Raising revenue: lessons from the Mirrlees Review

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1. Introduction

Over the course of the next few days, we will learn a lot about the intended path of taxation and public spending under our new coalition government.

Sir Alan Budd and his two colleagues in the newly created interim Office for Budget Responsibility have now published their first set of independent forecasts for the economy and the public finances. They have said that the structural deficit we are facing is, if anything, slightly worse than anticipated at the time of the last Budget – the required fiscal repair job is a daunting one.

The Budget next week will then tell us how the Coalition intends to go about the repair job. The Coalition will need to agree how quickly to try to fill the hole – they have said they wish to "significantly accelerate" the deficit reduction planned by Labour, but they have not said by how much. They will also need to agree how to divide the task between tax increases and spending cuts. Before the election Labour was aiming for a 2:1 ratio of spending cuts to tax increases, the Liberal Democrats 2½:1 and the Conservatives 4:1. The coalition agreement confirmed that the "main burden" should fall upon spending cuts, but again they have not said precisely how much.

Those decisions will determine whether the Coalition partners feel they need to announce fresh net tax increases on top of those already in the pipeline from the previous government. On specific tax measures, we also know that the Coalition is already looking to raise income tax allowances, to increase the threshold for employer National Insurance contributions, to move to a per-plane tax on air travel, to increase capital gains tax (CGT) rates for non-business assets, to increase the proportion of revenues coming from environmental taxes, and to review the tax rules for non-domiciles. But, once again, we have few precise details.

There is clearly a possibility that the Coalition will conclude that it needs new revenue-raising measures to help bring about the fiscal consolidation it wants and to pay for any other tax cuts. If so, there will be a very strong temptation to announce some of these in the first Budget, as it is the best opportunity at which to blame the previous government for the need to do so. Of course, that does not necessarily mean that any new tax increases would be implemented straight away – they could be pre-announced.

What I want to do this evening is say a little about how the Government might want to think about raising extra revenue, if it feels that is necessary. In doing so, I will draw on some of the lessons of the Mirrlees Review of the tax system, which is now drawing to a conclusion. The first volume – a collection of commissioned papers, some of which have been presented here in the past – has now been published and can be downloaded (or, better still, bought) from the IFS website. The second volume, containing the editorial team's final conclusions will soon be in the hands of Oxford University Press for publication in September. I should point out that Review did not set itself the explicit task of proposing how best to raise extra revenue – rather the goal was suggest how a government might make the tax system more efficient given existing revenue needs and distributional goals. But there are still relevant lessons to be drawn.

2. Current defects in the tax system and tax policy

Regular participants in these seminars will not need convincing that there has long been a lack of clear direction in tax policy in the UK. As former IFS director Dick Taverne said when launching the Meade Report (the predecessor of Mirrlees) more than 30 years ago: "For too long, tax reforms have been approached ad hoc, without regard to their effects on the evolution of the tax system 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".

The same holds true today. There have been useful reforms since the Meade Report was published, but more often the story has been one of drift punctuated by poorly thought out changes – sins both of commission and omission. We can all point to examples in different areas of the system: the endless cycle of reforms to CGT; the simplification and re-complication of the income tax and national insurance schedule; the failure to revalue properties for council tax, to name but three. One pervasive problem has been a reluctance to step back and look at the impact of the tax and benefit system as a whole, both in its effects on people's behaviour and its distributional impact.

As our new Government embarks on its own tenure as the steward of the tax system, it would be welcome if the Coalition partners had in their minds a vision of how they would like the tax system to look in the long-term and some sense of the key changes that they think would be necessary to get there. Of course, this would be a lot to ask of a single party government with a healthy majority, let alone a marriage of two parties that may need to reconcile different visions. We see this already in the debate over the Coalition's compromise plan to reform CGT.

Put at its broadest, the tax system should be designed in such a way as to raise the revenue that the government thinks it needs, to redistribute resources in the way it thinks fair and to influence people's behaviour in the ways it thinks desirable, while at the same time minimising the costs to the economy and to people's wellbeing that arise from influencing behaviour in undesirable ways – such as discouraging paid work, saving and investment, and distorting people's choices over what goods and services to buy, what assets to save and invest in, what form of remuneration to take, and in what legal structure to run their business.

Different governments will of course of have different priorities within this overall goal. But there are some broadly shared objectives for tax policy and, judged against these, the Mirrlees Review has identified six major defects in the current UK tax system:

- First, despite improvements for some groups in recent years, the current system of income tax and welfare benefits creates serious disincentives to work for many people with a relatively low earning capacity;

- Second, there is a range of unnecessary complexities and inconsistencies, created by the fact that various parts of the tax system are poorly joined up. These range from the lack of integration between income tax and national insurance to the lack of coherence between personal and corporate taxes.

- Third, the present tax treatment of savings, housing and wealth transfers lacks a clear rationale.

- Fourth, we remain some way short of having a coherent system of environmental taxes to achieve shared goals for climate change, and to address other environmental spillovers.

- Fifth, the current system of corporate taxes discourages business investment and favours debt finance over equity finance. Its lack of integration with other parts of the tax system leads to distortions over choice of legal form. Corporate taxes have also been subject to increasing international pressures.

- Sixth, distributional goals are pursued in inefficient and inconsistent ways. For example: zero rating and reduced rates within VAT are very costly, with most of the benefits going to the better off; and council tax is regressive for no obvious efficiency-improving reasons.

It would be unrealistic to expect this month's Budget to resolve all these issues – to do so would be the task of a long-term reform programme and it is that to which the final report of the Mirrlees Review will address itself in the autumn. That said, it would clearly be helpful if any measures to raise revenue that are announced in the near term do not make these problems worse and, if possible, start to tackle them.

3. Options for raising revenue

The last time that a British government confronted a fiscal adjustment anything like the size of the one that we now confront was in the early 1990s, following sterling's departure from the European Exchange Rate Mechanism. In the two Budgets of 1993, Chancellor Norman Lamont and Kenneth Clarke announced net tax increases totalling around 2% of national income or around £30 billion a year in today's money. They chose to spread the pain across the tax system. They invented two entirely new taxes – Insurance Premium Tax and Air Passenger Duty. Petrol duties went up year on year, fiscal drag was allowed to work its magic on tax allowances and thresholds, and the low hanging fruits that were the Married Couples Allowance and Mortgage Interest Relief (MIRAS) were gratefully plucked.

They had one other revenue raising trick up their sleeves – one that did not work so well. The Government announced that it would impose VAT at the full 17.5% rate on domestic energy consumption. But the political furore which accompanied this announcement – despite a relatively generous and well worked out compensation package for the poorest families – ensured that only first tranche of the increase was ever introduced, raising the rate from 0% to 8%. Even this was partially reversed by the incoming Labour government in 1997, which took the rate back down to 5%. We armchair reformers should not forget these practical political difficulties.

Since then the tax system has continued to change in a rather incoherent way. The basic income tax rate has come down, while the [equivalent] NI rate has gone up. The fuel duty escalator was given an extra spurt of speed between 1997 and 2000, and then thrown into sharp reverse (before being reintroduced more recently). A 0% rate of corporation tax was introduced and swiftly abolished.

Fiscal drag has quietly brought millions more into the income tax system and into the higher rate band. A reduced, 10%, rate of income tax has been introduced (a bad policy change) to great fanfare and then abolished (a good policy change) to a fanfare of raspberries.

The previous government made the first tentative steps towards increasing the tax take in its last years in office. A new and bizarre income tax rate structure has been introduced, such that the marginal rate now rises to 60% for those earning £100,000, then falls back to 40% before rising again to 50% for those earning over £150,000. Meanwhile tax relief for pension contributions has been sharply curtailed for high earners in a poorly designed way, reversing years of careful reform and simplification of that system.

If the new government goes beyond these measures to look for significant extra revenues, how might it go about it? There are many ways of increasing tax revenues. In the review we consider environmental and other taxes where there is certainly scope. But the really big money is in the big taxes. The simplest thing to do would be to raise the main rate of the three largest revenue raising taxes: income tax, VAT and NI. Adding 1p to the main rate of any of these would bring in between £4 and 5 billion a year. Raising the main rate of corporation tax would be less fruitful, raising £800 million a year.

Unfortunately, raising the main rates of any of these taxes would exacerbate existing distortions in the system:

- Increase the main NI rate and you increase the differential between the taxation of labour income and capital income;
- Increase the basic rate of income tax and you further discriminate against many forms of savings;
- Raise the standard rate of VAT and you increase the distortion created by the current system towards consumption of zero-rated and exempt goods (of which the UK has far more than most OECD economies);
- Raise the main rate of corporation tax and you further discourage investment, exacerbate the incentive for debt finance over equity finance and make the UK a less attractive location for footloose multinationals.

Increases to income tax, NI, and indeed VAT, also have undesirable impacts on work incentives.

This is not to say none of them should be increased if we need the money. But, if the government wanted to raise significant revenue from these taxes, then it should look at doing so in ways that would facilitate future reform and would not cause additional damage.

So let me illustrate the issues in designing an effective tax system in the context of raising revenue first by looking at income tax, NI and CGT in the context of the taxation of savings, and in the context of work incentive issues, and then at VAT. I will also briefly explain why we do not see the main rate and allowances in corporation tax as a candidate for any additional revenue raising even in the short term.

Income tax, NI and the taxation of savings (and the tricky issue of CGT)

Consider the choice between raising the basic rate of income tax and the main NI rate. The impact on most people in work would be quite similar. But one central difference is in the treatment of income from capital.

Income tax is charged on income from savings and dividends, whereas NICs are charged only on earnings. One effect of the lack of NICs on capital income is that there is a major incentive to set up a company rather than be an employee. This also leaves the self-employed in an awkward limbo. Tax the self-employed like companies and you give people an incentive to be self-employed rather than employees; tax the self-employed like employees and you give them an incentive to set up a company. If the rate of NICs is increased for employees, then one of these distortions is going to be exacerbated whether or not the self-employed rate is increased as well.

But this is just one aspect of the broader question of whether we should tax capital income (as income tax does) or just earnings (as NICs do). On the one hand, there are advantages to taxing earnings and savings in the same way. On the other hand, we don't want to discourage saving. Before deciding which to raise, the government needs to know how it wants to tax savings.

(In the longer term, an obvious question is whether we really want to keep two separate taxes on income. Rather than having two separate but similar taxes, it would clearly be an administrative saving to merge them into a single tax, as well as being much more transparent to taxpayers.)

Knowing where you want to go with the taxation of savings is even more important when it comes to the knotty issue of CGT – a tax which has been reformed and re-reformed in a depressingly familiar 10 year cycle over the last 40 years. The Coalition already has plans to reform it further, so what it does in this area will be a very important signal of intent for the future.

The reason for this cycle of uncertainty and reform has been the quest for a balance between two competing objectives: first, the desire to minimise the scope for tax avoidance created when capital gains are taxed more lightly than income, and second, the desire to keep capital taxes as low as possible to avoid discouraging saving and investment.

A good first principle is that the tax system should not distort people's behaviour in a costly way without good reason. This leads to four conclusions about the structure of CGT:

- First, the tax rate on capital gains should be aligned with the rates on earned and dividend income, ideally with a single tax-free allowance. Different tax rates encourage people to take income in more lightly taxed forms and to move into occupations where this is easier.

- Second, CGT should not discriminate between business and non-business assets, as has been the case since 1998. People should be left to decide un-bribed whether to put their money into a bank account, housing, shares, or into their own businesses, based on their own judgement of the risks and returns involved. (There is an argument for taxing shares more lightly, however, because company profits that give rise to capital gains have already been subject to corporation tax.)

- Third, we should not try to bribe people into holding assets for longer than they would otherwise wish to do – economic welfare is best served by having assets owned by the people who value them most.

- Fourth, we should tax real gains rather than the illusory gains from inflation. So there is a strong case for re-introducing indexation allowances (although these do have drawbacks).

But what of the objection that taxing capital gains at income tax rates would discourage saving and investment?

High CGT rates certainly discourage saving and investment, but reducing them is not necessarily the best way to encourage it. Capital allowances, including schemes like the Annual Investment Allowance aimed at small firms, are more effective ways because they specifically reduce the tax rate on capital investment rather than on the other factors that generate capital gains.

An alternative approach would be to reintroduce indexation allowances, not just for inflation, but also for the minimum return that someone would require to invest a pound today rather than spend it. This would move us closer to an "expenditure tax" system that would not distort levels of saving and investment, especially if accompanied by similar changes to income tax and corporation tax.

Indeed this idea is at the heart of what the Mirrlees Review will recommend on the taxation of savings: that we should not tax the *normal* return to savings, but that we should look to tax any excess returns at the same rates that we tax labour income. So savings that yield a low, fixed rate of return, such as interest earned on bank and building society deposits – the savings mainstay of those with least wealthy – would be exempt from tax altogether. And returns to equities, for example, would be taxed only in so far as they exceeded (say) 5%.

This would go a long way to squaring the CGT circle – aligning rates on excess returns with income tax rates, and avoiding the discouragement of saving.

Work incentives

Taxes reduce incentives to work. Increases in taxes are likely to exacerbate this. So once again, if taxes are to be increased, getting the structure right so as to minimise these effects is important.

Much debate focuses on these effects at the very top of the income distribution. Our view is that the 50% income tax rate is around, and possibly even above, the revenue maximising level. In other words there is no guarantee that an increase in this rate would actually raise for money for the Exchequer. So no further increases in the 50% rate of tax should be contemplated unless the government is prepared to forgo tax revenue in order to limit extreme affluence.

In fact most of the evidence suggests that under the current system disincentive effects are most pronounced, and certainly most prevalent, at the bottom of the income distribution. They tend to affect decisions over whether or not to work at all more than they affect decisions over exactly how many hours to work. And these effects are much bigger for some groups than for others – in particular for second earners, for mothers with school age children and for older workers.

There may well be scope to increase incentives to work for some lower income groups by increasing working tax credits and means testing less aggressively. The downside of applying this approach is that it would bring more people into means testing. The upside is that our simulations suggest it could increase employment levels quite significantly. There is a trade-off here.

We can be more definitive about other recommendations:

- Rebalancing the child tax credit so that it is less generous to families whose youngest child is of school age and more generous to families with pre-school children. Mothers with younger children are less responsive to taxation than those with children in school. So reforms along these lines could lead to a net increase in employment leading to an increase in aggregate earnings of around £0.9bn. And of course, in a life-cycle sense, these reforms would have offsetting effects once in place, with families who receive child tax credit gaining when children are younger and losing later.

- Improving work incentives for those around normal pension age – a group which is highly responsive to such changes. If we exempt people from employee NICs at age 55 instead of the state pension age, raise the tax free personal allowance from age 55 instead of age 65 and delay eligibility for the pension credit until age 70 we estimate that aggregate earnings could be increased by just over £2bn. As with our child tax credit reforms there are offsetting effects over the life-cycle with losses to younger workers and gains to older workers from remaining in the labour force.

- Simplifying and integrating the benefit system. There is much to be gained from making the benefit system as a whole simpler and more internally consistent, probably through moving towards a single integrated benefit. On the other hand full integration of the tax and benefit systems is in reality likely to be too complex to achieve, not least because recent British governments have quite reasonably preferred assessing benefits on the basis of *family* income, while assessing tax on the basis of *individual* income.

- Integrating the income tax and national insurance systems.

Between them these reforms pay due attention not just to marginal rates but incentives to participate in the labour force. They provide a focus on increasing incentives for those most likely to respond to them. And they increase transparency and simplicity.

In each case the reforms would take from some and give to others at different points in their lifecycle, but would substantially increase numbers in work.

VAT

VAT is a pretty efficient tax in many ways. But the existence of unusually extensive zero-rating and exemption in the UK creates both a great deal of complexity and great deal of inefficiency. Even disregarding the complexity, the economic costs of distorting households' consumption choices are likely to amount to around £3 billion a year. HM Revenue and Customs has also estimated that it received £14.4 billion (about 15%) less VAT revenue than it was entitled to in 2008–09 as a result of fraud, evasion, avoidance and error. Some of this doubtless reflects unnecessary complexities in the system.

Much of the current zero (and reduced) rating has been justified on the grounds of fairness – poorer families spend a larger proportion of their weekly budget on food (zero-rated at an exchequer cost of cost £11 billion a year) and fuel (reduced rated at a cost of £3 billion a year) than richer ones.

Meanwhile, financial services are exempt from VAT (cost £6 billion) because it has traditionally been considered impossible to bring them within the ambit of the VAT system. Construction of new housing is also zero rated (at a cost of £4 billion).

Simply raising the main rate of VAT would amplify the distortions in the current system, by widening the gap between the treatment of exempt, reduced-rated and zero-rated items on the one hand and items taxed at the standard rate on the other. Bringing the treatment of these items closer together, rather than pushing them apart, would make for a more efficient and less welfare-reducing system.

In this spirit the Mirrlees Review will recommend that we: first, remove most of the zero- and reduced-rating on goods such as fuel and food; second, deal with the exemption of financial services; and third, overhaul the taxation of housing.

Extending VAT

The traditional argument against broadening the base of VAT is of course that this would hit the poor. Observe the reaction in 1993 to the last Conservative government's attempts to extend VAT to domestic fuel. But three important observations flow from our analysis in the Mirrlees Review:

- First, it is possible, *on average*, to compensate poor families for an extension of VAT.

- Second, this needs to be done *much* more carefully than is usually understood in order to ensure that work incentives are maintained. Simply increasing benefit rates to provide maximum compensation to the poor at a given cost can seriously damage work incentives, especially coming on top of the disincentives created by the extension of VAT itself;

- Third, broadening the VAT base is not as regressive as it looks. Much of the apparent regressivity comes from the impact on households who appear to be spending very large amounts relative to their incomes. This is evidently not something they can keep up in the long term. When thinking about equity it is best to judge whether people are rich or poor by looking at their life-time living standards rather than at an often unrepresentative short-term snapshot of income.

It is also worth noting that, if we started with a uniform VAT system, it is unlikely we would think it sensible to spend £11 billion removing food from the system, a change which would in absolute terms benefit the rich much more than the poor.

More generally, issues of equity are best dealt with using the tools designed to deal with them – income tax and welfare benefits. Not every tax needs to be progressive – tobacco taxation certainly is not, and it is rarely challenged as a sensible element of the tax system on those grounds.

We should be clear. We are not saying necessarily that extending VAT to food, fuel and so on should be seen as a way of raising revenue in itself. There is a strong case for broadening the VAT base whether we need revenue or not – if all the proceeds were used to compensate poorer families and to protect work incentives, people's welfare would be improved because they could purchase more of the goods and services they want for every pound in their budgets. Once such a reform had been implemented, the economic costs of raising the VAT rate to raise more revenue would be much reduced.

Financial Services

Financial services are currently exempt from VAT. This means that financial services to consumers are significantly under-taxed, and also introduces a range of other distortions. The reason for exemption has always been that it is not really possible to bring financial services into the traditional VAT system. Much of the value added in financial services is reflected in *implicit* charges – the difference between interest rates paid on deposits and those charged on loans, for example – which means there are not clear prices on which to charge VAT.

But ,as we argue in the Review, in principle VAT could be extended to financial services by treating all cash inflows as representing sales and all cash outflows as input purchases. This may pose practical difficulties, but a clear understanding of what we are trying to achieve, and of how different taxes relate to each other, open up possibilities for achieving the same outcome in ways that might be more administratively appealing. For example, the IMF's proposals for a *Financial Activities Tax* levied on an appropriate measure of profits and remuneration offers one route towards taxing financial services in a way that is economically equivalent to a VAT – though it would need a little tweaking (restricting attention to retail rather than business-to-business transactions, for example) in order to ensure that the tax fell only on financial consumption and did not distort the structure of economic activity.

So there is scope for raising money from the financial services sector, and in a way which improves the tax system and brings the taxation of financial services more in to line with that of the rest of the economy.

Housing

No VAT is currently paid on owner occupied housing either at the point at which it is built or when it is consumed (over the life of the property). Instead we levy council tax in a way that is deliberately regressive relative to its base – the rate as a proportion of value falls with the value, and is capped. There is no obvious reason on efficiency grounds to make council tax regressive in this way.

One could simply impose VAT on the construction of new dwellings, but that would not levy a proper consumption tax on the vast majority of properties for many decades. It would also create distortions in the market between new and older properties.

Instead we should think about taxing the consumption of housing directly by imposing an annual tax at a rate proportional to the consumption value of the property. That could be done by reforming the council tax so as to make it proportional to the current (as opposed to 1991) consumption value of the property. This would increase both equity and efficiency in the taxation of housing, although politicians would have to grasp the nettle of a property revaluation. That said, we would not necessarily recommend making this change in such a way as to raise more revenue than council tax

– unless this reformed tax were also used to replace the grossly inefficient stamp duty that currently distorts the housing market.

Corporation tax

Looking beyond the current fiscal crisis, we would advocate significant reform of the corporation tax base, with the key ingredient being the introduction of an allowance for the cost of using equity to finance corporate investment. This would level the playing field between debt and equity finance, lower the cost of capital for domestic firms, and make the UK a more attractive location for investment by multinationals. This reform would also be consistent with our broader aims of shifting the tax base from income to consumption, eliminating the taxation of ordinary returns earned on savings and investments, and thereby providing a substantial stimulus to both household saving and corporate investment.

This direction of reform would probably reduce rather than increase corporation tax revenue overall – although some parts of the package, such as abolishing the small companies' rate, could raise money. The main implication of this in the short-term is that corporation tax reform does not look like a promising avenue for revenue-raising. Increasing the corporation tax rate would make the UK a less attractive location for investment by international companies. Reducing capital allowances or restricting tax relief for financing costs would make investment more expensive for many companies, moving in the opposite direction from that we would advocate. In this area, as in others, a strategic vision for the long-term is needed; but, in the short-term, the best advice might be for the government to follow the Hippocratic oath and above all do no harm.

4. Conclusions

Big decisions are going to have to be made about tax and spending. This will be painful. The government should approach the task in a way which is not only socially just, but also economically efficient. Otherwise it risks imposing much greater economic costs than necessary.

There is both an economic need to ensure we have as efficient and coherent a tax system as possible if taxes are to be increased, and a political opportunity to move in that direction.

How the government starts off next week needs to be informed by where it wants to end up in 5 or more years' time. It would be sad indeed if – like its predecessor – it were to make a series of changes at the start of its tenure only to unravel them some years later.

Much attention in the run-up to this Budget has focussed on the Coalition's plans to reform CGT and on the speculation that it will decide to increase VAT. The work of the Mirrlees Review suggests that the former should be approached as part of a coherent strategy for the taxation of saving, while the latter should be done in a way that alleviates welfare-reducing distortions rather than increasing them. Its approach in these two areas will give us some early idea of the Coalition's commitment to tax reform over the longer term.