

**“TAX REFORM AND THE PUBLIC FINANCES”  
KEYNOTE SPEECH TO CBI TAX SUMMIT, 13 OCTOBER 2008  
ROBERT CHOTE, INSTITUTE FOR FISCAL STUDIES**

**Introduction**

[Preamble]

My aim this morning will be to put the current debate on the future of corporate taxation in context in two ways:

- First, I will say a little bit about the goals and progress of the Mirrlees Review of the UK tax system, which is currently taking place under the auspices of the IFS. The Review team is still some way from a final set of proposals, but I will try to give you a sense of their direction of travel – both on corporate taxation and some other parts of the system.
- Second, I will say something about the likely fiscal backdrop that will constrain any tax decisions over the next few years. At the risk of spoiling the surprise, I can exclusively reveal that the outlook is pretty grim! There may well be some more policy loosening in the near term, but within a couple of years whichever party is in Government will be looking for significant amounts of extra revenue. An interesting political question is whether the growing popular perception that it was overpaid, under-taxed bankers and City financiers who got us into this mess will affect how the Government chooses to raise the money. For example, will it affect how much the Government tries to collect from high-income households versus middle-income households and from taxes levied formally on the personal sector versus the corporate sector?

**The Mirrlees Review**

Let me begin with the Mirrlees Review.

Thirty years ago the IFS asked the Nobel Laureate Professor James Meade to review the UK tax system, assisted by a number of bright young researchers, including the likes of John Kay and Mervyn King.

Our then Director, now Lord Dick Taverne, explained the motivation for the review as follows: “For too long, tax reforms have been approached *ad hoc*, without regard to their effects on the evolution of the tax structure

as a whole. As a result many parts of the system seem to lack a rational base. Conflicting objectives are pursued at random; and even particular objectives are pursued in contradictory ways”.

In the eyes of many observers, this critique still holds true today. In some important respects the tax system has evolved in the way that Meade recommended, but often it remains the product of piecemeal change rather than strategic design. The tax system has also struggled to adapt to changes in the economic, social and institutional environment in which it operates. And tax design has not benefited as much as it could from advances in our understanding of how taxes affect people’s behaviour.

For all of these reasons, we felt that the time was ripe once again to ask an independent commission to take a look at the economics of the tax system – and we have asked another Nobel Laureate – Sir James Mirrlees – to chair it. The team working on the final report also includes Malcolm Gammie QC, of the IFS Tax Law Review Committee, Richard Blundell, research director of the IFS, Tim Besley, of the Bank of England’s monetary policy committee, and Jim Poterba, president of the National Bureau of Economic Research in the US. My colleagues Stuart Adam and Paul Johnson at the IFS, Steve Bond in Oxford and Gareth Myles in Exeter are all on the team too.

To provide a reservoir of ideas from which the overview report could draw, we began by asking small teams of experts from around the world to address a number of key themes in tax design, and asked equally distinguished experts to comment publicly on them. Those studies and commentaries are now on the IFS website and we hope that they will be of value and interest whether or not the overview report agrees with them. The overview and the studies will both be published by OUP next year.

The starting point of the review is a recognition that the tax and welfare system is trying to achieve a number of potentially conflicting objectives simultaneously – to raise revenue for spending on public services, to influence behaviour in desirable ways, and to redistribute resources from rich to poor and across the life-cycle – while doing as little damage as possible to the functioning of the economy, both by distorting behaviour in damaging ways and by imposing excessive administration and compliance costs. Any one part of the tax system is likely to be good at achieving some of these objectives, but bad at achieving others.

What matters in terms of efficiency and fairness is the effectiveness of the system as a whole in achieving these goals – in other words the impact of

the interaction between different taxes (and benefits) as well as the design of each one. Unfortunately, that is not always what matters politically. Many worthwhile reforms have long been left undone, because - although they would contribute to a better-functioning system overall - they are easy to attack for their impact when viewed in isolation.

The goals of the review do not include reaching a judgement on how much the Government should aim to spend on public services or how much redistribution it should try to achieve. Those are judgements for society to reach and they are political at least as much as economic.

The aim in the first instance is to come up with a package that is broadly neutral in revenue and distributional terms - as far as the team can judge - but which is more efficient and which can therefore deliver gains in people's welfare overall. To the extent that these gains show up in higher national income, the government could of course choose to spend them on public services or on greater redistribution if it wished to do so.

Any single reform that the review proposes may *not* of course be neutral in its revenue and distributional impact. That is the advantage of looking at the tax system holistically, as the positive effects of one reform can offset the negative effects of another. But we do not underestimate the political challenge that implementing such reforms may still involve.

The background studies for the Mirrlees Review have thrown up many interesting insights that the review team are pondering in designing their final package. At the risk of putting words into their mouths, let me try to summarise a few emerging themes outside the area of corporate tax before moving on to talk about that in a little more detail:

- Let us begin with the structure of income tax, National Insurance and tax credits. The study commissioned by the review found that effective tax rates – the combined effect of income tax and National Insurance rates, plus the rates at which benefits and tax credits are withdrawn as incomes rise - are still inefficiently high for working age people on low and modest incomes. This is true both of the disincentive that they create to enter work in the first place and then to seek higher wages. Other things being equal, reducing these effective tax rates would require us to push means-testing further up the income distribution. The same would also be true if we have to compensate low-income households for other efficiency-improving reforms. To limit the extension of means-testing, the review team is looking at ways to target tax cuts on

those for whom they would be most effective in improving work incentives and at possible ways to integrate parts of the tax, tax credit and benefit systems in a way that would reduce the problem.

- At the other end of the income scale, the same study tentatively suggests that the combined income tax and national insurance rate that we apply to the top 1% of the population – those with incomes of around £100,000 or more – may already be around its revenue maximising level. This suggests that those who would like to see a higher income tax rate on the highest earners used to finance greater redistribution towards the bottom might have less money to play with than they would have wished. There are of course other ways one might try to get more revenue from these individuals.
- In terms of the taxation of savings, the guiding principle of the review is that the tax system should not unnecessarily distort when in their lives people choose to spend and in what form they choose to save. Taxing the ‘normal’ return to saving simply taxes income spent tomorrow more than income spent today and there is no reason why we should wish to do this. This suggests that the return from holding funds in interest-bearing accounts should be exempt from income tax, but that super-normal returns should not be. The team is trying to design a package that achieves this and avoids the problems with inflation and accrued capital gains that bedevil capital income taxes. The tax treatment of saving does need to recognise the importance of impatience and lack of self-control among some individuals, so basic mandatory savings vehicles and incentives for longer-term investments are important. Some lock-in incentives for pension saving should remain, but the generous tax treatment which currently encourages early retirement should be reduced and tilted toward incentivising retirement at later ages. Of course recent market developments will already be playing their part in encouraging later retirement.
- As regards Value Added Tax, the UK makes unusually widespread use of zero and reduced rates by the standards of other industrial countries. This is typically defended as a way to achieve distributional objectives. But these lower rates reduce people’s welfare by distorting their spending decisions. They are also an inefficient way to help the less well-off, because the gains depend on the allocation of people’s spending rather than on their overall level of income or spending. There are more cost-effective ways to redistribute. The study prepared for the review in this area suggests

that a more uniform VAT would be more efficient and that it would raise sufficient revenue both to compensate poorer households and to provide revenue to spend on other tax or welfare reforms. Although countries like New Zealand have moved more-or-less happily in this direction, this will obviously remain a very hard sell politically. It would certainly be easier to implement when food and domestic fuel prices were falling rather than rising.

- The reduced VAT rate on domestic fuel not only distorts people's spending – it also flies in the face of the Government's professed environmental objectives, which is another reason to remove it. The study of environmental taxation for the Mirrlees Review found important opportunities for reform, but did not think it sensible to shift revenue collection significantly towards environmental taxes and away from those on income and spending. The potential revenue gain from sensible green tax reform may be 1% of national income at best. The notion that a bigger "green switch" would automatically deliver a "double dividend" of environmental and other efficiency gains by taxing so-called "bads" (like pollution) rather than "goods" (like work) is appealing, but false. The study suggested a tax on gas (if it cannot be included in the Emissions Trading Scheme), greater differentiation of vehicle excise duty according to the pollution emitted by different vehicles and greater use of congestion charging offset by lower road fuel duties.

These are just a few themes, not a comprehensive list. I do not want to prejudge the review's conclusions, but I think we can see some potential elements of an overall package: a system that reduces effective income tax rates for low and modest-income families with the weakest work incentives, that does less to distort people's spending and saving decisions in a welfare-reducing way, and which pursues the Government's environmental objectives more efficiently.

So where does the taxation of corporate profits fit in?

The Review team are focusing on three main questions: What should we tax? Where should we tax it? And how should the company tax and personal tax systems interact in the treatment of small businesses?

Coming at this issue from an economic perspective, an important underlying principle is that all company taxes are paid by individuals. Corporations may have a legal identity, but we do not care directly about their welfare. We care instead about the welfare of the people affected by

company taxes. What matters is how far they reduce the incomes of shareholders (through lower dividends), workers (through lower wages and employment) and consumers (through higher prices). The extent to which a tax on company profits falls on the shareholders - or is 'shifted' onto its workers or consumers - will depend on the form the tax takes, the nature of the economy, and the responses available to the firms affected.

So why do we tax company profits at all rather than allocating them to shareholders and taxing them as personal income? Administrative convenience and the desire to tax the foreign owners of companies operating in the domestic economy are the usual motivations. But politically important too is the public perception that by taxing company profits we are taxing faceless corporations or their wealthy owners.

In an open economy there are good reasons to believe that much of the burden of a tax on company profits will – at least in the long run - be shifted onto domestic workers in the form of lower wages and employment. Indeed, we can argue that domestic workers would be better off if we were to raise the same revenue directly by taxing their labour income. Understandably, this argument has always been hard to sell to domestic voters and it is likely to become even more so in a climate in which poor business decisions and corporate irresponsibility in the financial sector are being blamed for our current economic difficulties.

Let me turn briefly to team's thinking on the three questions I mentioned.

First, what should we tax?

Simplifying heroically, most countries try to tax company profits net of depreciation and interest payments. This means that the 'normal' return required to make an investment worthwhile (over sticking the money in a risk-free bond) is taxed on equity-financed investments, but not on debt-financed investments. Only a third of corporate investment is debt-financed, so taxing profits in this way raises the required pre-tax rate of return, resulting in lower investment and less capital intensive firms.

There is no good reason to wish to tax debt- and equity-financed investments differently and in the last two years Germany and Belgium have both sought to narrow the gap – albeit from opposite directions. Germany has limited the extent to which firms can deduct interest, while Belgium has introduced an allowance for the cost of equity finance.

As Meade argued, on efficiency grounds we would prefer not to tax the normal return on investment, however it is financed. So the Mirrlees team see some form of Allowance for Corporate Equity as worth considering, even though it goes against the trend of seeking to broaden the tax base. Depreciation rules would be less relevant, incentives would not change with inflation, financing decisions would not be distorted, and defining what qualifies as an interest payment would become less important. We would forgo some revenue - perhaps £5 billion a year on some estimates - but this is money that could be collected more efficiently elsewhere.

In contrast, we would like to tax profits above the normal rate of return, especially for practical reasons when they derive from location-specific factors, so that the investment cannot move elsewhere. However, other than specific examples, such as North Sea Oil taxation, attempts to tax immobile super-normal profits more heavily than mobile ones are rare and constrained by international agreements.

In setting a single tax rate on super-normal profits we would need to trade off the revenue gain from taxing immobile ones more heavily against the revenue loss from driving mobile ones overseas and not taxing them at all. Globalisation means that the optimal tax rate on super-normal profits is likely to be lower than it was in Meade's time. But the fact that we are still collecting 3% of national income from corporation tax today suggests that it is far from zero.

Second, where should we tax profits?

The first instinct of the team is to stick with source-based taxation. But in their evidence to the Mirrlees review, Mike Devereux and colleagues argued that source-based corporate taxes were illogical and ultimately unworkable. They argued for taxing economic rents where they are consumed, rather than produced, in other words on a destination basis.

As Mike has pointed out, taxing profits in this way is equivalent to levying Value Added Tax with a deduction for labour costs. In principle this could be implemented by increasing the rate of VAT and reducing National Insurance contributions. The idea of abandoning corporation tax at a stroke and replacing the revenue from VAT is unlikely to see favour with many politicians. But if the revenues from a source-based corporation tax erode significantly in the face of globalisation, we may well end up moving in that direction whether the politicians like it or not.

Before advocating the ACE approach, the team will need to satisfy themselves that adopting it will not make a source-based corporation tax harder to administer. There is also the live issue of taxing foreign profits, where I think the team see the choice between a credit and exemption system as finely balanced. If we see the credit system as an anti-avoidance mechanism discouraging resident companies from shifting taxable income overseas, the question is whether an exemption system would still be better given the need for alternative anti-avoidance measures.

Third, what about the interface between company and personal tax?

An important justification for a corporation tax is that it prevents owner-managers from sheltering their earnings from personal taxation by converting their salaries into business profits. The Government's ill-fated experiment with a zero rate of corporation tax for firms with modest profits provided a salutary but expensive reminder of this, as the number of incorporations soared and a measure promoted by the Government as a way to nurture the Microsofts of tomorrow ended up as a costly giveaway to the Dave's Minicabs of today.

There seems no compelling reason for the tax system to favour one legal form of business over another. In their study for the review, Rachel Griffith and colleagues suggest combining an ACE corporation tax with a similar "Rate of Return Allowance" approach to the taxation of dividends and realised capital gains on corporate equity at the personal level. Choosing the tax rates so that the combined tax rate on super-normal corporate profits and personal dividends equals the tax rate on labour income should avoid most distortions to the choice of legal form.

Again I do not want to prejudge the Review team's conclusions, but I hope that this gives a fair guide to their current thinking. The team would welcome any comments you may have on these approaches.

## **The fiscal background**

Now let me turn from Mirrlees to the "elephant in the room" for any current discussion of tax reform – namely the outlook for the public finances. The two are of course linked. As I mentioned earlier, taxing company profits raises the Exchequer around 3% of national income in revenue. Corporation tax is a much more cyclical revenue stream than taxes levied on personal incomes and spending, which makes it particularly hard even for the Treasury to predict.



Overoptimistic forecasts for corporation tax were an important reason why the Treasury's Budget predictions for the public finances were consistently too rosy in the run-up to the 2005 general election. The resulting decision to delay significant tax raising measures and cuts in public spending as a share of national income until after the 2005 election helps explain why we are going into the current crisis with government borrowing and public sector debt as high as they are. As a result the Government would probably be expecting to breach its famous fiscal rules even if we were facing only a modest economic slowdown, let alone the banking crisis and full-blown recession that we now confront.

The unexpected weakness of corporation tax receipts in Labour's second term was notable in the financial sector, where Treasury forecasts had assumed a long-run increase in financial sector profits as a share of national income. In the short-term, revenues were depressed by the impact more than the Treasury expected by the stock market fall between 2000 and 2002. Only after the 2005 general election did Treasury forecasts recognise that the trend assumption was too optimistic.

As we look forward, the medium and long-term prospects for profits, salaries and bonuses in the financial sector have to be a major source of uncertainty in judging the outlook for the public finances. Bear in mind that although on some measures the financial sector accounts for only about 10% of national income, it accounts for around 25% of corporation tax revenue. The pay and bonuses of financial sector employees are of course very important for other revenues too.

But let us take look at the overall fiscal picture – and it is not a pretty one.

At the time of the Budget in March - and how long ago that now seems - the Treasury expected to have to borrow £43 billion or 2.9% of national income this year. With economic activity assumed to be near its sustainable trend level, this was largely accounted for by one of the biggest structural budget deficits in the industrial world. But the Chancellor reassured us that the deficit would shrink to 1.3% of national income within four years, thanks to modest cuts in public spending as a share of national income, plus the usual assumption of a rise in the tax burden thanks to “fiscal drag” – tax allowances and thresholds failing to keep pace with expected real earnings growth.

As a result, the Government's target measure of public sector net debt was forecast to peak only a whisker below its self-imposed ceiling of

40% of national income in 2010-11 before edging down again. This was based on the assumption – which was already looking optimistic even then - that economic growth would slow from an above-trend 3% last year to 1.75% this year before returning to a 2.5% trend next year.

Things look very different now. Government borrowing so far this year is running 70% up on last year, rather than the 19% increase predicted at Budget time. Adding in the Government's three tax giveaways since the Budget, at this rate the Treasury will need to borrow around £65 billion or 4½ percent of national income this year. Weaker-than-expected economic growth probably explains only a small part of this overshoot to date – there is also the impact of the falls in the stock market and the value of housing market transactions, plus some further structural element.

Independent forecasts for economic growth have been revised down significantly since then and it seems reasonable to expect that the budget deficit will climb even higher over the next couple of years than it is this year. This would push the Government's target measure of public sector net debt well above the 40% ceiling that it set itself in 1997.

At a headline level, the debt position looks even worse. The Budget forecast I mentioned excludes the impact of the nationalisation of Northern Rock and Bradford & Bingley, plus the costs of last week's bank recapitalisation plan and any compensation that has to be paid to depositors losing money in the Icelandic banks. All these together will probably add about £175 billion to the headline measure of public sector net debt, lifting it to a 30 year high of around 50% of national income. It also looks likely that the Office for National Statistics will rule that Royal Bank of Scotland should be treated as a public corporation for the purposes of the public accounts. In its last published results, RBS had a £1.8 trillion balance sheet. The Treasury will be able to net off any short-term financial assets within this total, but at worst it could raise public sector net debt by 120% of national income, taking the total to levels last seen in the aftermath of the Second World War. On this measure of net debt at least, the public sector looks increasingly like a large bank with a small government attached.

The debt figures look as bad as they do because the figures do not take account of the non-liquid assets the Government is in effect acquiring, notably the banks' mortgage books. The Government hopes that it will make a profit on its unintended bank investments, as Norway did after the Nordic banking crises of the early 1990s. So while the long term profit or loss remains uncertain, this dramatic upward surge in net debt may not

affect the outlook for tax and spending decisions as much as the increase in borrowing we expect over the next two to three years. There the big question is how much of the deterioration can we expect to reverse naturally when the economy returns to normal – whatever “normal” looks like after the smoke from the current battle clears.

Experience from the last recession suggests that we may well be left with an unsustainably large structural budget deficit. This would reflect a combination of factors – the large structural deficit we already had, a lower estimate of present economic capacity, a possible fall in the future trend growth rate of the economy, the policy loosening we have seen since the Budget, the big declines in the housing market and the equity market, and a diminished medium-term role for the financial sector.

Then there is the much more uncertain magnitude of any long-term losses on the Government’s investments in the banks, plus any costs accrued if its guarantees to the inter-bank market are called upon.

So what of the likely policy response?

The Government may feel it has to give away more money in the short term, to help the Bank of England sustain economic growth (and thereby stop inflation falling too far now that the headline rate is thought to be around its peak) - and to show the voters that it feels their pain. It will certainly have to rewrite its fiscal rules in the process and do something to restore public confidence in the believability of its forecasts.

Thereafter the Government (or its successor) will need to impose a significant fiscal tightening once the economy has stabilised. In the Pre-Budget Report this autumn the Chancellor and the Prime Minister will have to decide just how explicit they wish to be now about the expected size and shape of that fiscal tightening.

When we bear in mind that, even before the crisis, the Treasury was pencilling in cuts in public spending as a share of national income to make its public finance forecasts for the next five years add up, it seems clear that significant tax raising measures will be needed.

Think back to what was deemed necessary in the wake of the last recession. The two Budgets of 1993 set out to raise an additional 2% of national income in tax revenue by 1995-96 – £30 billion in today’s money. We saw income tax allowances frozen, the married couple’s allowance cut, MIRAS reduced, the ACT rate reduced, North Sea taxes

increased, VAT levied on domestic fuel, excise duties increased, National Insurance contributions raised, incapacity benefit taxed, and insurance premium tax and air passenger duty introduced.

I am afraid that this does not bode well for the recommendations of the CBI Tax Taskforce. I imagine that if there is to be further fiscal loosening in the near term the Government will want voters to see the money going straight into their pockets. And even if you believe – as the task force did - that the cuts in the headline corporation tax rate it proposed would eventually finance themselves through an increase in the capital stock and a temporary increase in trend growth, this may not be the best time to persuade ministers to accept the upfront hit to the public finances that would happen result - and the additional risk that the improvement in trend growth may take longer than expected to materialise. Twice in two decades we have seen what happens when Governments take fiscal policy decisions based on the assumption that they have improved the trend growth rate of the economy or abolished the business cycle.

Of course, one interesting twist may be that fiscal problems across the industrialised world prompt more aggressive cuts in corporation tax rates to attract a larger share of the shrunken pool of globally mobile profits.

But if we are to find a silver lining in the current cloud, it may be that the very certainty that that this or the next Government will have to announce fresh tax increases and inflict pain on the voters might encourage it to do so in a way that improves the functioning of the tax system. If unpopular things need to be done, they might as well be virtuous ones. I hope that the Mirrlees Review will provide some food for thought if this is the case. And although the basic structure of the report will be to set out a revenue neutral package, I hope that the team will also be able to distinguish between good and bad ways to raise revenue if that needs to be done.

Let me end though with the political thought I mentioned earlier. It will be very interesting to see if anger towards the financial sector affects attitudes to business in general, and whether this in turn will affect how Governments feel they can and should raise taxes when they need to. When the Prime Minister says that those in the financial sector responsible for the current problems need to be “punished” in some a yet unspecified way - and when even the Conservatives are calling for restrictions on executive remuneration - how will this affect the approach to “business taxes” and to the taxation of the wealthy and high earners?

To conclude, we obviously live in very uncertain times. But I think we can be certain that whichever party is in Government after the next general election will be looking to raise significant sums in extra revenue. If they can be persuaded to do so in a way that leaves us with a better structured tax system as a result, that at least will be some compensation.

Thank you very much.