict of accountabilities here. There is certainly a case for greater transparency, auditing, and accountability, but tax decisions cannot be taken out of politics. They are the stuff of the party battle.

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Commentary by Guido Tabellini

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1. INTRODUCTION

The political economy of tax policy is a huge topic, and the Alt, Preston, and Sibieta chapter does an excellent job of discussing some of the most relevant issues. It succeeds in linking real-world policymaking in the UK to the recent background literature in political economics. And it produces several novel insights that enhance our understanding of how tax policy is made in the UK.

This chapter contains a very rich and complete discussion of several issues, but essentially it develops three main themes. First, UK tax policy is very centralized, and it emanates from one key institution: the Treasury. Second, the political, economic, or ideological convictions of individuals in this key policymaking institution are the main drivers of UK tax policy; political opportunism, organized interests, or voters' demands seem to play a less important role. Third, voters don't understand the tax system well; from a positive point of view, this enables politicians to take advantage of this ignorance to pursue their political goals; from a normative point of view, voters' ignorance is undesirable and calls for much greater transparency in tax policy.

Here I briefly comment on each of these three themes, and conclude by raising an important general question that this chapter leaves unaddressed.

2. THE INSTITUTIONAL FRAMEWORK

The claim that UK tax policy emanates from the Treasury's office and reflects the will and opinion of key bureaucrats and policymakers in that institution is very convincing. The UK tax system is very centralized, the executive is controlled by a single party with absolute majority in Parliament, and the Chancellor has strong agenda setting prerogatives with regard to both the Cabinet and Parliament. Hence, the authors are right in insisting that, to understand the determinants of UK tax policy, we must start from the organization of the Treasury's office.

To someone trained in monetary economics like myself, this raises a natural question. Why is there such a big difference in the institutional framework of tax policy versus monetary policy? And is this difference desirable? In monetary policy, decisions are delegated to an independent and accountable agency, with very transparent decision-making procedures. Similar delegation has taken place with many regulatory policies. When it comes to taxation, instead, decisions are directly controlled by a political office, even to the smallest detail. Naturally, bureaucrats also operate inside the Treasury. But unlike in monetary policy, they do not enjoy independent decision-making power. Their influence on policy decisions has to be conquered through persuasion or by exploiting the inattention of their political principal. And outside observers have very little knowledge of how decisions are taken inside the Treasury and for what true reasons.

Of course, this is not a peculiarity of the UK. But we cannot simply dismiss this question with the answer that tax policy is 'too political' to be delegated to independent bureaucracies, or that representative democracy has developed precisely on the principle that there cannot be taxation without political representation. One can imagine alternative arrangements whereby political representatives choose general features of the tax code, but then delegate the execution to independent and accountable bureaucrats according to efficiency or other pre-established criteria, just as in regulation or other policy areas.

Personally, I doubt that there is a valid normative reason for current arrangements. There are several reasons of political expediency why office holders do not want to delegate control over any aspect of tax policy. But from a normative perspective, retaining full political control is likely to result in socially suboptimal outcomes under a robust set of assumptions.¹

¹ Blinder (1997) advocated bureaucratic delegation over aspects of fiscal policy, and Alesina and Tabellini (2007, 2008) discuss political vs bureaucratic delegation in a more abstract setting.

The observation that voters don't have a full understanding of the tax system reinforces this conclusion, because it increases the need for a more transparent decision-making procedure. Sections 13.6 and 13.7 of the chapter, on institutional checks and balances over tax policy, briefly discuss the role of non-political or external institutions to audit revenue figures, or to offer advice. But their logic is one of oversight, rather than delegation of specific responsibilities.

Even retaining the focus on oversight, as opposed to delegation, the authors seem reluctant to advocate a greater role for an independent bureaucracy. They instead lean towards asking for greater accountability towards Parliament. I am sceptical that this would be effective, for two reasons. First, because in a Parliamentary democracy (unlike in a Presidential regime) there is no real separation of power between executive and legislative authority. The opposition of course would have the right incentives to question government choices in Parliament. But, and this takes me to the second reason, tax policy unavoidably hinges on many technical details that are bound to escape the attention of public opinion, and often also of elected representatives. Such details are better discussed by trained professionals, which calls for relying on independent and well-trained bureaucrats rather than political opponents in Parliament.

3. PASSIVE VOTERS AND IDEOLOGICAL POLITICIANS

Is tax policy mainly driven by the policymakers' convictions or by the wishes of the voters? This chapter leans towards the first answer. It presents two empirical arguments in support of this conclusion, one from voters' opinions and party manifestos, the other from a case study of how the R&D tax credit was enacted.

While I find the R&D case study interesting and persuasive, the interpretation of voters' opinions and party manifestos is very ambiguous and open ended. According to the opinion polls surveyed in this chapter, British voters are concerned about rising income inequality, but since the mid-1980s they are less supportive of redistributive policies and have less trust in government. A majority would also be prepared to pay more taxes if this extra tax revenue were used to increase public good provision.

What to make of this evidence, and how to relate it to actual tax policy, is not clear. If anything, these attitudes reveal that most voters would like

a different mix of public spending (more public good provision and less redistributive transfers). But this is not surprising, since it is well understood that political competition induces politicians to under-provide public goods in favour of targeted redistribution to influential groups. Whether the observed reduction in statutory tax rates (but not in tax revenue, as the authors correctly remark) was a reaction to electoral concerns, or whether instead it was induced by the ideological agenda of partisan politicians, is hard to say on the basis of this evidence.

4. TRANSPARENCY OF FISCAL POLICY

We often take it for granted that more policy transparency is always good in a democracy. Implicitly this chapter seems to share this presumption. An interesting recent paper by Gavazza and Lizzeri (2006) clarifies that this simplistic view is incorrect.

The important distinction is between transparency of individual versus aggregate tax payments. Full transparency of individual tax payments means that the individual voter fully understands how much in taxes he is paying to the government. Full aggregate transparency means that he knows aggregate tax revenue (i.e. how much other tax payers are contributing).

Individual transparency, as defined above, generally improves government incentives. Intuitively, if voters fully understand how much they are paying to the government, they are more likely to demand something in return. Hence, individual transparency discourages corruption and wasteful redistribution, because it raises the political cost of government spending.

But aggregate transparency can be counterproductive, unless it is accompanied by a full understanding of how the government uses tax revenue. Suppose that voters are not sure about the true size of the budget deficit or surplus. In this case, as shown by Gavazza and Lizzeri (2006), transparency of aggregate tax revenues encourages 'fiscal churning'. The reason is that voters mistakenly interpret higher aggregate tax revenues as a higher budget surplus (rather than as more targeted redistribution to others). Thus, they reward the government if aggregate tax revenue is higher, which encourages politicians to have more distorting taxation than would be necessary to sustain the same amount of net redistribution (i.e. they encourage fiscal churning).

In general, wasteful redistribution is discouraged if voters observe the taxes that they individually pay, and the targeted benefits that others receive. On the contrary, wasteful redistribution is encouraged if voters observe the targeted benefits that they individually receive, and the taxes that others pay. Unfortunately, opportunistic politicians have strong incentives to provide the wrong kind of transparency. To maximize consensus, they want to increase the visibility of the individual gifts they provide, and to hide the individual costs; to appear virtuous, they also want to show that they collect large amounts of aggregate tax revenues and do not spend a lot. Hence, we should always expect to have the wrong kind of fiscal transparency. This is important, because it has implications for what the systematic distortions are that need to be corrected.²

5. WHAT SYSTEMATIC DEVIATIONS FROM OPTIMAL TAXATION?

The theory of optimal taxation has strong implications for how the tax structure ought to be designed, and how tax rates on different tax bases ought to react to shocks to government spending. Are there systematic deviations from these optimal prescriptions, and if so can they be explained by systematic political distortions? Perhaps this is the most important question in the political economics of tax policy.

Despite many contributions on politics and fiscal policy, this question has generally remained unaddressed in the literature. There is just one important exception: the time inconsistency problem. As is well known, lack of commitment imparts a systematic bias to tax policy. Whenever the elasticity of a tax base differs in the long-run from in the short run, a benevolent government that cannot commit neglects the long run elasticity. This implies over taxation of the tax bases that are more elastic in the long run, like any capital stock. Unfortunately, despite its many interesting insights, this chapter does not fill this gap in the literature, nor does it discuss the practical relevance of the time inconsistency problem with regard to the UK tax structure.

² There is evidence that voters often ignore how much they individually pay to support redistributive programmes. For instance, Boeri and Tabellini (2007) show that individual employees in countries in Continental Europe generally ignore by large margins the contribution rate that they or their employer pays into the social security system.

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Commentary by Chris Wales

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In this chapter, Professors Alt and Preston and Luke Sibieta make an important contribution to our understanding of the dynamics of the political economy of tax policy in the UK. They present a broad-based analysis of the subject, ranging across the institutional structure of policy-making, the influence of purely party political thinking on policy formation and the significance of the framework of scrutiny and accountability for legislative proposals. They provide an interesting and multi-perspective example of the tax policy-making process under Chancellor Brown that shows the interaction between economic theory, political intent, lobbying and consultation, and sheds some light on how relationships between the Chancellor's departments are perceived. The significance of the practical influence of the consultation process in shaping policy is well-illustrated.

In the comments that follow, I build on the analysis that the authors have presented with some thoughts of my own, drawing on my experience at HM Treasury as a member of Chancellor Brown's *Council of Economic Advisers* between 1997 and 2003, and as the individual with the most direct responsibility for tax policy in that period.

I argue that the democratic deficit in relation to tax policy-making, to which the authors allude, arises because:

- The public are ill-informed about the tax system and the education system does nothing to address that.
- Governments do not adequately present policy choices to the electorate and Opposition parties shy away from firm policy commitments in the run-up to general elections.
- There is an unnecessary imbalance of information relevant to tax policy choices between government and the rest of the population.
- The mechanisms through which the public can engage on tax policy issues are too limited and ill-defined.
- Standards of journalism on taxation issues are too low, partly because of the information deficit.

I set out an analysis of policy development that explains how the situation is exacerbated by the narrow base for tax policy-making in the UK and institutional weaknesses.

Finally, I comment on three other factors that affect tax policy-making in the UK: the nature of the electoral system; attitudes to radical change, which I illustrate briefly by reference to the balance between national and local taxation; and the absence of effective scrutiny and accountability for tax policy choices.

1. THE DEMOCRATIC DEFICIT

One of the key points that emerges from this chapter is the extent of the democratic deficit in relation to tax policy-making. How do policy-makers, including ministers, know what the people want and how do they present choice to a largely uninformed public? How do the people decide what they want? And if and when they do, what are the mechanisms through which they can communicate their views?

It would be difficult to identify any element in the education system in the UK that adequately prepares the general population to participate in a meaningful way in a debate about tax policy choices. Beyond a narrow group of specialists who are mostly practitioners working with existing legislation, there are frighteningly few individuals who have any real understanding of how the tax system works and of the likely consequences of making changes to it. The sums of money that are raised by taxation are unimaginably large for the average voter; and the relationship between tax and public spending is poorly understood. How many hospitals does inheritance tax fund? How

many new teaching posts would a 1p increase in capital gains tax allow? How many voters can visualize a tax to GDP ratio of 40% and what it means to private sector wealth creation, the size of government, or the quality of public services? How many understand the impact of a change in that ratio to 35% or 45%; and how many can judge the impact of raising a given level of taxation through one set of instruments rather than another? Tax policy-making is a very specialist game.

To say this is not to criticize the general population but rather to highlight the difficulty of trying to engage, even at a headline level, on complex issues on which the vast majority are simply not informed. The problem exists in other policy areas as well but generally to a lesser extent. Most of us, for example, are not experts in education but we will have experienced the UK education system first hand and many of us will have seen it in relation to our own children as well. We are more likely to have experience-based views that we can articulate on the quality of teaching, the state of our schools and the relevance and rigour of the examination system, than on the efficacy of taxes on expenditure rather than income. We can more easily envisage the impact on education of proposals to introduce a system of specialist schools, than the effect on investment of reforming the taxation of North Sea oil production. Election manifestos map out the differences between the education policies of the parties and we can make reasonably informed choices. It is rare in the UK to have a broadly based debate about taxation policy, even at the time of a general election. In recent elections, there has been a reluctance to set out any detailed proposals and have them tested by the electorate.

So how *do* tax policy-makers know what the public want? And how do we break the circle of ignorance that makes sensible debate about tax policy all but impossible?

The first issue is information. One of the key issues is for government to be more open and a critical step in achieving that is to institute a policy of publishing more data in a quality and form that is usable by economists outside government. Data has historically been closely guarded by government and the very limited availability of data, even in an anonymized or aggregated form, makes it exceptionally difficult for those outside central government, including opposition parties, academic economists, and think-tanks to develop tax policy proposals with any degree of confidence. A publication programme for tax system data would make a major contribution to the development of ideas and it could, potentially, provide a mechanism through which to transform public debate.

The second issue is to publish policy choices well in advance of final decisions by the Executive. This is now done in some areas, particularly

business taxation, where there is extensive consultation, at least with the largest companies, but the process needs to become much more widespread. Steps taken in the last ten years to require the publication of the rationale for significant policy proposals, the alternatives considered and the costs of compliance have made a contribution but they are published in any detail only very late in the decision-making process. The Freedom of Information Act provides only limited assistance. The publication of detailed analysis in support of tax policy changes proposed by government would do much to improve the trust and confidence of the electorate in government and the quality of public debate around policy options. This is a process that will become much easier the more often it is used.

The third issue is that there has to be a clearer mechanism through which the electorate can express its views on tax policy issues. The media have a role to play here. Standards of journalism around taxation policy are relatively low, a problem exacerbated by the limited access to relevant hard information. Wider publication of data should support higher standards among the most influential news media.

At present, when debate arises on tax policy issues, it is normally very narrowly focused. It is easy enough to get a reaction to a specific proposal put forward in isolation. But the discussion and the follow-up have to be handled with greater maturity and less political opportunism. We have learned in autumn 2007, for example:

- that inheritance tax is very unpopular even among those who are likely to be well beyond its reach—an echo of experience in the US;
- that the British public is happy to see a random amount of tax charged on a group of people with little in common save that they are perceived (whether rightly or wrongly) to be well off and more importantly to be demonstrably of foreign origin;
- that targeting simplification above policy purpose may sub-optimize outcomes and run into significant opposition as the recent round of capital gains tax proposals has demonstrated.

We have learned that environmental taxation is regarded by many as a good thing but we also know from the fuel tax disputes in 2000 that there are limits to public tolerance of heavier taxation, even when the underlying justification is powerful.

The challenge is to get a debate going about broader choices and to allow it time to mature. That is inextricably linked to the first two issues: the availability of quality data to support analysis by institutions (including the

press) external to government and a willingness to put broad ideas out into the public for discussion. The result will be that ministers and other policy-makers will be much better equipped to make policy choices that reflect what the electorate really want.

2. SOURCES OF TAX POLICY

Today, the problem with achieving democratic inputs to the development of tax policy is a real one. Ministers are not tax policy experts. They are professional parliamentarians. Even Treasury ministers are unlikely to have wide experience of tax policy-making before taking office. Most that do will have gained it on the Opposition Front Bench where the skills required are somewhat different from those needed in office. Focus groups can be useful at the two ends of the spectrum: the very broad and the very narrow; but they are better for testing out ideas than for inspiring them. Policy-makers have little to go on in terms of broad attitudes towards taxation. Most media research is shallow and of limited value. The British Social Attitudes survey, cited by the authors, is interesting but of limited utility in forming anything other than high level policy thoughts. So where do ministers' ideas for tax policy come from? Essentially, there are three main sources.

The first is their own fundamental political beliefs. The second is the internal institutions of government. The third is external institutions.

Fundamental political beliefs provide a natural frame of reference within which tax policy options can be considered: the optimal balance between state and private provision with its implications for the need to raise revenues; the importance and direction of redistribution of wealth; and the desirability of using taxation instruments to achieve behavioural change. The political overlay to tax policy-making is essential. Policy cannot be made on economic principles alone. However, the political overlay is ultimately no more than that. It does not of its own generate tax policy proposals. The principal utility of political beliefs is in decision-making rather than policy generation.

Of much more direct significance to the development of policy options are the internal institutions of government. In the UK, ministers today rely substantially on HM Treasury and HMRC officials to generate policy proposals. Before the O'Donnell Review in 2003–04, the Treasury was more of a clearing house for tax policy than a policy initiator. Tax Policy, as a department, was a small sub-set of Budget and Public Finance that ensured

that proposals from Inland Revenue and HM Customs & Excise were properly presented and considered by ministers and that worked with the relevant departmental officials on costing individual measures. Relatively little work was done by that group in bringing forward policy, although there were some notable exceptions, such as the development of the Climate Change Levy. It was mostly staffed by quite junior economists who had limited previous experience of working on taxation issues. An advantage of this approach was that policy proposals were largely put together in departments that had direct experience of dealing with taxpayers and taxpayer situations and that had a high level of expertise on both the policy purpose and legislative form of individual taxes. Weaknesses were that policy-making in the revenue departments was too narrowly focused on individual taxes, often with little thought given to the system as a whole and the overall economic purpose; and, at times, it was over-concerned with avoidance. As things stood in the late 1990s and early years of this century, the Treasury lacked senior economists with the experience, knowledge, and vision to provide the policy direction to harness effectively the skills and detailed understanding of Inland Revenue and HM Customs & Excise.

The implementation of the O'Donnell Review made substantial changes to the order of things. It was clearly desirable to strengthen the policy-making capability of the Treasury but the changes left a number of significant weaknesses:

1. The new structure put the Treasury firmly in control of all aspects of tax policy-making. The balance of views between the largely theory-based Treasury approach and the more experience-based approach of the revenue departments that was often evident in the pre-O'Donnell period effectively disappeared in 2004. The authors refer to 'the sheer dominance of the Treasury over the entire process'. It is difficult to find a democratic country where tax policy-making power is so concentrated.
2. The new structure did not involve the creation of any new senior posts for experienced economists to take responsibility for the structure of the tax system as a whole. The Treasury does not have a heavyweight economist with such a role. The reorganization removed some of the narrowness of focus that had previously resulted in policy being developed on a tax-by-tax basis but missed the opportunity to create one or more expert posts to co-ordinate between the directorates dealing, for example, with business and indirect tax, international tax, personal tax, and welfare reform. As a result, there is a continuing failure to develop policy on a fully joined-up basis. Despite the importance of

the overall design of the system, the structure of the tax policy-making departments clearly demonstrates that the lowest priority is given to system-wide coherence.

3. The strengthening of the tax policy capability of HM Treasury was achieved largely at the expense of the other revenue departments. The merger of Inland Revenue and HM Customs & Excise may have been a wise strategy (although the full benefits of the merger have yet to be realized) but denuding them of senior policy roles was not. The transfer of the policy-making function to the Treasury disconnected it from the underlying relationships with taxpayers and taxpayer issues and seems likely, in the longer term, to lead to a weakening in the policy-making process. The expertise necessary for the proper functioning of the Treasury as a policy-making unit was initially largely sourced from the revenue departments. It is not obvious where that will come from in the future, since HMRC has only a limited policy-making role and seems unlikely to generate a supply of experienced policy-makers in the future. Those with a policy inclination are more likely to join the Treasury at the start of their careers and will thus miss out on the experience in the field that was a strength of the previous system.
4. The O'Donnell changes also missed an opportunity to give a stronger role to the development of economics-led policy. The two revenue departments employed a substantial number of economists and statisticians. It would have been possible to bring these together, as part of the O'Donnell changes, into a new free-standing department, reporting to Treasury ministers—an *Office of Tax Analysis (OTA)*. An OTA would carry out research on tax policy options based on the full statistical information available to government and could, potentially, be an important engine room for the development of tax policy initiatives. It could give new prominence to economics-based policy development which is currently weak in the UK. It could have responsibility for the collection of tax statistics and act as the analysis and research team for HMRC and HM Treasury in relation to their tax proposals. It could also take responsibility for the publication of tax statistics and data for use by external organizations (including Parliament).

Given the extent to which Treasury ministers currently rely on the generation of policy proposals by HM Treasury and HMRC officials, these are issues that need to be addressed.

The difficulties with the internal institutions are compounded by the relative weakness of external institutions with a focus on taxation policy. The

quality of policy initiatives is often closely related to the strength of external institutions and, in the taxation area, these have historically been quite weak. There are few institutions that have a forward-looking policy focus. The IFS is normally a commentator on government policy rather than a generator of policy proposals itself, the Mirrlees Review itself being a major exception. There are many organizations that focus on the detail of new legislation and its impact but most of these look at the economics and policy purpose only to a limited extent and rarely put forward specific proposals of their own. A number of business organizations, including, for example, the CBI and the ABI, LIBA, and the BBA, engage with the policy process but mostly from a relatively narrow standpoint and again, more as commentators and analysts of government proposals than as generators of policy ideas themselves.

There is evidence that some think-tanks have a more direct influence on ministerial thinking: for example, the Fabian Society, IPPR, and the Smith Institute under the present government. Both the Fabians and IPPR have engaged on the debate about the use of taxation instruments in relation to environmental policy, with some apparent success, but the Fabian attempt to initiate a debate around inheritance tax policy was notably less successful.

There are relatively few academic centres in the UK that engage directly on UK tax policy issues. This deficiency was partly addressed in the establishment of the Oxford University Centre for Business Taxation, funded by the Hundred Group of leading UK quoted companies. The Centre operates entirely independent of its funders, has a broad remit to address tax policy issues that affect business in the UK, and to publish its research findings. One of the main objectives in setting up the Centre was to provide a source of new research-based ideas that would provide Treasury ministers and officials with an alternative perspective and a wider range of policy options.

There remain, however, a relatively small number of institutions outside government that support the tax policy-making process and few of these have the kind of public profile that can generate a broadly based policy debate in which the public will engage.

In the short to medium term, it is very much in the hands of government to create an opportunity for the electorate to debate tax policy. By making data more readily available, by setting out the direction of taxation policy for a whole parliament, by publishing policy options in advance of the Executive making decisions, the government could extend significantly the opportunity for public discussion. At present, there is almost no transmission mechanism for public views on taxation. A systematic process of publication and the creation of opportunities for debate through the early publication of policy options could change that.

3. OTHER FACTORS AFFECTING THE DEVELOPMENT OF TAX POLICY IN THE UK

In this section, I comment on three other factors that affect the development of tax policy in the UK.

3.1. The electoral system

The authors comment on the significance of the electoral system in shaping tax policy. In the UK, unlike in most European countries, governments are normally strong and not dependent on the formation of policy-aligned coalitions. Political differences on the left and the right in the UK tend to be subsumed within what is essentially a two-party system. Fragmentation of parties is discouraged by an electoral system that delivers first-past-the-post victories at a constituency level and the potential of a large and absolute majority in Parliament to a party that may have taken as little as 40% of the votes cast. Fringe parties remain just that. Those that achieve even a handful of seats in Parliament have little or no influence. It is usually better to fight for specific policies within a major party than to form a new one. This is as true of taxation as it is of other policies.

In such a system, it might be logical to expect a greater degree of extremism and volatility in tax policy. Parties would seek to reward their own supporters rather than develop policies that appeal primarily to the median voter. As the authors note, this was evident in the period from 1979 through to the mid-1990s when the UK all but abandoned the progressive taxation of income for the better off; but has been much less of a feature of more recent government. The median voter is rarely the swing voter in UK elections but tax policy has been surprisingly skewed towards that median voter in the recent past.

Under the present Labour government, although there has been a redistribution of income from the better off particularly to the very poorest, the focus of policy seems to have been on the redistribution of opportunity rather than of wealth.

In fact, the extremes of the income spectrum have grown further apart in the last decade, mostly through an acceleration of earnings and wealth at the upper end of the scale and in spite of significant improvements in the absolute position of the bottom decile of the population. This has given rise to surprisingly little demand for redistribution through the taxation system. There are a number of possible explanations for this: a general growth in absolute levels of prosperity which have allowed the middle classes apparently

to accept that they pay proportionately too much and the rich, too little; the absence of effective mechanisms through which to give prominence to the issue; or the absence of effective political leadership for the group most significantly affected by what is largely explicable as fiscal drag. Another relatively benign explanation would be that, like the US, the UK has become a society that is fundamentally optimistic and positive towards wealth creation. People see themselves as able to improve their economic status and therefore do not want to see high earners and wealth more heavily taxed. This would fit with the attitudes displayed towards inheritance tax.

3.2. The approach to radical change

Political parties are often even less radical in power than they seem likely to be in opposition, to the disappointment of many of their supporters. I have already commented on some of the reasons for this: their own lack of specialist expertise that leads them to rely heavily on the internal institutions of government for ideas and analysis; the relative weakness of external institutions providing serious input on tax policy; the structural weaknesses in the policy-making process that stress the importance of particular taxes over a system-wide approach; and the political drift to the centre right in pursuit of the median voter. However, there are other factors that also contribute to the 'sameness' of policy approach between governments of different political persuasion:

- the absence of a clear electoral mandate for specific reform proposals (recent exceptions include the windfall tax on the excess profits of the privatized utilities introduced in 1997);
- the natural conservatism of the Chancellor's departments (HM Treasury and HMRC);
- the normative effect of international influences (the EU, tax treaties, and the OECD);
- the limitations on modelling capability, including the inadequacy of computerized records, that inhibit the simultaneous implementation of major changes in more than one area;
- the perceived wisdom that an old tax is a good tax and that a new tax is a bad tax;
- the stifling effect of complexity and detail;
- a pre-occupation with avoidance;
- the generally negative role of the media.

The Labour administration of 1997 in which I was closely involved was moderately radical in its first years, introducing substantial changes in corporate and individual taxation, including the creation of the controversial tax credits system, a rebalancing of the capital gains tax system in favour of the entrepreneur, and putting forward a doctrine of structural simplification for the corporate sector that encompassed changes in the treatment of groups, the realization of gains on the sale of subsidiaries, the taxation of intangible property, and the abolition of advance corporation tax as well as a reduction in rates.

There is an assumption in government that the electorate has no appetite for radical change in tax policy and structures but the reality is that that appetite is untested. None of the major parties has campaigned for radical change, even though there are elements in each of the main parties that would be willing to do so.

This is not simply a question of the level of taxation. There are extreme views on both the right and the left about the size of the state that would, if implemented, create a major shift in the overall scale of tax revenues. However, there is a debate which is overdue in the UK about the balance between local and national taxation and to which the authors refer. They note that 'the British tax system is exceptionally centralized by international standards: little actual discretionary power is located anywhere outside central government. In 2003, over 95% of UK tax revenues were raised by central government.'

They draw a strong link between this imbalance and the fact that 'Britain has a narrow base from which policy initiatives can be made: the only body that can put forward tax policy proposals is the Treasury'. Against this background, a truly radical shift would be to give more substantial tax-raising powers to local government.

The logic of such a move is clear.

There is an enormous democratic deficit in local government. As much as 70–80% of the electorate regularly abstain from voting in local government elections. Even though local government spending has a major impact on the delivery of public services, the electorate is disconnected. There is a wide range of reasons for this but part of the problem is the perception that local government choices are not significant enough; and part is a direct result of the way in which local government spending is financed.

The financing structure for local government is seriously flawed. Central government grants and allocations mean that on average as much as 75% of local authority spending is financed out of general taxation. This places enormous stress on local authorities that want to increase spending. The

council tax has to rise by a disproportionate amount to fund small increases. Similarly, the system rewards over-generously the authorities that seek to reduce spending.

This set of problems could be solved but it would require radical change, including the surrender of some of the taxing powers of central government. Three steps to make a real difference to the democratic deficit:

- Create larger local authorities. Local government units are small and fail to attract the calibre of officials who would normally seek Whitehall positions.
- Make a serious investment in raising skill levels in local government and attracting well-qualified management and workers. There is not enough emphasis on raising the level of public sector skills and this has a significant effect on the quality of local service delivery.
- Give them meaningful tax-raising powers on which the local electors could decide.

The tax changes to support this could include:

- Allocating control over setting the basic rate of income tax to the local authorities, initially within limited ranges such as are set for the Scottish Parliament. This would give them a more dynamic revenue base. It would still need to be underpinned by a balancing system of grants but the aim would be to invert the ratio of locally to nationally raised taxes so that the minimum local funding proportion became around 75%. It would dramatically change the public perception of the role and significance of local government. The system works in other countries. Sweden is a classic example, where there are significant differences in the tax rates levied by different local authorities, each approved by the local electorate. In the US, there is significant choice at the local level and real examples of local populations voting, for instance, for much higher expenditure on education funded out of locally raised revenues. From an administrative perspective, the change to a tax system for basic rate taxpayers where the rate was set locally should not have to be complex. It can be driven by tagging PAYE information with address-based codes. But for a Treasury that has grown used to complete control over taxation structures and rates, this would involve a huge conceptual leap.
- Abolishing council tax in favour of a more broadly based, nationally set tax on land and property. Land and property is arguably under-taxed in the UK and the proposed changes in the capital gains tax rules

will weaken the existing scheme of taxation still further by reducing the effective rate of tax on second and third homes. Replacing the council tax with a nationally set tax would bring to an end the rather tenuous link between the taxation of land and property from the delivery of local public services and allow the tax to be levied on a basis that was fairer across the country as a whole rather than just within communities.

Alongside these changes, it is possible to see a much stronger case for removing inheritance tax, a significant element of which is land- and property-based. If the value of land was more effectively taxed on a current basis than it is today, the argument for taxing its value again on death would be weakened.

These would be radical changes and they would require not only careful modelling but a willingness on the part of central government to see some meaningful powers devolved to the regions. It was not apparent from the outcome of the Lyons Review (Lyons, 2004) that central government was ready for this level of devolution.

The changes would also require a serious level of public debate and a gradual transition. Moving tax-raising powers without first dealing with the issue of local government skills and the size of the new single-tier local government units that would be required would be a recipe for disaster, not improvement.

Governments face genuine difficulty in putting forward ideas for radical change. In taxation matters there is even more nervousness than in other policy areas. Part of this is an education and information issue, as discussed earlier on in this commentary. Part of it is to do with institutions: the development of radical policy ideas is much less sensitive if it is undertaken at one step removed from central government. Where there is an 'almighty' institution such as HM Treasury, with a stranglehold on tax policy initiatives, it is not surprising that the public assumes that if policy ideas are being generated within it, they are likely to come to fruition; but if they are generated, say, by the IFS or the Oxford University Centre for Business Taxation, it may be possible to achieve a more balanced public reaction. This does not mean that HM Treasury should not risk putting forward radical ideas at an early stage in their development; but it does mean that government should also look to external institutions to do some of the early development work.

3.3. The influence of current arrangements for scrutiny and accountability

One of the areas where the authors focus is on the issue of scrutiny and its relationship with the policy-making process. Scrutiny has two main

functions: to improve proposals by a process of debate and amendment; and to hold the Executive accountable. As the authors note, 'scrutiny is even weaker for tax policy than it is for other areas'.

The problems of scrutiny outside the framework of central government have already been touched upon in this note. Consultation, particularly in the area of business taxation, has been dramatically improved in the last ten years and that has both enabled certain areas of tax policy-making to become more effective through drawing in external expertise, and highlighted the need for wider consultation on other aspects of tax policy-making. Wider access to relevant data and the early publication of the strategic direction of tax policy within a Parliament and of specific tax policy options and choices will further enhance the quality of public scrutiny.

This should not stop with the introduction of a tax or a taxation measure. There should be a formal process of post-legislative review. At present, there is normally no public process that seeks to establish whether a taxation measure has achieved either its intended behavioural impact or the expected revenue effect. Some changes cry out for such a review: the capital gains tax changes of 1998 and subsequent years, for example. Have they had a marked effect on entrepreneurial activity? Are gains now being realized onshore that would previously have been realized by individuals who have gone offshore for that purpose? Another case might be the research and development tax credits. Has the aggregate level of R&D expenditure increased (or was that always too susceptible to non-tax-related decisions of the aerospace and pharmaceutical companies to be a useful indicator)? Has there been a real shift in R&D expenditure by small companies? Or has the net effect of the changes been primarily the spawning of a new activity among accounting firms based on re-classifying expenditure to ensure that the maximum benefit can be claimed by their clients? A formal process of post-implementation review would improve the scrutiny of these kinds of changes and arguably ensure, in the long term, better value for public money.

There is also the issue of parliamentary scrutiny. Here the authors spend some time and point the way towards a potentially better state of affairs, albeit a little timidly.

The problem is, as I have argued elsewhere, that the present parliamentary system provides little or no effective scrutiny of taxation proposals. I do not believe the answer is, as some have argued, to have a technical Finance Bill separated out from the annual Finance Bill process. I believe the answer is structural change.

Parliament needs to be put in a position where it can have a meaningful and informed debate about taxation policy. It needs to be able to discuss

the macro-economic issues, the impact of legislative proposals and, perhaps most importantly of all, the possible range of policy options. With the present structures it cannot. MPs are no more tax policy experts than ministers are and they have much more restricted access to information.

I would suggest three fundamental structural changes:

1. Parliament should set up a body of economists and lawyers dedicated to providing analysis to MPs serving on parliamentary committees such as the Finance Bill Committee and the Treasury Select Committee. It should have a similar remit to the Congressional Budget Office in the US and be resourced to a level where it can analyse proposals from the Executive and examine alternative policy options on behalf of Committees. Such an organization would transform the quality of debate on taxation policy within Parliament. Ideally, it would be provided with the necessary data to carry out its work by an Office of Tax Analysis.
2. Alongside the democratization of the House of Lords, its members should be given a more significant role in the scrutiny of tax proposals. The absence of a 'normal' review process in the House of Lords for Finance Bills creates a significant and unnecessary weakness in the process of parliamentary scrutiny for taxation policy measures. It is increasingly anomalous in the context of the changes in the composition of the House of Lords, the greater balance in party representation there and the undoubted qualification of some of its members to comment on tax policy.
3. The introduction of a requirement for the publication of a statement in Parliament at the start of an Administration setting out the intended strategic direction of tax policy for the life of the Parliament. Such a requirement would be likely to drive a greater openness in the preparation of election manifestos. It would facilitate a more thorough debate about policy objectives that would aid policy-development and the scrutiny process. It would inform external institutions about policy direction and enable them to make a more effective contribution; and it would create a greater climate of certainty among the public and the business community.

I believe that the implementation of these proposals, together with the formal requirement for a post-implementation review of major policy changes, would have a dramatic effect on the quality of scrutiny and provide a much better system of accountability than exists today.

4. FINAL THOUGHTS

As I indicated at the start of this note, the authors of this chapter on ‘The Political Economy of Tax Policy’ have raised some important issues in their work. In providing this commentary, I have attempted to draw out more directly some of the key points: the importance of access to information; the value of putting choices out for public scrutiny and debate; the need for structural changes to strengthen and empower the process of scrutiny. At the heart of the suggestions made in this note is the desire to see a greater engagement between government and the governed on taxation issues, and an informed engagement in which the current imbalances are addressed. Over the last decade there have been some significant improvements, but they have served to highlight the need to go further and to establish a much stronger and more democratic base for tax policy-making.

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