Institute for Fiscal Studies

A survey of the UK tax system

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1. Introduction

This briefing note provides an overview of the UK tax system. It describes how each of the main taxes works and examines their current form in the context of the past 35 years or so. We begin, in Section 2, with a brief assessment of the total amount of revenue raised by UK taxation and the contribution made by each tax to this total. In Section 3, we describe the structure of each of the main taxes: income tax; National Insurance contributions; value added tax and other indirect taxes; capital taxes such as capital gains tax and inheritance tax; corporation tax; taxes on North Sea production; the bank levy; council tax; and business rates. The information given in these subsections relates, where possible, to the tax system for the fiscal year 2015–16.

In Section 4, we set the current system in the context of reforms that have taken place over the last 35 years or so. The section examines the changing structure of income tax and National Insurance contributions and developments in the taxation of savings, indirect taxes, taxes on companies and local taxation.[1]

Much of the information in this briefing note is taken from HM Revenue & Customs (HMRC) manuals.[2] Information relating to tax receipts is from the Office for Budget Responsibility (OBR)'s *Economic and Fiscal Outlook* published alongside the July 2015 Budget.[3] Occasionally, sources can be inconsistent because of the different timing of publications or minor definitional disparities.

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[1] There is more information on historical tax rates on the IFS website at http://www.ifs.org.uk/tools_and_resources/fiscal_facts.

[2] See http://www.hmrc.gov.uk/thelibrary/manuals-a-z.htm.

[3] See http://budgetresponsibility.org.uk/economic-fiscal-outlook-july-2015/.

2. Revenue raised by UK taxes

Total UK government receipts are forecast to be £672.8 billion in 2015–16, or 36.0% of UK GDP. This is equivalent to roughly £12,800 for every adult in the UK, or £10,400 per person.[4] Not all of this revenue comes from taxes: taxes as defined in the National Accounts are forecast to raise £628.9 billion in 2015–16, with the remainder provided by surpluses of public sector industries, rent from state-owned properties and so on.

Table 1 shows the composition of UK government revenue. Income tax, National Insurance contributions and VAT are easily the largest sources of revenue for the government, together accounting for almost 60% of total tax revenue. Duties and other indirect taxes constitute around 10% of current receipts, with fuel duties of £27.1 billion the largest component. The only other substantial category is company taxes, which come to 11% of current receipts, predominantly corporation tax and business rates.

There has been some variation over time in the composition of government receipts and the size of receipts as a proportion of GDP. These topics are returned to in Section 4.

[4] Using table A1-1 of Office for National Statistics, *Principal Population Projections (2012-Based)*.

Table 1. Sources of government revenue, 2015–16 forecasts

	Revenue (£bn)	*Percentage of total receipts*
Income tax (gross of tax credits)	170.2	*25.3*
National Insurance contributions	114.8	*17.1*
Value added tax[a]	115.9	*17.2*
Other indirect taxes		
Fuel duties	27.1	*4.0*
Tobacco duties	9.1	*1.4*
Alcohol duties	10.7	*1.6*
Betting and gaming duties	2.6	*0.4*
Vehicle excise duty	5.6	*0.8*
Air passenger duty	3.1	*0.5*
Insurance premium tax	3.5	*0.5*
Landfill tax[b]	1.0	*0.1*
Climate change levy	2.3	*0.3*
Aggregates levy	0.3	*0.0*
Customs duties	3.0	*0.4*
Capital taxes		
Capital gains tax	6.4	*1.0*
Inheritance tax	4.2	*0.6*
Stamp duty land tax[b]	11.5	*1.7*
Stamp duty on shares	3.2	*0.5*
Company taxes		
Corporation tax (net of tax credits)	42.3	*6.3*
Petroleum revenue tax	0.0	*0.0*
Business rates	28.0	*4.2*
Bank levy	3.7	*0.6*
Council tax	28.4	*4.2*
Other taxes and royalties[c]	30.7	*4.6*
Net taxes and National Insurance contributions	**627.6**	***93.4***
Interest and dividends	5.8	*0.9*
Gross operating surplus, rent, other receipts & adjustments	38.9	*5.8*
Current receipts	**672.3**	***100.0***

[a] Net of (i.e. after deducting) VAT refunds paid to other parts of central and local government; these are included in 'Other taxes and royalties'.
[b] For England, Wales and Northern Ireland. Land and buildings transaction tax (LBTT) operates instead of stamp duty land tax in Scotland, while landfill tax is devolved to Scotland but maintains the same system as the rest of the UK.
[c] 'Other taxes and royalties' includes environmental levies, EU ETS auction receipts, VAT refunds and other HMRC receipts.
Note: Figures may not sum exactly to totals because of rounding.
Source: Office for Budget Responsibility, *Economic and Fiscal Outlook*, July 2015, http://budgetresponsibility.org.uk/economic-fiscal-outlook-july-2015/.

3. The tax system

3.1 Income tax

The tax base

Income tax is forecast to raise £170.2 billion in 2015–16, but not all income is subject to tax. The primary forms of taxable income are earnings from employment, income from self-employment and unincorporated businesses,[5] jobseeker's allowance, retirement pensions, income from property, bank and building society interest, and dividends on shares. Incomes from most means-tested social security benefits are not liable to income tax. Many non-means-tested benefits are taxable (e.g. basic state pension), but some (e.g. disability living allowance) are not. Gifts to registered charities can be deducted from income for tax purposes, as can employer and employee pension contributions (up to an annual and a lifetime limit), although employee social security (National Insurance) contributions are not deducted. Income tax is also not paid on income from certain savings products, such as National Savings certificates and Individual Savings Accounts (ISAs).

Allowances, bands and rates

Income tax operates through a system of allowances and bands of income. Each individual has a personal allowance, which is deducted from total income before tax to give *taxable* income. The majority of taxpayers receive a basic personal allowance of £10,600, while those born before 6 April 1938 are entitled to a higher age-related allowance (ARA) of £10,660.[6] From 2015–16, a married person with some unused personal allowance is able to transfer up to 10% of that allowance to a higher-earning spouse, as long as the higher earner is not paying higher- or additional-rate income tax.

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[5] Self-employed individuals and owners of unincorporated businesses can deduct allowable business expenses when calculating taxable income. For buy-to-let landlords, an important deduction is mortgage interest, though measures to restrict relief to the basic rate of income tax will be phased in over four years from April 2017. See https://www.gov.uk/government/publications/restricting-finance-cost-relief-for-individual-landlords/restricting-finance-cost-relief-for-individual-landlords.

[6] Budget 2012 announced that the ARA would be abolished for new claimants from 6 April 2013 and frozen at its 2012–13 level for existing claimants. In 2016–17, the basic personal allowance will rise to £11,000 and the ARA will be abolished entirely.

In the past, married couples were also entitled to a married couple's allowance (MCA). This was abolished in April 2000, except for those already aged 65 or over at that date (i.e. born before 6 April 1935). For these remaining claimants, the MCA does not increase the personal allowance; instead, it simply reduces final tax liability by up to £835.50.

Each of these allowances is withdrawn from taxpayers with sufficiently high incomes.

- The ARA is withdrawn at a rate of 50 pence in the pound for income exceeding the ARA limit – £27,700 in 2015–16 – until it is reduced to the basic personal allowance at an income level of £27,820.
- Regardless of age, the personal allowance is reduced by 50 pence for every pound of income above £100,000, gradually reducing it to zero for those with incomes above £121,200.
- The MCA begins to be withdrawn at income levels above £27,820 at a rate of 5 pence in the pound until the relief reaches the minimum amount of £322 at income levels of £38,090.

Taxable income (i.e. income above the personal allowance) is subject to different tax rates depending upon the band within which it falls. The first £31,785 of taxable income is subject to the basic rate of 20%. Taxable income between the basic-rate limit of £31,785 and the higher-rate limit of £150,000 is subject to the higher rate of 40%, and the additional rate of 45% is payable on taxable income above £150,000. Higher-rate tax is payable on income above £42,385 (the personal allowance plus the basic-rate limit) and additional-rate tax is payable on income above £150,000 (those with incomes this high have had their personal allowance eliminated, as described above, meaning that all their income is taxable).[7]

[7] The withdrawal of personal allowances effectively creates extra tax rates in the system. Those facing withdrawal of the age-related allowance have an effective marginal income tax rate of 30% as they lose 50p of their allowance for each additional pound of income, which is worth 10p (20% of 50p), as well as paying income tax at a rate of 20p in the pound. Similarly, those facing withdrawal of the MCA lose 5p on top of the basic rate for each additional pound of income, creating a 25% marginal income tax rate for those claiming the allowance whose income is between £27,820 and £38,090. Those with incomes between £100,000 and £121,200 lose 50p of personal allowance for each additional pound of income, which is worth 20p (40% of 50p), meaning that their overall marginal income tax rate is 60% once this is added to the 40% higher rate of income tax. In addition, child benefit is reduced by 1% for every £100 of earnings above £50,000. This creates additional tax rates that depend on the

From April 2016, the basic, higher and additional rates of income tax in Scotland will be reduced by 10 percentage points and a new Scottish rate of income tax will apply to those living in Scotland. This has yet to be set, but if introduced by the Scottish parliament at 10% it will mean no changes in income tax rates for affected taxpayers.[8] The Smith Commission proposed that income tax rates and bands on non-savings or dividend income and all associated revenues could in future be devolved to the Scottish parliament. This would give the power to vary each rate of tax individually – for instance, putting up only the top rate of tax, or cutting only the basic rate – and to change the thresholds at which the higher (40%) and top (45%) rate become payable. In principle, it would also allow for the creation of new bands and rates, and be a significant increase in powers over the current situation where the Scottish parliament has only the (hitherto unused) power to vary the basic rate only by up to 3 percentage points.

Savings income and dividend income are subject to slightly different rates of tax.[9] Savings income is taxed at 20% in the basic-rate band, 40% in the higher-rate band and 45% above £150,000, like other income, except that savings income that falls into the first £5,000 of taxable income is free from tax. Dividend income is taxed at 10% up to the basic-rate limit, 32.5% between the basic-rate limit and the additional-rate limit, and 37.5% above that. However, this is offset by a dividend tax credit, which reduces the effective rates to 0%, 25% and 30.56% respectively. This means that, for basic-rate taxpayers, company profits paid out as dividends are taxed once (via corporation tax on the company profits) rather than twice (via both corporation tax and income tax). When calculating which tax band different income sources fall into, dividend income is treated as the top slice of income, followed by savings income, followed by other income.

The July 2015 Budget announced large changes to the taxation of both savings and dividend income from April 2016. The first £1,000 of savings income for basic-rate taxpayers and £500 for higher-rate taxpayers will be

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amount of child benefit received, and so the number of children. For further details, see A. Hood and L. Oakley, 'A survey of the GB benefit system', IFS Briefing Note BN13, 2014, http://www.ifs.org.uk/publications/1718.

[8] See https://www.gov.uk/government/news/the-scottish-rate-of-income-tax.

[9] Note that income from pensions is treated as earned income, not savings income.

tax-free, though there will be no such allowance for additional-rate taxpayers. The dividend tax credit will be abolished; instead, the first £5,000 of dividend income will be subject to zero tax, with dividend income above this taxed at 7.5% up to the basic-rate limit, 32.5% between the basic-rate limit and the additional-rate limit, and 38.1% above that.

Of a UK adult population of around 52.7 million, it is estimated that there will be 29.7 million income tax payers in 2015–16. Around 4.7 million of these will pay tax at the higher rate, providing 39.3% of total income tax revenue, and 332,000 taxpayers will pay tax at the additional rate, providing 28.9% of total income tax revenue.[10]

Most bands and allowances are increased at the start (in April) of every tax year in line with statutory indexation provisions, unless parliament intervenes. These increases are announced at the time of the annual Budget and are in line with the percentage increase in the Consumer Prices Index (CPI) in the year to the previous September. Increases in personal allowances and the starting-rate limit are rounded up to the next multiple of £10, while the basic-rate limit is rounded up to the next multiple of £100. The additional-rate limit and the £100,000 threshold at which the personal allowance starts to be withdrawn are frozen in nominal terms each year unless parliament intervenes.

Taxation of charitable giving

There are two ways in which people can donate money to charities tax-free: Gift Aid and payroll giving schemes.

Gift Aid gives individuals (and companies) tax relief on donations. Individuals make donations out of net (after-tax) income and, if the donor makes a Gift Aid declaration, the charity can claim back the basic-rate tax paid on it; higher- and additional-rate taxpayers can claim back from HM Revenue & Customs (and keep) the difference between basic-rate and higher-rate or additional-rate tax. In 2014–15, charities received £1.19 billion under the Gift Aid scheme on £4.78 billion of donations, while

[10] Source: Tables 2.1 and 2.6 at https://www.gov.uk/government/collections/income-tax-statistics-and-distributions.

higher- and additional-rate taxpayers received £480 million in relief on charitable donations from HMRC.[11]

Under a payroll giving scheme (Give-As-You-Earn), employees nominate the charities to which they wish to make donations and authorise their employer to deduct a fixed amount from their pay. This requires the employer to contract with an HMRC-approved collection agency, and tax relief is given by deducting donations from pay before calculating tax due. The cost of the payroll giving scheme was estimated to be £40 million in 2014–15.[12]

Payments system

The Pay-As-You-Earn (PAYE) system of withholding income tax from earnings (and from private and occupational pensions) involves exact cumulative deduction – i.e. when calculating tax due each week or month, the employer considers income not simply for the period in question but for the whole of the tax year to date. Tax due on total cumulative income is calculated and tax paid thus far is deducted, giving a figure for tax due this week or month. The cumulative system means that, at the end of the tax year, the correct amount of tax should have been deducted – at least for those with relatively simple affairs – whereas under a non-cumulative system (in which only income in the current week or month is considered), an end-of-year adjustment might be necessary.

Since April 2013, employers have been obliged to report salary payment to HMRC in real time, rather than just at the end of the year. This – in principle – allows HMRC to calculate and deduct tax based on real-time knowledge of individuals' income from all sources,[13] although small existing employers (those with up to nine employees) will be allowed to

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[11] Source: Table 10.3 at https://www.gov.uk/government/statistics/gift-aid-donations-amounts and table 10.2 at https://www.gov.uk/government/statistics/cost-of-tax-relief.

[12] Source: Table 10.2 at https://www.gov.uk/government/statistics/cost-of-tax-relief.

[13] There could also be benefits beyond income tax from this: for example, it might become possible to adjust benefit and tax credit awards automatically when income changes, eliminating the need for individuals to notify the government separately. The government intends its new universal credit, discussed below, to use such a system for calculating entitlements.

report payments on a monthly basis until April 2016. About 90% of income tax revenue is collected through PAYE.

Tax on bank interest is collected through a simpler withholding system, which operates under the assumption that this income is not subject to higher-rate tax.[14] Those with more complicated affairs – such as the self-employed, those with very high incomes, company directors and landlords – must fill in a self-assessment tax return after the end of the tax year, setting down their incomes from different sources and any tax-privileged spending such as pension contributions or gifts to charity; HMRC will calculate the tax owed given this information. Tax returns must be filed by 31 October if completed on paper or by 31 January if completed online; 31 January is also the deadline for payment of the tax. Fixed penalties and surcharges operate for those failing to make their returns by the deadlines and for underpayment of tax.

PAYE works well for most people most of the time, sparing two-thirds of taxpayers from the need to fill in a tax return. However, in a significant minority of cases, the wrong amount is withheld – typically when people have more than one source of PAYE income during the year (e.g. more than one job/pension over the course of the year), especially if their circumstances change frequently or towards the end of the year. Such cases can be troublesome to reconcile later on, which is one reason the government has embarked on a programme of modernisation for PAYE.[15]

Tax credits

The Labour government of 1997–2010 oversaw a move towards the use of tax credits to provide support that would previously have been delivered

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[14] The current system of withholding will cease on 6 April 2016 with the introduction of reforms to the taxation of savings and dividends. The government is currently consulting as to what system of withholding – if any – will operate after this date (see https://www.gov.uk/government/consultations/deduction-of-income-tax-from-savings-income-implementation-of-the-personal-savings-allowance).

[15] For an assessment of PAYE, see J. Shaw, J. Slemrod and J. Whiting, 'Administration and compliance', in J. Mirrlees, S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles and J. Poterba (eds), *Dimensions of Tax Design: The Mirrlees Review*, Oxford University Press for IFS, Oxford, 2010, http://www.ifs.org.uk/publications/7184 and the associated commentaries by R. Highfield and by B. Mace (same volume).

through the benefit system. Since April 2003, there have been two tax credits in operation – child tax credit and working tax credit. Both are based on family (as opposed to individual) circumstances and both are refundable tax credits, meaning that a family's entitlement is payable even if it exceeds the family's tax liabilities.

Child tax credit (CTC) provides means-tested support for families with children as a single integrated credit paid on top of child benefit. Families are eligible for CTC if they have at least one child aged under 16, or aged 16–19 and in full-time non-advanced education (such as A levels) or approved training. CTC is made up of a number of elements: a family element of £545 per year, a child element of £2,780 per child per year, a disabled child element worth £3,140 per child per year (payable in addition to the child element) and a severely disabled child element worth £1,275 per child per year (payable in addition to the disabled child element). Entitlement to CTC does not depend on employment status – both out-of-work families and lower-paid working parents are eligible for it – and it is paid directly to the main carer in the family (nominated by the family itself).

Working tax credit (WTC) provides in-work support for low-paid working adults with or without children. It consists of a basic element worth £1,960 per year, with an extra £2,010 for couples and lone parents (i.e. everyone except single people without children). Single claimants working at least 30 hours a week are entitled to an additional £810 payment, as are couples with at least one child who jointly work at least 30 hours with one working at least 16 hours. Lone parents, couples where at least one partner is entitled to carer's allowance, workers over 60 and workers with a disability are eligible for WTC provided at least one adult works 16 or more hours per week. Couples with children are eligible if they jointly work at least 24 hours per week, with one partner working at least 16 hours per week. For those without children or a disability, at least one adult must be aged 25 or over and working at least 30 hours per week to be eligible. There are supplementary payments for disability. In addition, for families in which all adults work 16 hours or more per week, there is a childcare credit, worth 70% of eligible childcare expenditure of up to £175 for families with one child or £300 for families with two or more children (i.e. worth up to £122.50 or £210). The childcare credit is paid directly to the main carer in the family. The rest of WTC is paid to a full-time worker (two-earner couples can choose who receives it); originally, this was done through the pay packet where possible, but this proved rather burdensome for employers, and so since April 2006 all WTC has been paid directly to claimants.

A means test applies to child tax credit and working tax credit together. Currently, families with pre-tax family income below £6,420 per year (£16,105 for families eligible only for CTC) are entitled to the full CTC and WTC payments appropriate for their circumstances. Once family income exceeds this level, the tax credit award is reduced by 41p for every £1 of family income above this level. The main WTC entitlement is withdrawn first, followed by the childcare element of WTC, then the child and disability elements of CTC and finally the family element of CTC. This means that a family without any eligible childcare costs or disabilities will exhaust their entitlement to tax credits once their total income exceeds around £24,200 if they have one child, around £31,000 if they have two children or around £37,750 if they have three children.

HMRC paid out £29.1 billion in tax credits in 2014–15, of which £22.9 billion was CTC and £6.3 billion WTC. Of this, £2.5 billion is counted as negative taxation in the National Accounts, with the remaining £26.5 billion classified as public expenditure.[16] However, many families are paid more (and some less) than their true entitlement over the year, mostly because of administrative errors or because family circumstances changed to reduce their entitlement (e.g. spending on childcare fell) and HMRC did not find out early enough (or did not respond quickly enough) to make the necessary reduction in payments for the rest of the year. The scale of this problem has been reduced since the first two years of operation of CTC and WTC, but HMRC still overpaid between £1.12 billion and £1.41 billion (and underpaid between £0.15 billion and £0.22 billion) in 2013–14.[17,18] As at April 2015, 4.6 million families containing 7.6 million

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[16] Source: HM Revenue & Customs, *Annual Report and Accounts 2014–15*, 2015, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/449343/HMRC_Annual_Report_and_Accounts_2014-15__Web_accessible_version_.pdf.

[17] Source: HM Revenue & Customs, 'Child and working tax credits error and fraud statistics 2013 to 2014', https://www.gov.uk/government/statistics/child-and-working-tax-credits-error-and-fraud-statistics-2013-to-2014.

[18] For more on the operational problems with tax credits and attempts to solve them, see M. Brewer, 'Tax credits: fixed or beyond repair?', in R. Chote, C. Emmerson, R.

children were receiving tax credits (or the equivalent amount in out-of-work benefits). Of these, 2.1 million receive just child tax credit, 0.6 million receive just working tax credit and 1.9 million receive both.[19]

The government is in the process of replacing tax credits (and other means-tested benefits for those of working age) with a unified payment called universal credit. Implementation of the policy has been much delayed, however, and on current plans, roll-out to existing benefit claimants is not expected to begin until January 2018.[20]

3.2 National Insurance contributions (NICs)

National Insurance contributions act like a tax on earnings, but their payment entitles individuals to certain ('contributory') social security benefits.[21] In practice, however, contributions paid and benefits received bear little relation to each other for any individual contributor, and the link has weakened over time. Some contributions (19.6% of the total in 2015–16[22]) are allocated to the National Health Service; the remainder are paid into the National Insurance Fund. The NI Fund is notionally used to finance contributory benefits; but in years when the Fund was not sufficient to finance benefits, it was topped up from general taxation revenues, and in years when contributions substantially exceed outlays (as they have every year since the mid 1990s), the Fund builds up a surplus,

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Harrison and D. Miles (eds), *The IFS Green Budget: January 2006*, IFS Commentary C100, London, 2006, http://www.ifs.org.uk/publications/3552.

[19] HM Revenue & Customs, 'Child and working tax credits statistics, April 2015', 2015, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/423621/ChildandWorkingTaxCreditsStatistics-April_2015.pdf.

[20] For more details on universal credit, see A. Hood and L. Oakley, 'A survey of the GB benefit system', IFS Briefing Note BN13, 2014, http://www.ifs.org.uk/publications/1718.

[21] For details of contributory benefits, see A. Hood and L. Oakley, 'A survey of the GB benefit system', IFS Briefing Note BN13, 2014, http://www.ifs.org.uk/publications/1718.

[22] Source: Appendix 4 of Government Actuary's Department, *Report by the Government Actuary on the Draft Social Security Benefits Up-Rating Order 2015; the Welfare Benefits Up-Rating Order 2015; and the Draft Social Security (Contributions) (Re-Rating and National Insurance Funds Payments) Order 2015*, 2015, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/396524/46187_GAD_s_Up-rating_Report_accessible_v0.2.pdf.

largely invested in gilts: the government is simply lending itself money. These exercises in shifting money from one arm of government to another maintain a notionally separate Fund, but merely serve to illustrate that NI contributions and NI expenditure proceed on essentially independent paths. The government could equally well declare that a fifth of NICs revenue goes towards financing defence spending, and no one would notice the difference.

In 2015–16, NICs are forecast to raise £114.6 billion, the vast majority of which will be Class 1 contributions. Two groups pay Class 1 contributions: employees under the state pension age as a tax on their earnings (primary contributions) and employers as a tax on those under the state pension age they employ (secondary contributions). Class 1 contributions for employers and employees are related to employee earnings (including employee, but not employer, pension contributions), subject to an earnings floor. Until 1999, this floor was the lower earnings limit (LEL). In 1999, the levels at which employees and employers started paying NI were increased by different amounts. The resulting two floors were named, respectively, the primary threshold (PT) and the secondary threshold (ST). The LEL was not abolished, but became the level of income above which individuals are entitled to receive social security benefits previously requiring NI contributions. The rationale was that individuals who would have been entitled to these benefits before 1999 should not lose eligibility because of the overindexation of the NI earnings floor. Between 2001–02 and 2007–08, the PT and ST were aligned at the level of the income tax personal allowance, but further reforms resulted in this alignment being broken.

Employee NICs are paid at a rate of 12% on any earnings between the PT (£155 per week in 2015–16) and the upper earnings limit (UEL, £815 in 2015–16) and at 2% on earnings above the UEL. Employer NICs are paid at a flat rate of 13.8% on earnings above the ST (set at £156 per week in 2015–16), with employers entitled to a rebate of £2,000 or their total employers' NICs liability, whichever is lower.

Since April 2015, employer NICs are charged only on earnings above the UEL for employees under the age of 21. Reduced rates of NICs are also paid by those who have contracted out of the state second pension (formerly the State Earnings-Related Pension Scheme, SERPS) and instead belong to a recognised defined benefit private pension scheme. The percentage levied on earnings between the LEL (£112 per week in 2015–16) and the upper accrual point (UAP, £770 per week in 2015–16) is currently reduced by 1.4 percentage points for employee contributions and by 3.4 percentage points for employer contributions.[23] Note that since the rebate applies from the LEL but contributions start at the PT/ST, there is a small range in between where the NICs rate is negative and so some people receive a net payment from the government. Members of defined contribution pension schemes are (since April 2012) no longer permitted to contract out of the state second pension. The Pensions Act 2014 legislated that a flat-rate pension would be introduced for all who reach the state pension age after April 2016, replacing the two-tiered system. There will no longer be the option of contracting out for defined benefit schemes. Table 2 summarises the Class 1 contribution structure for 2015–16.

Table 2. National Insurance contribution (NIC) rates, 2015–16

Band of weekly earnings (£)	***Employee NICs***		***Employer NICs***	
	Standard rate (%)	*Contracted-out rate (%)*	*Standard rate (%)*	*Contracted-out rate (%)*
0–112 (LEL)	0	0	0	0
112–155/156 (PT/ST)	0	–1.4	0	–3.4
155/156–770 (UAP)	12	10.6	13.8	10.4
770–815 (UEL)	12	12	13.8	13.8
Above 815	2	2	13.8	13.8

Note: Rates shown are marginal rates, and hence apply to the amount of weekly earnings within each band. Contracted-out rate applies to defined benefit pension schemes, i.e. contracted-out salary-related schemes (COSRSs). Members of defined contribution pension schemes – i.e. contracted-out money-purchase schemes (COMPSs) – are not permitted to contract out.
Source: HM Revenue & Customs, https://www.gov.uk/government/publications/rates-and-allowances-national-insurance-contributions.

The self-employed pay two different classes of NI contributions – Class 2 and Class 4. Class 2 contributions are paid at a flat rate (£2.80 per week in 2015–16) by those whose earnings (i.e. profits, since these people are self-employed) exceed the small profits threshold of £5,965. Class 4 contributions are paid at 9% on any profits between the lower profits limit (£8,060 per year in 2015–16) and the upper profits limit (£42,385 per year in 2015–16), and at 2% on profits above the upper profits limit. This regime for the self-employed is much more generous than the Class 1

[23] Before 2009, the contracted-out rebate applied between the LEL and the UEL.

regime, and the self-employed typically pay far less than would be paid by employee and employer combined.

Class 3 NI contributions are voluntary and are usually made by UK citizens living (but not working) abroad in order to maintain their entitlement to benefits when they return. Class 3 contributions are £14.10 per week in 2015–16.[24]

3.3 Value added tax (VAT)

VAT is a proportional tax paid on all sales and is expected to raise £115.9 billion in 2015–16. Before passing the revenue on to HMRC, however, firms may deduct any VAT they paid on inputs into their products; hence it is a tax on the *value added* at each stage of the production process, not simply on all expenditure. The standard rate of VAT has been 20% since 4 January 2011; previously, it was 17.5%. A reduced rate of 5% applies to domestic fuel and power, women's sanitary products, children's car seats, contraceptives, certain residential conversions and renovations, certain energy-saving materials, and smoking cessation products. A number of goods are either zero-rated or exempt. Zero-rated goods have no VAT levied upon the final good, and firms can reclaim any VAT paid on inputs as usual. Exempt goods have no VAT levied on the final good sold to the consumer, but firms cannot reclaim VAT paid on inputs; thus exempt goods are in effect liable to lower rates of VAT. Table 3 lists the main categories of goods that are zero-rated, reduced-rated and exempt, together with estimates of the revenue forgone by not taxing them at the standard rate in 2014–15.

Only firms whose sales of non-exempt goods and services exceed the VAT registration threshold (£82,000 in 2015–16) need to pay VAT. Since April 2002, small firms (defined as those with total sales of no more than £230,000, including VAT, and non-exempt sales of no more than £150,000, excluding VAT, in 2015–16) have had the option of using a simplified flat-rate VAT scheme. Under the flat-rate scheme, firms pay VAT at a single rate on their total sales and give up the right to reclaim VAT on inputs. The

[24] Those living abroad can also pay Class 2 contributions if they were employed or self-employed immediately before leaving the country, have lived in the UK continuously for three years or have three years' worth of contributions in the past, and are employed or self-employed abroad.

Table 3. Estimated costs of zero-rating, reduced-rating and exempting goods and services for VAT revenues, 2014–15

	Estimated cost (£m)
Zero-rating of:	
Food	17,450
Construction of new dwellings*	8,300
Domestic passenger transport	4,450
International passenger transport*	300
Books, newspapers and magazines	1,650
Children's clothing	1,850
Water and sewerage services	2,250
Drugs and supplies on prescription	3,300
Supplies to charities*	300
Certain ships and aircraft	700
Vehicles and other supplies to disabled people	850
Cycle helmets*	10
Reduced rate for:	
Domestic fuel and power	4,800
Women's sanitary products	45
Contraceptive products	10
Children's car seats	20
Smoking cessation products	20
Energy-saving materials*	40
Certain residential conversions and renovations*	300
Exemption of:	
Rent on domestic dwellings*	4,350
Supplies of commercial property*	400
Private education*	3,800
Health services*	2,950
Postal services	200
Burial and cremation	300
Finance and insurance*	4,500
Betting and gaming and lottery duties*	1,850
Exemption for cultural admission charges*	35
Small traders below the turnover limit for VAT registration*	1,900
Total	66,930

* These figures are particularly tentative and subject to a wide margin of error.
Note: The figures for all reduced-rate items are estimates of the cost of the difference between the standard rate of VAT and the reduced rate of 5%.
Source: HMRC statistics, https://www.gov.uk/government/collections/tax-expenditures-and-ready-reckoners.

flat rate, which varies between 4% and 14.5% depending on the industry, is intended to reflect the average VAT rate in each industry, taking into account recovery of VAT on inputs, zero-rating and so on. The intention was that, while some eligible firms would pay more VAT and some would pay less by using the flat-rate scheme, all would gain from not having to keep such detailed records and calculate VAT for each transaction separately. But, in practice, it is not clear how great the administrative savings are, since firms must keep similar records for other purposes and many now make the extra effort of calculating their VAT liability (at least roughly) under both the standard scheme and the flat-rate scheme in order to decide whether it is worth joining (or leaving) the flat-rate scheme.

3.4 Other indirect taxes

Excise duties

Excise duties are levied on three major categories of goods – alcoholic drinks, tobacco and road fuels. They are levied at a flat rate (per pint, per

Table 4. Excise duties, April 2015

Good	*Duty (pence)*	*Total duty as a % of price*	*Total tax as a % of price*[a]
Packet of 20 cigarettes:			
specific duty	379.0	59.3	75.9
ad valorem (16.5% of retail price)	146.2		
Pint of beer	40.7	13.8	30.4
Wine (75cl bottle)	205.0	47.8	64.5
Spirits (70cl bottle)	774.5	47.6	64.2
Unleaded petrol (litre)	58.0	51.5	68.2
Diesel (litre)	58.0	48.7	65.4

[a] Includes VAT.

Note: Assumes beer (bitter) at 3.9% abv, still wine exceeding 5.5% but not exceeding 15% abv, and spirits (whiskey) at 40% abv.

Source: Duty and VAT rates from HMRC, https://www.gov.uk/government/collections/rates-and-allowances-hm-revenue-and-customs#excise-duties. Prices– cigarettes and beer from National Statistics, *Consumer Price Indices*, http://ons.gov.uk/ons/rel/cpi/consumer-price-indices/index.html; wine and spirits from HM Revenue & Customs, *Alcohol Bulletin*, https://www.uktradeinfo.com/Statistics/Pages/Statistics.aspx, uprated to April 2015 prices from 2012 prices using wine and spirits RPI sub-index from National Statistics, *Consumer Price Reference Tables*, http://ons.gov.uk/ons/rel/cpi/consumer-price-indices/july-2015/stb-cpi-july-2015.html; petrol and diesel from table 4.1.1 of Department of Energy and Climate Change, *Quarterly Energy Prices*, https://www.gov.uk/government/collections/quarterly-energy-prices.

litre, per packet etc.); tobacco products are subject to an additional *ad valorem* tax of 16.5% of the total retail price (including the flat-rate duty, VAT and the *ad valorem* duty itself). Table 4 shows the rates of duties levied since April 2015.

Since flat-rate duties are expressed in cash terms, they must be revalorised (i.e. increased in line with inflation) each year in order to maintain their real value. However, unlike benefit payments and direct tax thresholds, excise duties are by default increased in line with the Retail Prices Index (RPI). This is a discredited measure of inflation that was stripped of its National Statistic status in 2013 because of its flaws.

Excise duties are forecast to raise £46.9 billion in 2015–16.

Vehicle excise duty and road user levy

In addition to VAT and excise duties, revenue is raised through a system of licences. The main licence is vehicle excise duty (VED), levied annually on road vehicles. For cars and vans registered before 1 March 2001, there are two bands based on engine size. VED is £145 per vehicle for vehicles with engines not over 1,549cc; above this size, VED is £230. Cars and vans registered on or after 1 March 2001 are subject to a different VED system based primarily on carbon dioxide emissions. For petrol cars or vans, VED ranges from zero for vehicles emitting up to 100g of carbon dioxide per kilometre to £290 for vehicles emitting more than 200g of carbon dioxide per kilometre (g/km). Vehicles registered since 23 March 2006 that emit more than 225g/km are liable for even higher rates: £490 for those emitting between 226g/km and 255g/km and £505 for those emitting more than 255g/km. Different VED rates apply for newly-registered cars for the first year of ownership; they are more heavily graduated according to the vehicle's emissions, ranging from zero for vehicles emitting 130g of carbon dioxide per kilometre or less to £1,100 for those emitting more than 255g/km. Different rates also apply for alternative-fuel vehicles and for other types of vehicles, such as motorbikes, caravans and heavy goods vehicles.

Cars newly registered from 1 April 2017 will face different rates again, with only those cars emitting 0g/km exempt (as opposed to those emitting less than 100g/km). Cars with a list price in excess of £40,000 will also be subject to a £310 supplement for five years.

In 2015–16, VED is forecast to raise £5.6 billion.

Insurance premium tax (IPT)

Insurance premium tax came into effect in October 1994 as a tax on general insurance premiums. It is designed to act as a proxy for VAT, which is not levied on financial services because of difficulties in implementation. IPT is payable on most types of insurance where the risk insured is located in the UK (e.g. motor, household, medical and income replacement insurance) and on foreign travel insurance if the policy lasts for less than four months. Long-term insurance (such as life insurance) is exempt. Since 1 November 2015, IPT has been levied at a standard rate of 9.5% of the gross premium; previously, the standard rate had been 6%. If, however, the policy is sold as an add-on to another product (e.g. travel insurance sold with a holiday, or breakdown insurance sold with vehicles or domestic appliances), then IPT is charged at a higher rate of 20%. This prevents insurance providers from being able to reduce their tax liability by increasing the price of the insurance (which would otherwise be subject to insurance premium tax at 9.5%) and reducing, by an equal amount, the price of the good or service (subject to VAT at 20%).

Insurance premium tax is forecast to raise £3.5 billion in 2015–16.

Air passenger duty (APD)

On 1 November 1994, an excise duty on air travel from UK airports came into effect, with flights from the Scottish Highlands and Islands exempt. Following recent reforms, the rate of tax to be paid depends on the distance between London and the capital city of the destination country or territory and on the class of travel of the passenger, as shown in Table 5. Since 1 November 2011, flights from Northern Ireland pay the lowest rate

Table 5. Air passenger duty rates, April 2015

Distance between London and capital city of destination country or territory	*Standard rate (per passenger)*	*Reduced rate (per passenger)*
0–2,000 miles	£26	£13
More than 2,000 miles	£142	£71

Note: Reduced rate applies for travel in the lowest class of travel available on the aircraft. Standard rate applies for travel in any other class of travel. However, if a class of travel provides for seating in excess of 1.016 metres (40 inches), then the standard (rather than the reduced) rate of APD applies. Since January 2013, APD on direct flights from Northern Ireland longer than 2,000 miles has been devolved to the Northern Ireland Executive and is set at £0.
Source: HM Revenue & Customs, https://www.gov.uk/government/publications/rates-and-allowances-excise-duty-air-passenger-duty.

of tax irrespective of the destination. APD will be abolished for children under 16 from March 2016.

Air passenger duty is forecast to raise £3.1 billion in 2015–16.

Landfill tax

Landfill tax was introduced on 1 October 1996. It is currently levied at two rates: a lower rate of £2.60 per tonne for disposal to landfill of inactive waste (waste that does not decay or contaminate land) and a standard rate of £82.60 per tonne for all other waste. The government set a floor below which the standard rate cannot fall of £80 per tonne in 2014–15, which will rise in line with the RPI until 2019–20.[25]

Landfill tax is forecast to raise £1.0 billion in 2015–16.

Climate change levy

The climate change levy (CCL) came into effect on 1 April 2001. It is charged on industrial and commercial use of electricity, coal, natural gas and liquefied petroleum gas, with the tax rate varying according to the type of fuel used. The levy was designed to help the UK move towards the government's domestic goal of a 20% reduction in carbon dioxide emissions between 1990 and 2010. In 2015–16, the rates are 0.554 pence per kilowatt-hour for electricity, 0.193 pence per kilowatt-hour for natural gas, 1.240 pence per kilogram for liquefied petroleum gas (LPG) and 1.512 pence per kilogram for coal. The tax does not apply to fuels used in the transport sector.

In 2013, a carbon price floor (CPF) was introduced to extend the CCL to fuels used for electricity generation, which were previously exempt. In 2015–16, the CPF is set at £18.08 per tonne of CO_2 produced, and it will fall to £18.00 per tonne of CO_2 from April 2016 to April 2020, with generators in Northern Ireland exempt.[26] The levy was also (inexplicably) extended to renewable-source electricity from 1 August 2015.

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[25] Legislated for in the Scotland Act 2013, this tax is now devolved to the Scottish Parliament, yet operates on the same system.

[26] The carbon price floor effectively charges 0.334 pence per kWh for gas, 5.307 pence per kilogram for LPG and 4.597 pence per kilogram for coal, substantially higher than the main CCL rates.

Energy-intensive sectors that have concluded climate change agreements that meet the government's criteria are charged a reduced rate equal to 10% of the standard climate change levy for electricity and 35% for all the other fuels.

The levy (including the CPF) is forecast to raise £2.3 billion in 2015–16.

Aggregates levy

Aggregates levy is a tax on the commercial exploitation of rock, sand and gravel (e.g. their removal from the originating site or their use in construction). The levy was introduced in April 2002 to reduce the environmental costs associated with quarrying. In 2015–16, it is charged at a rate of £2 per tonne and is forecast to raise £0.3 billion.

Betting and gaming duties

Until October 2001, most gambling was taxed as a percentage of the stakes laid. Since then, however, general betting duty (and pool betting duty for pool betting) has been charged at 15% of gross profits for all bookmakers and the Horserace Totalisator Board (the Tote), except for spread betting, where a rate of 3% for financial bets and 10% for other bets is applied. Pool betting duty is also charged at 15% of gross profits and bingo duty at 10% of gross profits on those activities. In all cases, 'gross profits' means total stakes (and any participation fees for bingo) minus winnings paid.

Gaming duty, which replaced gaming licence (premises) duty on 1 October 1997, is based on the 'gross gaming yield' for each establishment where dutiable gaming takes place. The gross gaming yield is money gambled minus winnings paid: this consists of the total value of the stakes, minus players' winnings, on games in which the house is the banker, and participation charges, or 'table money', exclusive of VAT, on games in which the bank is shared by players. Gaming duty is levied at marginal rates of between 15% and 50% according to the amount of gross gaming yield.

Since December 2014, gambling and gaming activity has been taxed on a 'point of consumption' basis, meaning that it is the location of the gambler rather than the operator that will determine the tax liability. Remote gaming operators, such as online gaming websites, offering gaming services to customers living in the UK are liable to pay gaming duty on those profits.

Duties on betting and gaming are forecast to raise £2.6 billion in 2015–16.

3.5 Capital taxes

Capital gains tax (CGT)

Capital gains tax was introduced in 1965 and is levied on gains arising from the disposal of assets by individuals and trustees. Capital gains made by companies are subject to corporation tax. The total capital gain is defined as the value of the asset when it is sold (or given away etc.) minus its value when originally bought (or inherited etc.). As with income tax, there is an annual threshold below which capital gains tax does not have to be paid. In 2015–16, this 'exempt amount' is £11,100 for individuals and £5,550 for trusts. It is subtracted from total capital gains to give taxable capital gains. Taxable capital gains are taxed at a rate of 18% for basic-rate taxpayers and 28% for higher- and additional-rate taxpayers, subject to certain exemptions and reliefs outlined below.

The key exemption from CGT is gains arising from the sale of a main home. Private cars and certain types of investment (notably those within pension funds or ISAs) are also exempt. Transfers to a spouse or civil partner and gifts to charity do not trigger a CGT liability: in effect, the recipient is treated as having acquired the asset at the original purchase price. Gains made by charities themselves are generally exempt. CGT is 'forgiven' completely at death: the deceased's estate is not liable for tax on any increase in the value of assets prior to death, and those inheriting the assets are deemed to acquire them at their market value at the date of death. This is partly because estates may instead be subject to inheritance tax (see below).

Entrepreneurs' relief reduces the rate of CGT to 10% on the first £10 million of otherwise taxable gains realised over an individual's lifetime.[27] These eligible assets are shares owned by employees or directors of firms who have at least 5% of the shares and voting rights, unincorporated businesses and business assets sold after the closure of a business.

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[27] Entrepreneurs' relief applied up to a lower limit for assets disposed of up to 5 April 2011. See https://www.gov.uk/government/publications/entrepreneurs-relief-hs275-self-assessment-helpsheet/hs275-entrepreneurs-relief-2015.

It is estimated that, in 2015–16, capital gains tax will raise £6.4 billion. Although this represents only a small proportion of total government receipts, CGT is potentially important as an anti-avoidance measure, as it discourages wealthier individuals from converting a large part of their income into capital gains in order to reduce their tax liability. In 2012–13, approximately 171,000 individuals and trusts paid capital gains tax.[28]

Inheritance tax (IHT)

Inheritance tax was introduced in 1986 as a replacement for capital transfer tax. The tax is applied to transfers of wealth on or shortly before death that exceed a minimum threshold, £325,000 in 2015–16 (and set to remain at this level until March 2021). Inheritance tax is charged on the part of the transfers above this threshold at a single rate of 40% for transfers made on death or during the previous three years, and is normally payable out of estate funds. Since 2012–13, a reduced rate of 36% has applied in cases where more than 10% of a deceased individual's estate is left to charity. Transfers made between three and seven years before death attract a reduced tax rate, while transfers made seven or more years before death are not normally subject to inheritance tax. This is set out in Table 6. Gifts to companies or discretionary trusts that exceed the threshold attract inheritance tax immediately at a rate of 20%, for which the donor is liable; if the donor then dies within seven years, these gifts are taxed again as usual but any inheritance tax already paid is deducted.

Table 6. Inheritance tax reductions for transfers before death, 2015–16

Years between transfer and death	*Reduction in tax rate (%)*	*Actual tax rate (%)*
0–3	0	40
3–4	20	32
4–5	40	24
5–6	60	16
6–7	80	8
7+	100	0

Source: HM Revenue & Customs, https://www.gov.uk/inheritance-tax/gifts.

[28] Source: HM Revenue & Customs, 'Numbers of taxpayers and registered traders', https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/424585/Apr15_Numbertaxpayerstraders_bulletin_v0.1.pdf.

Some types of assets, particularly those associated with farms and small businesses, are eligible for relief, which reduces the value of the asset for tax purposes by 50% or 100% depending on the type of property transferred. All gifts and bequests to charities and to political parties are exempt from inheritance tax. Most importantly, transfers of wealth between spouses and civil partners are also exempt.

Since October 2007, the IHT threshold is increased by any unused proportion of a deceased spouse or civil partner's nil-rate band (even if the first partner died before October 2007). This means that married couples and civil partners can collectively bequeath double the IHT threshold (i.e. £650,000) tax-free even if the first to die leaves their entire estate to the surviving partner. In addition, the July 2015 Budget announced the introduction of a new transferable main residence allowance of £100,000 in 2017–18, rising to £175,000 by 2020–21. The result of this is that the effective IHT threshold for a couple will rise to £1 million as long as their main residence exceeds £350,000 in value.

HMRC estimates that the number of taxpaying death estates in 2014–15 was 35,000, equivalent to around 6.1% of all deaths.[29] The estimated yield from inheritance tax in 2015–16 is £4.2 billion.

Stamp duties

The main stamp duties are levied on securities (share and bond) transactions and on conveyances and transfers of land and property. They are so named because, historically, stamps on documents, following their presentation to the Stamp Office, indicated payment. Nowadays, most transactions do not require a document to be stamped and are not

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[29] Number of taxpaying death estates from HM Revenue & Customs, 'Numbers of taxpayers and registered traders', https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/424585/Apr15_Numbertaxpayerstraders_bulletin_v0.1.pdf. Total number of registered deaths compiled from Office for National Statistics, 'Death registration summary tables, England and Wales', http://www.ons.gov.uk/ons/rel/vsob1/death-reg-sum-tables/index.html, National Records of Scotland, 'Monthly data on births and deaths registered in Scotland', http://www.nrscotland.gov.uk/statistics-and-data/statistics/statistics-by-theme/vital-events/general-publications/weekly-and-monthly-data-on-births-and-deaths/monthly-data-on-deaths-registered-in-scotland and Northern Ireland Statistics & Research Agency, 'Deaths 1887 to 2014', http://www.nisra.gov.uk/demography/default.asp10.htm.

technically subject to stamp duty: since 1986, securities transactions for which there is no deed of transfer (e.g. electronic transactions) have instead been subject to stamp duty reserve tax (SDRT) and, since 2003, land and property transactions have been subject to stamp duty land tax (SDLT). This is essentially a matter of terminology, however: the rates are the same and the term 'stamp duty' is still widely used to encompass SDRT and SDLT. The buyer is responsible for paying the tax.

Table 7. Rates of stamp duty, 2015–16

	Rate (%)
Land and buildings (residential): rate applies to value within band	
Up to and including £125,000	0
Between £125,000 and £250,000	2
Between £250,000 and £925,000[a]	5
Between £925,000 and £1,500,000[a]	10
Above £1,500,000[a]	12
Land and buildings (non-residential): rate applies to entire purchase price	
Up to £150,000[b]	0
Above £150,000 but not exceeding £250,000	1
Above £250,000 but not exceeding £500,000	3
Above £500,000	4
Shares and bonds	0.5

Note: For residential land and buildings, the rate applies to the value of the property within the corresponding band. For non-residential land and buildings and for shares and bonds, the rate applies to the entire purchase price.

[a] A rate of 15% (of the whole purchase price) is applicable for purchases by certain offshore companies and investment vehicles if the price is above £500,000.

[b] A 1% rate is payable if the annual rent on a leasehold property is at least £1,000 even if the purchase price is below £150,000

Source: HM Revenue & Customs, https://www.gov.uk/government/publications/rates-and-allowances-stamp-duty-land-tax and http://www.hmrc.gov.uk/sdrt/intro/sdrtrates.htm.

SDLT is charged at rates of 1, 3 or 4% on non-residential land or property purchased for more than £150,000, with the relevant thresholds and rates shown in Table 7. However, non-residential SDLT is charged on the whole purchase price, including the part below the relevant threshold. This means that a small difference in purchase price can lead to a large change in tax liability. However, since December 2014, SDLT on residential land and property has been structured differently. Rather than applying to the whole purchase price, rates of SDLT are charged only on the amount of the purchase price that falls within that band, as shown in Table 7. No stamp duty is paid on residential land or properties purchased for less than

£125,000, while a rate of 12% is charged on the part of the purchase price above £1.5 million.[30]

For shares and bonds, there is no threshold and stamp duty is levied at 0.5% of the purchase price.

Stamp duties are forecast to raise £14.7 billion in 2015–16, of which £11.5 billion is forecast to come from sales of land and property and £3.2 billion from sales of securities.

3.6 Corporation tax

Corporation tax is charged on the global profits of UK-resident companies, public corporations and unincorporated associations.[31] Firms not resident in the UK pay corporation tax only on their UK profits. The profit on which corporation tax is charged comprises income from trading, investment and capital gains, less various deductions described below. Trading losses may be carried back for one year to be set against profits earned in that period or carried forward indefinitely.[32]

Rates

In 2015–16, corporation tax is charged at a main rate of 20%, due to fall to 19% in 2017–18 and 18% in 2020–21. A reduced rate applies to profits made from exploiting patents that fall within the UK's Patent Box regime. This includes royalty income and sales income earned from a good or

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[30] From April 2015, stamp duty land tax for both residential and non-residential property has been replaced by the land and buildings transaction tax (LBTT) in Scotland. The LBTT duty rates also only apply to the amount of purchase price falling within the applicable band. The threshold below which no LBTT is paid is £145,000; a 2% rate applies up to £250,000, a 5% rate up to £325,000, a 10% rate up to £750,000 and a 12% rate on the portion of the property price above £750,000. Source: http://www.gov.scot/Topics/Government/Finance/scottishapproach/devolvedtaxes/LBTT.

[31] Since 2009, foreign-source dividends arising, for example, from an offshore subsidiary have been exempt from UK tax.

[32] The rules for offsetting trading losses, investment losses and capital losses are complicated. More details can be found in A. Klemm and J. McCrae, 'Reform of corporation tax: a response to the government's consultation document', IFS Briefing Note 30, 2002, http://www.ifs.org.uk/bns/bn30.pdf.

service that makes use of a qualifying patent.[33] The Patent Box regime is being phased in over five years from 2013 (though also applies to past patents, not just those granted after 2013). In 2015–16, companies are only entitled to 80% of the full benefit, increasing to 90% in 2016–17, with the reduced rate of 10% only entering fully into operation in 2017–18.

Tax base and allowances

In broad terms, current expenditure (such as wages, raw materials and interest payments) is deductible from taxable profits, while capital expenditure (such as buildings and machinery) is not. Instead, firms can claim capital allowances to allow for the depreciation of assets over time. Capital allowances may be claimed in the year that they accrue, carried forward to set against future profits or carried back for up to three years. These allowances generally reduce taxable profits over several years by a proportion of capital expenditure, although the precise structure (and generosity) of allowances varies by class of asset:

- The annual investment allowance allows a firm to fully write off a certain amount of plant and machinery investment against taxable profits immediately (£500,000 in the 12 months to January 2016, but due to fall to £200,000 from January 2016). Plant and machinery expenditure above this allowance is 'written down' on an 18% declining-balance basis.[34]
- Expenditure on commercial buildings, industrial buildings and hotels may not be written down at all. However, fixtures that are integral to a building can be written down on an 8% straight-line basis.
- Intangible assets expenditure incurred before 8 July 2015 is written down on a straight-line basis at either the accounting depreciation rate or a rate of 4%, whichever the company prefers. Expenditure incurred after this date is not eligible for a deduction.

[33] There is a relatively complex three-stage process for calculating the Patent Box tax base. For further details, see L. Evers, H. Miller and C. Spengel, 'Intellectual property box regimes: effective tax rates and tax policy considerations', *International Tax and Public Finance*, 2015, 22, 502–30.

[34] The declining-balance method means that for each £100 of investment, taxable profits are reduced by £18 in the first year (18% of £100), £14.76 in the second year (18% of the remaining balance of £82) and so on. The straight-line method with an 8% rate simply reduces profits by £8 per year for 12½ years for each £100 of investment.

- Capital expenditure on plant, machinery and buildings for research and development (R&D) is treated more generously: under the R&D allowance, it can all be written off against taxable profits immediately.

Current expenditure on R&D, like current expenditure in general, is fully deductible from taxable profits. However, there is now additional tax relief available for current R&D expenditure. For small and medium-sized companies, there is a two-part tax credit, introduced in April 2000. The first part is called R&D tax relief and currently applies at a rate of 130% (allowing companies to deduct a total of 230% of qualifying expenditure from taxable profits, since R&D expenditure is already fully deductible). The second part is a refundable tax credit, which is only available to firms with negative profit after the credit is taken into account. Firms can give up the right to offset losses equivalent to 230% of their R&D expenditure (or to offset their total losses, if these are smaller) against future profits, in return for a cash payment of 11% of the losses given up.

An R&D tax credit for large companies was introduced in April 2002. This credit applies at a rate of 30%, allowing 130% of qualifying expenditure to be deducted from taxable income. However, this will be replaced by an above-the-line tax credit from April 2016 (and offered alongside it as an alternative option until then). Rather than reducing the tax base by 30% of qualifying expenditure, the new regime provides a taxable credit of 10% of R&D expenditure to be used against the overall corporate tax liability.[35] This credit will be repayable such that companies without sufficient profits will be able to benefit, with the value of the repayable credit capped at the PAYE and NICs liabilities of the claimant company with respect to the R&D staff cost included in the claim.[36]

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[35] The credit is taxable, such that when the main rate is 20% the value of the 10% credit will be 8% of R&D expenditure. For a more detailed examination of the above-the-line R&D credit, see the HM Treasury response to the consultation on this issue: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/190280/atl_credit_response111212.pdf. Budget 2013 increased the proposed headline rate from 9.1% to 10%.

[36] The R&D tax credit allows that a loss incurred as a result of the enhanced R&D relief can be carried forward or back in the same way as trading losses for corporate tax purposes. Under the above-the-line credit, if there remains a positive credit above the

Large companies are required to pay corporation tax in four equal instalments on the basis of their anticipated liabilities for the accounting year. Small and medium-sized companies pay their total tax bill nine months after the end of the accounting year.

Corporation tax will raise approximately £43.1 billion in 2015–16.[37]

3.7 Taxation of North Sea production

The current North Sea tax regime has three layers of tax – corporation tax, a supplementary charge and petroleum revenue tax (PRT). All of these taxes are levied on measures of profit, but there are some differences in allowances and permissible deductions.

Corporation tax on North Sea production is ring-fenced, so that losses on the mainland cannot be offset against profits from continental-shelf fields. Until recently, corporation tax for North Sea production was otherwise the same as for onshore production, but important reforms announced in the 2007 Budget and subsequently do not apply to ring-fenced activities: the rate of corporation tax on these activities remains at 30% (or 19% if profits are below £300,000), while capital allowances are more generous than on the mainland.

The supplementary charge is levied on the same base as corporation tax, except that certain financing expenditure is disallowed. The charge was introduced in the 2002 Budget at 10% and is set at 20% in 2015–16.

There are a number of allowances and reliefs available for North Sea companies. A 100% first-year allowance for most capital expenditure and decommissioning relief allows the losses from decommissioning a field to be carried back, carried forward or offset against profits from another field.[38] From 2015–16, the UK Continental Shelf Investment Allowance has replaced a series of field allowances, and allows a further 62.5% of

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PAYE/NICs cap, then this amount can be carried forward and treated as an above-the-line credit in the following accounting period.

[37] Gross of tax credits.

[38] For a more detailed examination of allowances and reliefs, see box 10.3 in H. Miller, 'Corporate tax, revenues and avoidance', in C. Emmerson, P. Johnson and H. Miller (eds), *The IFS Green Budget: February 2013*, IFS Report R74, London, 2013, http://www.ifs.org.uk/publications/6562.

investment expenditure to be deducted from profits, representing a large subsidy for offshore investment (the justification for which is unclear).

Overall, corporation tax receipts from the North Sea (including the supplementary charge) are forecast to be £0.6 billion in 2015–16.

PRT is only payable on oil fields approved before 16 March 1993. It is assessed every six months for each separate oil and gas field and then charged at a rate of 50% on the profits (less various allowances) arising in each chargeable period. It is treated as a deductible expense for both the corporation tax and the supplementary charge. PRT is to be cut to 35% from January 2016 and is forecast to raise a negligible amount in 2015–16.

3.8 Taxation of banks

Reforms in recent years mean that banks are increasingly treated differently from other companies by the tax system. The bank levy – a tax on banks' equity and liabilities – was introduced in January 2011 and is set at 0.21% in 2015–16. Certain forms of equity and liabilities are not counted for the purposes of the levy: mainly, tier 1 capital and liabilities that are insured through the government's depositor protection schemes. The July 2015 Budget also announced that from January 2021, the levy would apply only on UK liabilities rather than worldwide, as currently.

The bank levy is forecast to raise £3.7 billion in 2015–16, but the rate (and revenues) is set to fall gradually each year to January 2021 when it will reach 0.10%. Partly offsetting these reductions, an 8% corporation tax surcharge will be applied to banks' profits from January 2016. This supplementary charge will be applied to the same base as corporation tax, although the first £25 million of profits will be exempt. Additionally, since April 2015 there is (unlike for other companies) a 50% cap on the proportion of taxable profits that banks can offset each year using losses accumulated before 2015.

3.9 Council tax

On 1 April 1993, the community charge system of local taxation (the 'poll tax', levied on individuals) was replaced by council tax, a largely property-based tax. Domestic residences are banded according to an assessment of their market value; individual local authorities then determine the overall level of council tax, while the ratio between rates for different bands is set by central government (and has not changed since council tax was introduced).[39]

Table 8 shows the eight value bands and the percentage of dwellings in England in each band. The council tax rates set by local authorities are usually expressed as rates for a Band D property, with rates for properties in other bands calculated as a proportion of this, as shown in the table. But since most properties are below Band D, most households pay less than the Band D rate; thus, in England, the average Band D rate for 2015–16 is £1,484 but the average rate for all households is only £1,078.[40]

Property bandings in England and Scotland are still based on assessed market values as at 1 April 1991; there has been no revaluation since council tax was introduced. In Wales, a revaluation took effect in April

Table 8. Value bands for England, September 2014

Band	*Tax rate relative to Band D*	*Property valuation as of 1 April 1991*	*Distribution of dwellings by band (%)*
A	$^{2}/_{3}$	Up to £40,000	24.4
B	$^{7}/_{9}$	£40,001 to £52,000	19.6
C	$^{8}/_{9}$	£52,001 to £68,000	21.8
D	1	£68,001 to £88,000	15.4
E	$1^{2}/_{9}$	£88,001 to £120,000	9.5
F	$1^{4}/_{9}$	£120,001 to £160,000	5.0
G	$1^{2}/_{3}$	£160,001 to £320,000	3.5
H	2	Above £320,000	0.6

Source: Department for Communities and Local Government, *Local Authority Council Taxbase – 2014 England*, https://www.gov.uk/government/statistics/council-taxbase-2014-in-england.

[39] Northern Ireland operates a different system: the community charge was never introduced there, and the system of domestic rates that preceded it in the rest of the UK remained largely unchanged – still based on 1976 rental values assessed using evidence from the late 1960s – until April 2007, when a major reform took effect. Domestic rates are now levied as a percentage of the estimated capital value of properties (up to a £400,000 cap) as on 1 January 2005, with the Northern Ireland Executive levying a 'regional rate' (0.4042% in 2015–16) across the whole country and each district council levying a 'district rate' (ranging from 0.2722% to 0.4332% in 2015–16). Reliefs are available for those with low incomes, those with disabilities, and those aged 70 or over living alone, among others. (Source: https://www.dfpni.gov.uk/articles/poundages-2015-2016.)

[40] Source: https://www.gov.uk/government/statistical-data-sets/live-tables-on-council-tax.

2005 based on 1 April 2003 property values, and a ninth band paying $2^1/_3$ times the Band D rate was introduced.

There are various exemptions and reliefs from council tax, which vary by local authority. These include a 25% reduction for properties with only one resident adult (across all local authorities) and discounts of up to 100% for vacant or unoccupied houses.[41] Properties that are exempt from council tax include student halls of residence and armed forces barracks. Low-income families can have their council tax bill reduced or eliminated by claiming council tax support. This is the responsibility of individual councils and replaced council tax benefit (which was set nationally) from April 2013.[42]

Council tax is expected to raise £28.4 billion in 2015–16.

3.10 Business rates

National non-domestic rates, or business rates, are a tax levied on non-residential properties, including shops, offices, warehouses and factories. Firms pay a proportion of the officially estimated market rent ('rateable value') of properties they occupy. In 2015–16, this proportion is set at 49.3% in England and Scotland and 48.2% in Wales,[43] with reduced rates for businesses with a low rateable value:

- In England, businesses with a rateable value below £18,000 (£25,500 in London) are charged a reduced rate of 48.0%. The liability is eliminated entirely (until 31 March 2016, and by 50% thereafter) for businesses with a rateable value not exceeding £6,000, and reduced on a sliding scale for rateable values of between £6,001 and £12,000. Non-

[41] Councils have the power to charge second homes up to 100% of council tax (50% for job-related accommodation) and empty homes 150% (if long-term unoccupied). Some empty properties are entirely exempt from council tax regardless of local authority, e.g. those left empty by patients in hospitals and care homes.

[42] For more information on these reforms, see S. Adam and J. Browne, *Reforming Council Tax Benefit*, IFS Commentary C123, 2012, http://www.ifs.org.uk/publications/6183.

[43] Northern Ireland operates a slightly different system of regional rates (set at 31.86% in 2015–16) and locally-varying district rates (ranging from 19.8031% to 27.7826% in 2015–16). Source: https://www.dfpni.gov.uk/articles/poundages-2015-2016.

residential properties in the City of London pay an additional 0.4% on top of the English standard and reduced rate.

- In Scotland, a reduced rate of 48.0% applies to businesses with a rateable value below £35,000. This is reduced by a further 25% for businesses with a rateable value between £12,001 and £18,000 (or those with multiple properties with a combined rateable value of less than £25,000 where each property's rateable value is £18,000 or less), 50% for rateable values between £10,001 and £12,000, and 100% for rateable values of £10,000 or less.
- In Wales, business rates liability is eliminated entirely for businesses with a rateable value not exceeding £6,000 and reduced on a sliding scale for rateable values of between £6,001 and £12,000 until 31 March 2016. After this date, 50% relief will apply to rateable values up to £2,400 and 25% relief to rateable values between £2,401 and £7,800.

Various other reductions and exemptions exist, including for charities, small rural shops, agricultural land and buildings, and unoccupied buildings (for an initial three-month period, longer in some cases).

The normal valuation cycle runs over a five-year period. Major changes in business rates bills caused by revaluation are phased in through a transitional relief scheme in England. The latest revaluation took effect in April 2010, based on April 2008 rental values. However, the government delayed the next revaluation from 2015 until 2017, citing a desire to avoid 'sharp changes' to rates bills but implying even sharper changes in 2017.

Business rates were transferred from local to national control in 1990. Rates are set by central government (or devolved administrations in Scotland and Wales), and are constrained by legislation from rising by more than RPI inflation. Under the 2011 Localism Act, local authorities in England and Wales are able to grant discretionary rates relief for 'any purpose',[44] in effect giving them broad powers to reduce rates but not to increase them. Local authorities in England and Wales do have powers, subject to certain restrictions, to increase rates by up to 2 percentage points on properties with a rateable value over £50,000, to pay for specific

[44] Subject to conditions such as European state aid rules.

economic development projects.[45] The first, and so far only, use of this additional revenue-raising power was by the Greater London Authority in 2010–11 to pay for the Crossrail project. Small local additions to rates can also be introduced to pay for activities or investments to improve the local business environment, subject to a vote of local ratepayers.[46]

Until recently, revenues were paid into a central pool before being redistributed via grants, meaning that the net income local authorities received bore little relation to the rates revenues raised. Since 2012–13 in Scotland and 2013–14 in England, increased business rate revenues from new developments have been split between local and central government under business rates incentives and retention schemes. For example, local authorities in England can keep up to half of the increase in rates revenues associated with new developments and refurbishments for a period of up to 10 years.[47] Local authorities in Wales do not retain any business rates revenue; it is all pooled and redistributed via grants to local authorities

Moves to allow local authorities across the UK to retain 100% of the increase in business rates revenues associated with new developments by 2020 were proposed at the 2015 Conservative Party conference, alongside reforms to local authorities' powers to reduce and increase rates.[48] The government is set to consult on whether and what mechanisms are required to limit resulting divergences in spending power of different authorities.

Business rates are expected to raise £28.0 billion in 2015–16.

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[45] For instance, if more than one-third of the cost of the project is to be funded by the supplement, a ballot of affected ratepayers must be held. For further details, see https://www.gov.uk/government/publications/business-rates-supplements-guidance.

[46] These areas are termed 'business improvement districts'. For further details, see https://www.gov.uk/guidance/business-improvement-districts.

[47] In practice, a complicated system of 'tariffs', 'top-ups', 'levies' and 'safety nets' serves to limit the gains and losses from business rates for individual local authorities.

[48] https://www.gov.uk/government/news/chancellor-unveils-devolution-revolution.

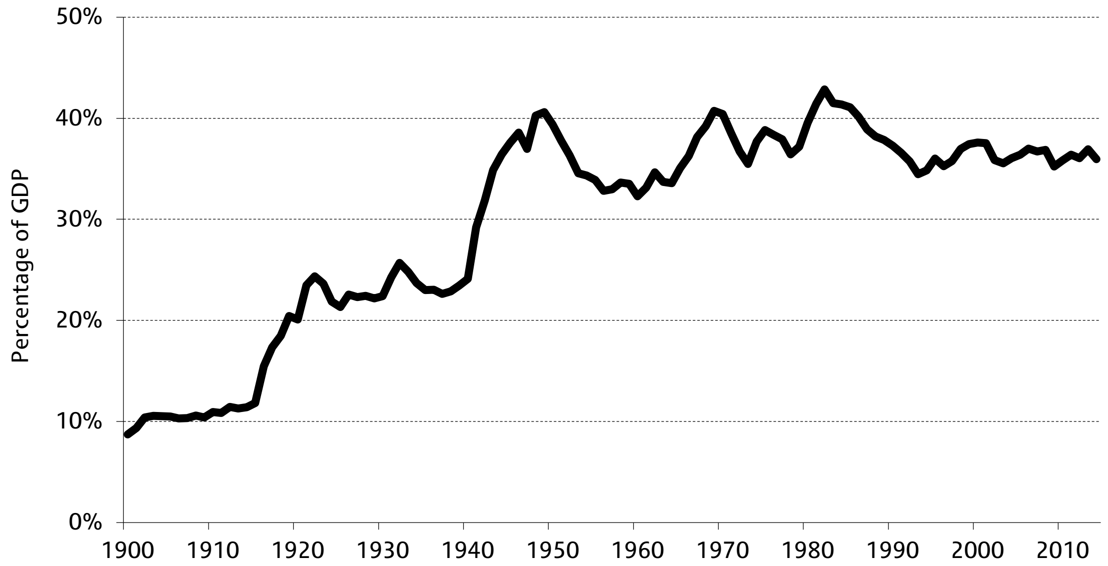
4. Summary of recent trends

4.1 How did we get here?

In previous sections, we have concentrated on the tax system in the UK as it is now; in this section, we discuss its development over recent decades. We describe and assess the major trends, looking at each part of the tax system in turn. We begin with a summary of the main changes and a description of the shifting balance of revenue.

Figure 1 shows the long-term trend in government revenues since 1900. There were sharp increases in government receipts at the times of the two world wars, as might be expected given the extra expenditure required; but in each case, taxation did not fall back to its pre-war level afterwards. Receipts rose sharply as a proportion of national income in the late 1960s, were highly volatile in the 1970s (partly reflecting large fluctuations in economic growth), fell steadily as a proportion of national income from the early 1980s until the mid 1990s and have remained fairly constant at just below 40% of GDP ever since.[49]

Figure 1. Government receipts as a percentage of GDP, 1900–2014



Note: Figures are for general government net receipts on a calendar-year basis.
Source: T. Clark and A. Dilnot, *Long-Term Trends in British Taxation and Spending*, IFS Briefing Note BN25, 2002, http://www.ifs.org.uk/bns/bn25.pdf; National Statistics series YBHA and ANBY.

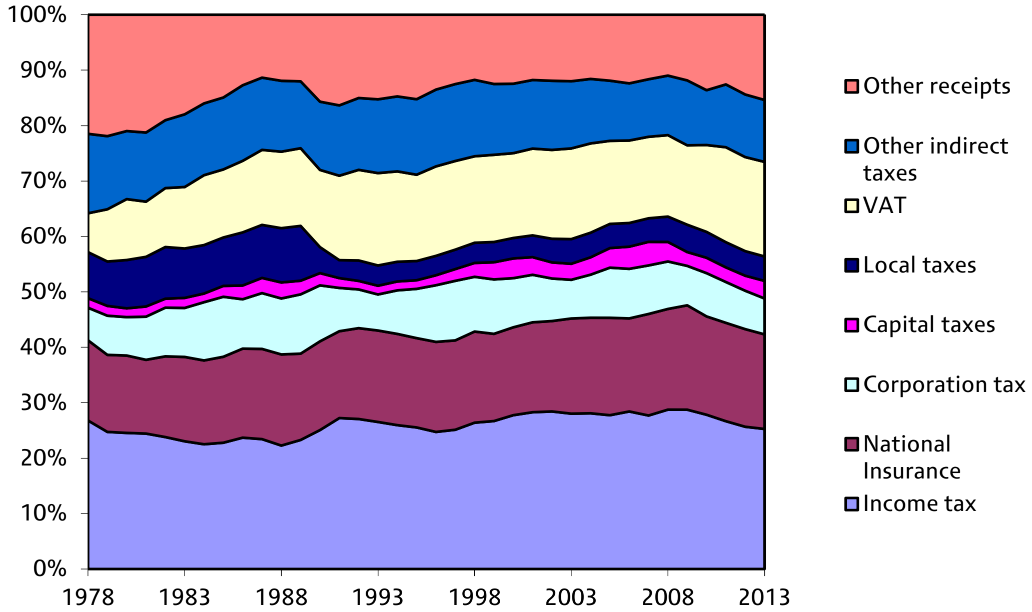
[49] For further information, see T. Clark and A. Dilnot, *Long-Term Trends in British Taxation and Spending*, IFS Briefing Note BN25, 2002, http://www.ifs.org.uk/bns/bn25.pdf.

Table 9. Summary of main reforms, 1979–2015

Income tax	Basic rate cut from 33% to 20% Top rate 98% (unearned income), 83% (earnings) cut to 40% then raised to 45% via 50% Starting rate abolished, reintroduced and abolished again Independent taxation introduced Married couple's allowance abolished, transferable marriage allowance introduced Children's tax credit and working families' tax credit introduced, then abolished Child tax credit and working tax credit introduced Mortgage interest tax relief abolished Life assurance premium relief abolished PEP, TESSA and ISA introduced
National Insurance	Employee contribution rate increased from 6.5% to 12% Ceiling abolished for employer contributions Ceiling for employees raised and contributions extended beyond it 'Entry rate' abolished Imposition of NI on benefits in kind Employers' allowance introduced
VAT	Higher rate of 12.5% abolished Standard rate increased from 8% to 20% Reduced rate introduced for domestic fuel and a few other goods
Other indirect taxes	Large real increase in duties on road fuels and tobacco Real decrease in duties on wine and spirits, little change for beer Graduated rates of vehicle excise duty based on engine size and carbon emissions introduced Air passenger duty, landfill tax, climate change levy and aggregates levy introduced
Capital taxes	Indexation allowance and then taper relief for capital gains introduced and then abolished Capital gains tax rates aligned with income tax rates, returned to flat rate, then higher rate for higher-rate taxpayers reintroduced Capital transfer tax replaced by inheritance tax Graduated rates of stamp duty abolished then reintroduced Structure of residential stamp duty reformed Stamp duty on shares and bonds cut from 2% to 0.5%
Corporation tax	Main rate cut from 52% to 20% Small companies' rate cut from 42% to main rate at 20% Lower rate introduced, cut to 0%, then abolished R&D tax credits introduced 100% first-year allowance replaced by 20% writing-down allowance Advance corporation tax and refundable dividend tax credit abolished Patent Box introduced
Local taxes	Domestic rates replaced by council tax (via poll tax) Locally-varying business rates replaced by national business rates

Note: PEP = Personal Equity Plan; TESSA = Tax-Exempt Special Savings Account; ISA = Individual Savings Account.

Figure 2. The composition of government receipts, 1978–79 to 2013–14



Note: Years are fiscal years, so 2008 means 2008–09. 'National Insurance' excludes NI surcharge when it existed, and 'VAT' is net of refunds paid to other parts of central and local government; these are both included in 'other receipts'. 'Other indirect taxes' are excise duties, environmental taxes and customs duties. 'Corporation tax' includes petroleum revenue tax, the supplementary charge and the 1997–98 windfall tax. 'Capital taxes' are capital gains tax, inheritance tax (and its predecessors) and stamp duties. 'Local taxes' are council tax, the community charge, domestic rates and business rates before 1990; from 1990, business rates are included in 'other receipts'.
Source: HM Treasury; see http://www.ifs.org.uk/tools_and_resources/fiscal_facts.

Table 9 lists some of the most important changes seen since 1979.[50] It is clear that the tax system is now very different from the one that existed then. The income tax rate structure has been transformed, the taxation of savings has been repeatedly adjusted, the National Insurance contributions system has been overhauled, the VAT rate has more than doubled, some excise duty rates have risen sharply while others have fallen, the corporate income tax system has been subject to numerous reforms, and local taxation is unrecognisable. Figure 2 shows the effect that these changes have had on the composition of aggregate government revenue.

The shares of revenue provided by different taxes have been remarkably stable since the mid 1990s. The principal change has been in the

[50] For a timeline of the main tax changes introduced in each Budget since 1979, see http://www.ifs.org.uk/ff/budget_measures.xls.

contribution of corporation tax, which has risen, fallen and then risen again. This largely reflects the changing fortunes of financial companies, whose profits were strong in the late 1990s, weaker thereafter, but then stronger again until the recession that began in 2008–09. The share of revenue coming from indirect taxes has fallen since the late 1990s, mainly because fuel duties have been cut substantially in real terms. Revenue from capital taxes increased during the period of booming stock and property markets, helped by the introduction of higher rates of stamp duty on property, but still only accounted for 4.25% of total revenue in 2007–08 before falling again in the slump in stock and property markets that began in late 2007.

There have been much bigger changes over the whole period. The most dramatic shifts have been a doubling of the share of revenue flowing from VAT and a substantial reduction in revenue from other indirect taxes. This pattern is mirrored across the developed world, with governments moving away from taxes levied on specific goods towards general consumption taxes such as VAT. The proportion of taxes raised locally has halved, largely because business rates have moved from local to national control. The share of revenue from income tax has remained virtually unchanged, despite radical structural changes.

4.2 Personal income taxes

There are two principal personal income taxes in the UK: income tax and National Insurance contributions. Capital gains tax, which has existed as a tax separate from income tax since 1965, can also be thought of as a tax on personal income, but it supplies very little revenue compared with income tax or National Insurance (see Table 1).

Income tax rate structure

The most dramatic change to income tax has been the reform of the rate structure, as illustrated in Table 10. In 1978–79, there was a starting rate of 25%, a basic rate of 33% and higher rates ranging from 40% to 83%. In addition, an investment income surcharge of 15% was applied to those with very high investment income, resulting in a maximum income tax rate of 98%. In its first Budget, in 1979, the Conservative government reduced the basic rate of income tax to 30% and the top rate on earnings to 60%. In 1980, the starting rate was abolished; in 1984, the investment income surcharge was abolished; and through the mid 1980s, the basic rate of tax was reduced. In 1988, the top rate of tax was cut to 40% and the basic rate to 25%, producing a very simple regime with three effective rates – zero up to the tax allowance, 25% over a range that covered almost 95% of taxpayers and 40% for a small group of those with high incomes.

Table 10. Income tax rates on earned income, 1978–79 to 2015–16

	Starting rate	*Basic rate*	*Higher rates*
1978–79	25	33	40–83
1979–80	25	30	40–60
1980–81 to 1985–86	—	30	40–60
1986–87	—	29	40–60
1987–88	—	27	40–60
1988–89 to 1991–92	—	25	40
1992–93 to 1995–96	20	25	40
1996–97	20	24	40
1997–98 to 1998–99	20	23	40
1999–2000	10	23	40
2000–01 to 2007–08	10	22	40
2008–09 to 2009–10	—	20	40
2010–11 to 2012–13	—	20	40–50
2013–14 to 2015–16	—	20	40–45

Note: Prior to 1984–85, an investment income surcharge of 15% was applied to unearned income over £2,250 (1978–79), £5,000 (1979–80), £5,500 (1980–82), £6,250 (1982–83) and £7,100 (1983–84). Different tax rates have applied to dividends since 1993–94 and to savings income since 1996–97. The basic rate of tax on savings income has been 20% since 1996–97, while the 10% starting rate (which was largely abolished in 2008–09) continued to apply to some savings income until April 2015. The basic rate of tax on dividends was 20% from 1993–94 to 1998–99 and has been 10% since 1999–2000, when the higher rate of tax on dividends became 32.5%. However, an offsetting dividend tax credit means that the effective tax rates on dividends have been constant at zero (basic rate) and 25% (higher rate) since 1993–94. The additional tax rate on dividend income has been 37.5% since 2014–15, which is an effective rate of 30.56% once the dividend tax credit is taken into account. When calculating which tax band different income sources fall into, dividend income is treated as the top slice of income, followed by savings income, followed by other income.
Source: *Tolley's Income Tax*, various years.

This very simple rate structure was complicated by the reintroduction of a 20% starting rate of tax in 1992 (in a pre-election Budget), cut to 10% in 1999 (fulfilling a pre-election promise made by the Labour Party). Budget 2007 announced the abolition again of the starting rate from 2008–09 to pay for a cut in the basic rate. The abolition of the starting rate proved highly controversial because many low-income families lost out (although many more potential losers were protected by other reforms announced at the same time). As a result, the government announced in May 2008 that it would increase the tax-free personal allowance for 2008–09 by £600, compensating most of those losing from the reform.[51]

Reforms announced by Alistair Darling in the 2008 Pre-Budget Report and Budget 2009 resulted in a considerable complication of the income tax rate structure for those on the highest incomes. Since 2010–11, the personal allowance has been withdrawn from those with incomes greater than £100,000, creating a band of income in which income tax liability increases by 60 pence for each additional pound of income (see Section 3.1); and incomes above £150,000 are taxed at a rate of 45%.

Table 11. Personal allowance and basic-rate limit in real terms (April 2015 prices)

	Personal allowance (£ p.a.)	*Basic-rate limit (£ p.a.)*
1979–80	5,536	47,517
1984–85	5,836	44,822
1989–90	6,286	46,724
1994–95	6,164	42,404
1999–2000	6,770	43,729
2004–05	6,592	43,625
2009–10	7,899	45,623
2014–15	10,090	32,152
2015–16	10,600	31,785

Note: 1990 marked the introduction of independent taxation. Prior to that date, the personal allowance was known as the single person's allowance. For a complete series of allowances in nominal terms, see http://www.ifs.org.uk/ff/income.xls.
Source: HM Revenue & Customs, https://www.gov.uk/government/collections/tax-structure-and-parameters-statistics; RPI used to uprate to April 2015 prices using Office for National Statistics, *Consumer Price Indices* reference sheet, http://ons.gov.uk/ons/rel/cpi/consumer-price-indices/july-2015/stb-cpi-july-2015.html.

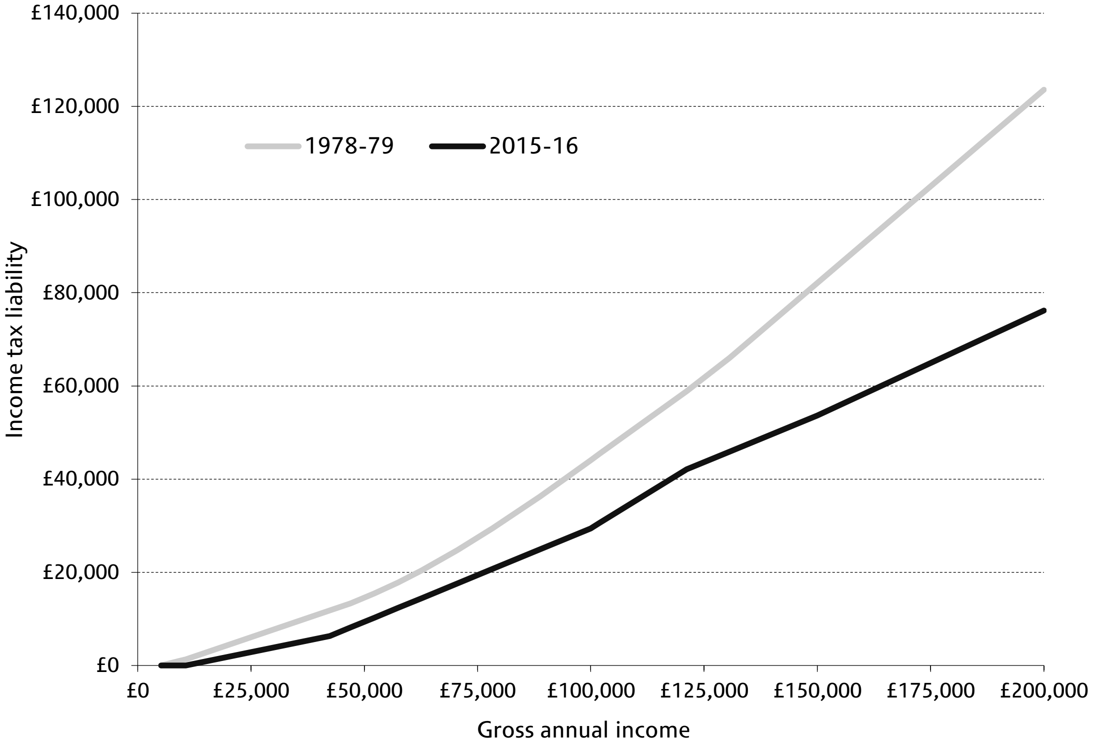
The income levels to which the various tax rates apply have changed significantly, as shown in Table 11. Over the period as a whole, the basic-rate limit, beyond which higher-rate tax becomes due, has failed to keep

[51] The basic-rate limit was correspondingly reduced to eliminate any gain from the increased personal allowance for higher-rate taxpayers. The personal allowance was increased only for under-65s; an increase in the allowances for those aged 65 and over was part of the original package announced in Budget 2007. For analysis of these reforms, see S. Adam, M. Brewer and R. Chote, 'The 10% tax rate: where next?', IFS Briefing Note BN77, 2008, http://www.ifs.org.uk/bns/bn77.pdf.

pace with price inflation, whilst the personal allowance has risen in real terms. Both of these have been particularly true in recent years.

The overall effect of rate, allowance and threshold changes on the shape of the income tax schedule is shown in Figure 3, with 1978–79 values expressed in April 2015 prices for ease of comparison.

Figure 3. Income tax schedule for earned income, 1978–79 and 2015–16



Note: 1978–79 thresholds have been uprated to April 2015 prices using the RPI. Assumes individual is aged under 65, unmarried and without children.
Source: HM Treasury, *Financial Statement and Budget Report*, various years; *Tolley's Income Tax*, various years;
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/418669/Table-a2.pdf.

Table 12 gives the numbers of people affected by these various tax rates. In 2015–16, out of an adult population in the UK of around 52.8 million, an estimated 29.7 million individuals will be liable for income tax. This is a reminder that attempts to use income tax reductions to help the poorest in the country are likely to fail, since less than two-thirds of the adult population have high enough incomes to pay income tax at all.[52]

[52] We might be more interested in the proportion of adults who live in a family containing a taxpayer. Authors' calculations using the IFS tax and benefit model, TAXBEN, run on data from the Family Resources Survey, suggest that this figure stood

Table 12. Numbers liable for income tax (thousands)

	Number of individuals paying tax	*Number of starting-rate taxpayers*	*Number of basic-rate taxpayers*[a]	*Number of higher-rate taxpayers*[b]
1979–80	25,900	—[c]	25,226[c]	674
1984–85	23,800	—	22,870	930
1989–90	25,600	—	24,040	1,560
1994–95	25,300	5,180	18,200	2,000
1999–2000	27,200	2,280	22,354	2,510
2004–05	30,300	3,570	23,333	3,330
2009–10	30,600	163[e]	27,202	3,190
2014–15[d]	29,800	205[e]	24,818	4,782
2015–16[d]	29,700	—	24,691	4,982

[a] Includes those whose only income above the starting-rate limit is from savings or dividends.
[b] Includes additional-rate taxpayers from 2010–11.
[c] Figure for 1979–80 covers both starting-rate and basic-rate taxpayers.
[d] Projected.
[e] From 2008–09, the starting rate applies only to savings income that is below the starting-rate limit when counted as the top slice of taxable income (except dividends).
Source: HM Revenue & Customs, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/306826/Table_2.1.pdf; table 2.1, *Inland Revenue Statistics 1994*.

The number of higher- and additional-rate taxpayers has grown quickly over the last 30 years or so, from less than 3% of the taxpaying population in 1979–80 to around 17% in 2015–16. Some of this growth reflects periods when the threshold above which higher-rate tax is due has not been raised in line with price inflation, some reflects the fact that incomes on average have grown more quickly than prices, and some the fact that the dispersion of incomes has grown, with especially rapid increases in the incomes of those already towards the top of the income distribution, pushing more of them into higher-rate income tax liability. The number of starting-rate taxpayers climbed in the years after 1992 as the width of the starting-rate band was increased, but it fell sharply in 1999–2000 as the 10% rate applied over a much narrower range of income than the 20% rate that it replaced. The abolition of the starting rate for non-savings income in 2008–09 massively reduced the number of starting-rate taxpayers, before it was abolished for savings income too in 2015–16.

at 72% for Britain in 2013–14 (the latest year for which data are available): most non-taxpaying adults do not have taxpayers in the family.

Although less than 17% of income taxpayers face higher rates of income tax, that group pays a very large share of the total amount of income tax that is paid. Table 13 shows that the top 10% of income taxpayers now pay over half of all the income tax paid, and the top 1% (most of whom face the additional 45% marginal tax rate) pay 28% of all that is paid. These shares have risen substantially since 1978–79, despite lower top tax rates.

Table 13. Shares of total income tax liability (%)

	Top 1% of income taxpayers	*Top 10% of income taxpayers*	*Top 50% of income taxpayers*
1978–79	11	35	82
1981–82	11	35	81
1986–87	14	39	84
1990–91	15	42	85
1994–95	17	45	87
1999–2000	21	50	88
2004–05	21	51	89
2009–10	27	55	89
2014–15[a]	27	58	90
2015–16[a]	28	59	91

[a] Projected.

Source: HM Revenue & Customs, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/306831/Table_2.4.pdf; various *Inland Revenue Statistics*.

The treatment of families

Prior to 1990, married couples were treated as a single unit for income tax purposes. The 1970 Income and Corporation Taxes Act (in)famously announced that, for the purposes of income tax, 'a woman's income chargeable to tax shall … be deemed to be her husband's income and not her income'. Reflecting the 'responsibilities' taken on at marriage, the tax system also included a married man's allowance (MMA). The system had developed over many decades and was widely felt to be unpalatable; a consensus emerged that a new system, neutral in its treatment of men and women, should be introduced. This was a widely-held view by the late 1970s but, despite a series of Green Papers, proved difficult to implement. While equal treatment for men and women was easy to agree upon, it was not easy to agree whether equal treatment should be given to married and unmarried people.

In his 1986 Budget Speech, the then Chancellor, Nigel Lawson, published a Green Paper suggesting that the UK should move to a system of 'transferable allowances', where spouses, regardless of whether husband or wife, could transfer unused allowances between themselves. Two years later, in his 1988 Budget Speech, before the previous proposals had been implemented, he announced the introduction in 1990 of a completely different system. The new system was based on the principle of independent taxation of husbands and wives, but included a married couple's allowance (MCA), which was available to either husband or wife. This established equal treatment of men and women, but not of married and unmarried people. In fact, married and unmarried people with children had been treated equally since 1973 through the additional personal allowance (APA), an allowance for unmarried people with children, which was set equal to the MMA and then the MCA; but unequal treatment persisted for those without children.

Between 1993 and 2000, the MCA and APA were reduced in value, and they were eventually abolished in April 2000 (except the MCA for people aged 65 or over at that date). A year later, children's tax credit was introduced, reducing the tax liability of those with children by a flat-rate amount (tapered away for higher-rate taxpayers) but making no distinction between married and unmarried people. Meanwhile, in-work support for low-paid families with children was brought within the tax system when working families' tax credit (WFTC) replaced family credit from October 1999.[53] Children's tax credit and WFTC (along with parts of some state benefits) were replaced in April 2003 by child tax credit and working tax credit (see Section 3.1), neither of which depends on marriage, and universal credit, which is due to replace these tax credits, will not change this feature. The UK income tax system therefore moved away from providing support for marriage and towards providing support for children over a 30-year period. Reforms introduced since 2010 have reintroduced an element of family taxation, albeit without a clearly articulated view of what roles individuals' and couples' circumstances should each play. There is a much wider, principled debate about the role of joint versus individual assessment that has not been had.

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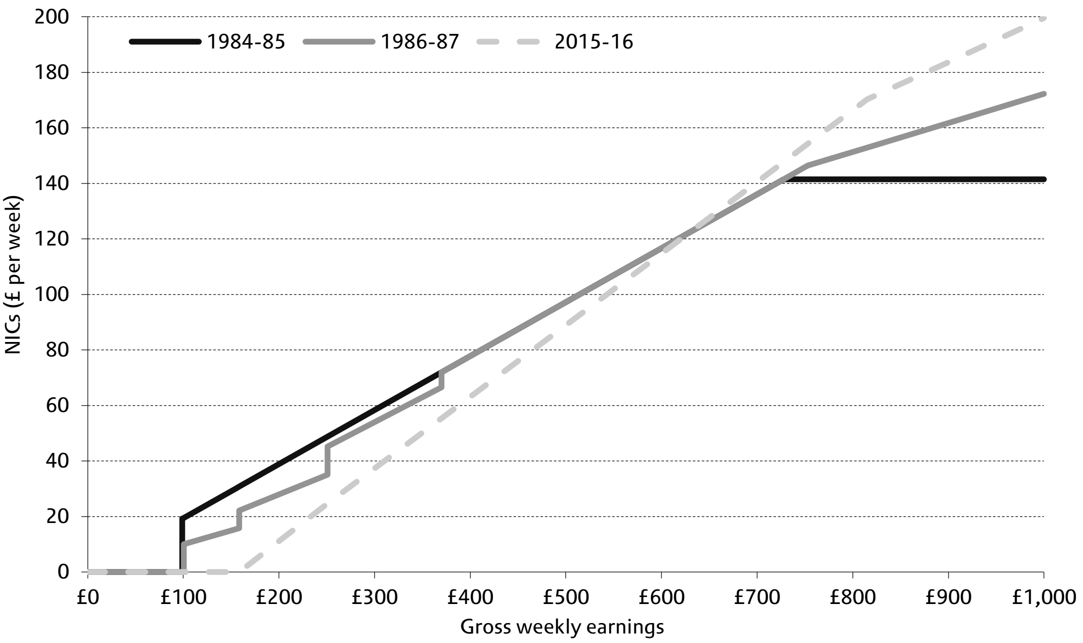
[53] For more information, see A. Dilnot and J. McCrae, *Family Credit and the Working Families' Tax Credit*, IFS Briefing Note BN3, 1999, http://www.ifs.org.uk/bns/bn3.pdf.

National Insurance contributions

The National Insurance system has its roots as far back as 1911, and until 1961 contributions continued as a (typically) weekly lump-sum payment by employers and employees to cover the cost of certain social security benefits – in particular, the flat-rate pension, unemployment benefits and sickness benefits. Since 1961, however, NI has steadily moved towards being simply another income tax. The link between the amount contributed and benefit entitlement, which was once close, has now almost entirely gone, and substantial progress has been made in aligning the NI rate structure and tax base with those of income tax. Most of this has occurred in the last 30 years.

Figure 4 shows the structure of the combined employee and employer NI system before and after the important 1985 reforms and as it stands in 2015–16. To enable comparison, thresholds from earlier systems have been uprated to April 2015 prices.

Figure 4. The changing structure of National Insurance contributions



Note: Previous years' thresholds have been uprated to April 2015 prices using the RPI. Assumes employee contracted into State Earnings-Related Pension Scheme (SERPS) or state second pension (S2P). The 1984–85 schedule excludes the 1% National Insurance surcharge abolished in September 1984.
Source: HM Treasury, *Financial Statement and Budget Report*, various years; *Tolley's National Insurance Contributions*, various years; https://www.gov.uk/government/statistics/main-features-of-national-insurance-contributions.

In 1984–85, no NI was due for those earning less than the lower earnings limit of £98.96.[54] For those earning at least this amount, employees paid contributions of 9% and employers 10.45% of total employee earnings, including earnings below the LEL. This meant a jump in contributions from zero to £19.25 at the LEL, and it is not surprising that this discontinuity led to significant bunching of earnings just below the LEL. The 1985 reform reduced the jump in NICs at the LEL to £10.04 (5% each from employee and employer), introducing a number of graduated steps instead. The 5% 'entry rate' was later cut to 2% for employers, and in 1999 the entry rate was removed altogether so that the earnings threshold in NI now operates in a similar way to the income tax personal allowance, essentially being discounted from taxable earnings. Furthermore, between 2001–02 and 2007–08, the earnings threshold for both employers and employees was set at the same level as the income tax personal allowance. The increase in the personal allowance announced in May 2008 (see page 42) decoupled it from the NI earnings thresholds, which since 2015–16 are themselves set at different levels following a decision to increase the primary threshold in line with the CPI but the secondary threshold in line with the RPI.

The NI treatment of high earners has also come to resemble their treatment under income tax more, in that there is no longer an upper limit on payments. In 1984–85, no NI was payable on earnings above the UEL of £727.63, giving a maximum weekly contribution of £141.52. The 1985 reform abolished the UEL for employers, and although the UEL is still in place for employees, it no longer acts as a cap on contributions. Instead, earnings above the UEL incur NI contributions at a lower rate of 2%.

The abolition of the entry rate, the closer alignment of thresholds with those for income tax and the abolition of the cap on contributions have made NI look more like income tax. Important differences remain: in particular, the self-employed face a very different, and much less onerous, NI system (see Section 3.2). NI also has a different tax base: it is a tax on earnings only, whereas income tax is paid on income under a broader definition. However, the NI base has expanded to match the income tax base more closely; this can be seen, for example, in the extension of the NI system to partially cover benefits in kind.

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[54] All figures are given in April 2015 prices.

Economically, there is little rationale for having separate income tax and NI systems. Their separate existence is largely a matter of historical accident and makes the tax system unnecessarily opaque, complex and administratively expensive, while differences remaining between the two systems are distortionary and inequitable. But the political advantages of having a separate NI system make it likely that it will continue: both the government and the electorate appear to like this separate tax. That being the case, the substantial problems caused by the lack of integration of the two systems have been somewhat reduced by their increased alignment.[55]

4.3 Taxation of savings and wealth

The income tax treatment of savings has changed significantly over the last 30 years or so. The radical reforms to the rate structure of income tax, reducing the top marginal rate on savings income from 98% to 45% and increasing the amount of savings income that is untaxed, are discussed in Sections 3.1 and 4.2. But there have also been major changes to the tax treatment of different savings vehicles, with some forms of savings becoming more generously treated and some less so.

The two most significant changes widening the base of income tax have been the abolition of life assurance premium relief in 1984, which had given income tax relief on saving in the form of life assurance, and the steady reduction and final abolition of mortgage interest tax relief (MITR). Until 1974, MITR had been available on any size of loan, but in that year a ceiling of £25,000 was imposed. In 1983, this ceiling was increased to £30,000, which was not enough to account for general price inflation and much too little to account for house price inflation. From 1983, the ceiling remained constant, steadily reducing its real value. From 1991, this erosion of the real value of MITR was accelerated by restricting the tax rate at which relief could be claimed, to the basic rate of tax in 1991 (25%), 20% in 1994, 15% in 1995 and 10% in 1998, with the eventual abolition of the relief in April 2000.

[55] Despite this, the July 2015 Budget announced that the Office for Tax Simplification would be carrying out a review into the closer alignment of income tax and NICs. More details on the review can be found at https://www.gov.uk/government/collections/tax-and-national-insurance-alignment.

The main extension of relatively tax-favoured savings came in 1988 with the introduction of personal pensions, which allowed the same tax treatment for individual-based pensions as had been available for employer-based occupational pensions (tax relief on contributions, no tax on fund income, tax on withdrawals apart from a lump sum not exceeding 25% of the accumulated fund). The other main extensions were the Personal Equity Plan (PEP) and the Tax-Exempt Special Savings Account (TESSA), introduced in 1987 and 1991 respectively. The PEP was originally a vehicle for direct holding of equities, but it was reformed to allow holdings of pooled investments such as unit trusts. The TESSA was a vehicle for holding interest-bearing savings accounts. Both PEP and TESSA benefited from almost the reverse tax treatment to that of pensions: saving into a PEP or TESSA was not given any tax relief, there was no tax on income or gains within the fund and there was no tax on withdrawals. The PEP and TESSA have now been superseded by the Individual Savings Account (ISA), which is similar in most important respects.

For those (very few) who can and wish to save more than £15,240 per annum (the current ISA limit) in addition to any housing or pension saving, capital gains tax (CGT) is potentially relevant. Prior to 1982, CGT was charged at a flat rate of 30% on capital gains taking no account of inflation. Indexation for inflation was introduced in 1982 and amended in 1985, and then in 1988 the flat rate of tax of 30% was replaced by the individual's marginal income tax rate. The 1998 Budget reformed the CGT system, removing indexation for future years and introducing a taper system which reduced the taxable gain for longer-held assets by up to 75%, depending on the type of asset. The taper system created predictable distortions and complexity, and the 2007 Pre-Budget Report announced the abolition of both tapering and indexation from April 2008 and a return to a system like that before 1982, in which gains are taxed at a flat rate, now 18%, with no allowance for inflation.[56] The coalition government that came to office in 2010 increased the rate of CGT for higher- and additional-rate taxpayers to 28%, in part in recognition of the fact that the large difference between the CGT rate of 18% and the higher income tax rate of

[56] These reforms are discussed in S. Adam, 'Capital gains tax', in R. Chote, C. Emmerson, D. Miles and J. Shaw (eds), *The IFS Green Budget: January 2008*, IFS Commentary C104, 2008, http://www.ifs.org.uk/budgets/gb2008/08chap10.pdf.

40% gave higher-rate taxpayers a strong incentive to engage in activities where remuneration could be obtained through capital gains rather than income. However, the extension of entrepreneurs' relief which accompanied this change limited the extent to which this reform succeeded in reducing this distortion.[57]

Capital is taxed not only directly by taxes levied on investment income and capital gains, but also by stamp duty on transactions of securities and properties and by inheritance tax on bequests.[58] The current form of inheritance tax was introduced in 1986 to replace capital transfer tax. When capital transfer tax had replaced estate duty 11 years earlier, gifts made during the donor's lifetime had become taxable in the same way as bequests. But differences in treatment were soon introduced and then widened, until finally the new inheritance tax once again exempted lifetime gifts except in the seven years before death, for which a sliding scale was introduced (see Table 6 in Section 3.5) in an attempt to prevent people avoiding the tax by giving away their assets shortly before death.

With all of these capital taxes, the 1980s saw moves to reduce the number of rates and/or align them with income tax rates. Thus in 1978 capital transfer tax had no fewer than 14 separate rates; since 1988 its successor, inheritance tax, has been charged (above a tax-free threshold) at a single 40% rate, equal to the higher rate of income tax. As mentioned above, capital gains tax was charged at the individual's marginal income tax rate from 1988. Four rates of stamp duty on properties were replaced by a single 1% rate in 1984. Stamp duty on shares and bonds was almost abolished entirely: the rate fell from 2% to 0.5% during the 1980s, and in 1990 the then Chancellor John Major announced that stamp duty on shares and bonds would be abolished in 1991–92 when the London Stock Exchange introduced a paperless dealing system known as TAURUS.

[57] Entrepreneurs' relief (described in Section 3.5) was originally introduced as a concession following an angry reaction to the proposals in the 2007 Pre-Budget Report from business organisations. Originally, only the first £1 million of gains were eligible, but this was subsequently increased to £2 million in the March 2010 Budget, to £5 million in the June 2010 Budget and then to £10 million in Budget 2011.

[58] Corporation tax is also relevant for capital invested in companies, and council tax or business rates for capital invested in property. These taxes are discussed in Section 3.6 and in Sections 3.9 and 3.10 respectively.

However, this system was never introduced and stamp duty on shares and bonds remained.

Labour's first Budget following the party's election in 1997 announced the reintroduction of graduated rates of stamp duty on properties. The higher rates were subsequently increased, along with additional rates for properties worth more than £1 million. Policy under the Conservative–Liberal-Democrat coalition government continued in this vein until it followed the Scottish government in replacing the so-called 'slab structure' of SDLT for residential land and property (where higher rates for a particular transaction applied to the full sale price, not just the part above the relevant threshold) with a less – though still heavily – distortionary 'slice structure', described in Section 3.5. Curiously, the coalition government saw fit only to remove the slab structure of SDLT from residential properties, unlike in Scotland, despite the same rationale applying.

Beyond these frequent changes, what did most to bring SDLT, along with inheritance tax, to public attention was rapid growth in house prices. From 1997 to 2005, house price inflation averaged more than 10% a year, far outstripping both the inheritance tax threshold (which has typically increased in line with general price inflation) and the stamp duty zero-rate threshold (which has typically been frozen in cash terms).

Table 14 illustrates the implications of this. When Labour came to power in 1997, around half of property transactions attracted stamp duty; over the following six years, this proportion rose to almost three-quarters as house prices doubled while the stamp duty threshold was unchanged. The link between house prices and inheritance tax is less direct, but since housing makes up about half of total household wealth, house prices are clearly an important determinant of how many estates are affected by inheritance tax. A widely-reported concern was that rising house prices were making inheritance tax into a tax on 'ordinary people' instead of only on the very wealthy. However, although the proportion of death estates liable for inheritance tax more than doubled in a decade – increasing from 2.3% of the total in 1996–97 to 5.9% in 2006–07 – it remained small. Since then, policy reforms have counteracted the spread of stamp duty and inheritance tax: the SDLT threshold was doubled in April 2005, temporarily increased by a further £50,000 for one year only from 3 September 2008, and then doubled again for first-time buyers for two years starting 25 March 2010; and in October 2007, unused inheritance tax nil-rate bands became transferable to a surviving spouse or civil partner, reducing the number of estates liable to tax by a third and removing the threat of future inheritance tax for many couples. However, with the threshold frozen since 2008, a higher percentage of deaths were liable for inheritance tax in 2014 than ever before. The introduction of the main residence allowance in 2017–18 will reduce the proportion of estates liable for inheritance tax, but the projected trend remains upwards.

Table 14. Stamp duty, inheritance tax and house prices

Year[a]	*Average house price*[b]	*Inheritance tax threshold*	*Stamp duty (land tax) zero-rate threshold*[c]	*Death estates liable for inheritance tax*	*Property transactions liable for stamp duty*[d]
1993	£62,333	£150,000	£60,000	2.7%	42%
1994	£64,787	£150,000	£60,000	3.0%	43%
1995	£65,644	£154,000	£60,000	3.1%	43%
1996	£70,626	£200,000	£60,000	2.3%	45%
1997	£76,103	£215,000	£60,000	2.5%	49%
1998	£81,774	£223,000	£60,000	2.9%	53%
1999	£92,521	£231,000	£60,000	3.2%	58%
2000	£101,550	£234,000	£60,000	3.6%	62%
2001	£112,835	£242,000	£60,000	3.8%	69%
2002	£128,265	£250,000	£60,000	4.4%	73%
2003	£155,627	£255,000	£60,000	5.1%	73%
2004	£180,248	£263,000	£60,000	5.5%	71%
2005	£190,760	£275,000	£120,000	5.7%	60%
2006	£204,813	£285,000	£125,000	5.9%	64%
2007	£223,405	£300,000	£125,000	4.4%	66%
2008	£227,765	£312,000	£125,000/£175,000[e]	2.8%	51%
2009	£226,064	£325,000	£125,000/£175,000[e]	2.7%	45%
2010	£251,174	£325,000	£125,000[f]	2.8%	55%
2011	£245,319	£325,000	£125,000[f]	3.3%	53%
2012	£246,032	£325,000	£125,000	3.9%	63%
2013	£250,768	£325,000	£125,000	4.5%	67%
2014	£267,132	£325,000	£125,000	6.1%	70%

Notes and source to this table appear on the next page.

Notes and source to Table 14

[a] Years are fiscal years (so 1993 means 1993–94) except for average house prices, which are for calendar years.

[b] Simple average, not mix-adjusted, so changes reflect changes in the types of property bought as well as changes in the price of a given type of property.

[c] Threshold for residential properties not in disadvantaged areas.

[d] Excludes Scotland pre-2006. 2006 onwards and other columns are UK-wide.

[e] Stamp duty threshold was increased to £175,000 for one year from 3 September 2008 and then extended until 31 December 2009.

[f] Stamp duty threshold for first-time buyers was increased to £250,000 for two years from 25 March 2010.

Source: Average house prices from Office for National Statistics, 'House price index', annual table 23. Numbers of taxpayers from https://www.gov.uk/government/statistics/numbers-of-taxpayers-and-registered-traders. Total number of registered deaths compiled from *Death Registration summary tables, England and Wales*, http://www.ons.gov.uk/ons/rel/vsob1/death-reg-sum-tables/index.html; *National Records of Scotland: Monthly Data on Deaths Registered in Scotland*, http://www.nrscotland.gov.uk/statistics-and-data/statistics/statistics-by-theme/vital-events/general-publications/weekly-and-monthly-data-on-births-and-deaths/monthly-data-on-deaths-registered-in-scotland; *Northern Ireland Statistics Research Agency: Deaths 1887 to 2014*, http://www.nisra.gov.uk/demography/default.asp10.htm. Property transactions liable for stamp duty from https://www.gov.uk/government/statistics/numbers-of-uk-property-transactions-by-liable-and-non-liable.

4.4 Indirect taxes

Value added tax

As noted in Section 4.1, the most dramatic shift in revenue-raising over the last 35 years has been the growth in VAT, which has doubled its share of total tax revenue. The bulk of this change occurred in 1979, when the incoming Conservative government raised the standard rate of VAT from 8% to 15%, to pay for reductions in the basic rate and higher rates of income tax. The rate was increased from 15% to 17.5% in 1991, to pay for a reduction in the community charge (poll tax), and then again from 17.5% to 20% in January 2011 as part of the coalition government's deficit reduction package.

There have been a number of (mostly minor) extensions to the base of VAT over the years. Perhaps the most significant was the extension of VAT to cover domestic fuel and power from April 1994, then at a reduced rate of 8%. The original intention was to increase this to the full rate (then 17.5%) a year later, but this second stage of reform was abandoned in the face of fierce political opposition. In fact, the reduced rate was cut from 8% to 5% in 1997, fulfilling a pre-election promise by the Labour Party. The reduced rate has since been extended to cover a few other goods that were previously subject to VAT at the standard rate.

Two general issues arise in the context of VAT: incentives and redistribution. It is frequently suggested that a revenue-neutral shift from direct to indirect taxation, such as that introduced in 1979, will reduce tax-induced disincentives to work. But if the attractiveness of working relative to not working, or working an extra hour as opposed to not doing so, is determined by the amount of goods and services that can be bought with the wage earned, a uniform consumption tax and a uniform earnings tax will clearly have very similar effects. Cutting income tax will not increase the attractiveness of work if the price of goods and services rises by an equivalent amount because of the increase in consumption tax. It may be, of course, that the shift will reduce the burden of taxation for one group and raise it for another, and that this redistribution will affect incentives. But this has little to do with the choice between direct and indirect taxes.

The second general issue concerning VAT relates to redistribution. As described in Section 3.3, many goods in the UK are zero-rated for VAT, with food and children's clothing being examples. This zero-rating is often defended on distributional grounds, because those with low incomes allocate a large proportion of their expenditure to these items. But VAT should not be considered in isolation from the rest of the tax and welfare system. Since the UK government is able to levy a progressive income tax and pay welfare benefits that vary according to people's needs and characteristics, this will generally prove a much more effective means of meeting its equity objectives – although the better-off spend a smaller proportion of their incomes on zero-rated goods, they spend larger amounts of money and are therefore the main cash beneficiaries of zero rates of VAT.[59] Removing zero-rating would also have the advantage of removing the distortions in people's consumption decisions that result from differential tax rates for different goods.

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[59] Indeed, the Mirrlees Review of the UK tax system demonstrated that it is possible to apply a uniform VAT rate with a revenue-neutral compensation package that ensures that the overall reform is broadly distributionally neutral and does not significantly weaken work incentives. See chapter 9 of J. Mirrlees, S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles and J. Poterba, *Tax by Design: The Mirrlees Review*, Oxford University Press for IFS, 2011, http://www.ifs.org.uk/publications/5353.

Excisable goods

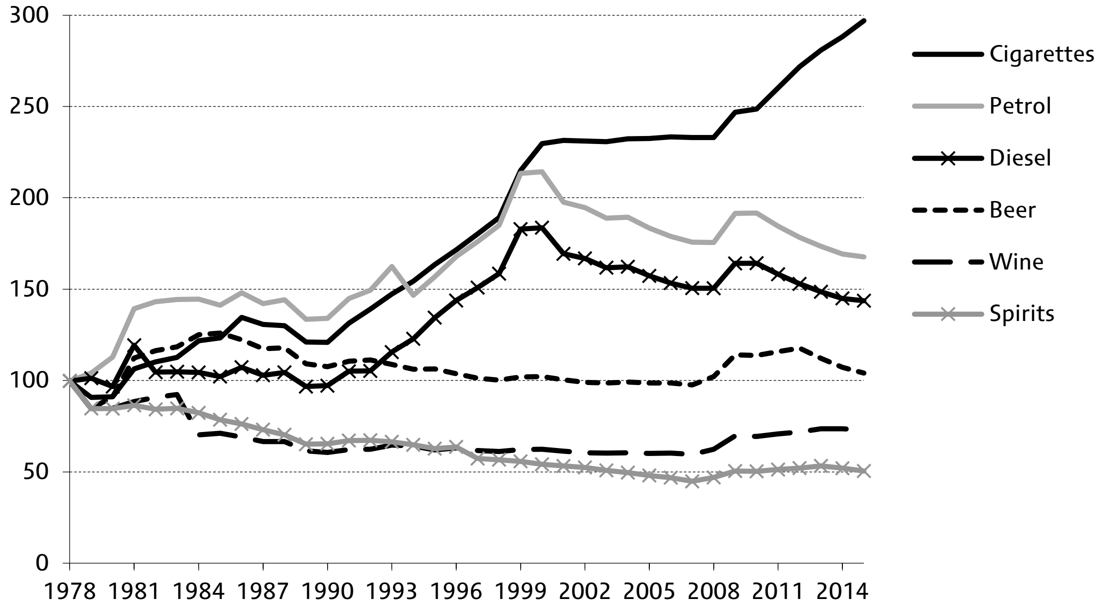
Table 15 shows the total rate of indirect tax (VAT and excise duty) on the principal goods subject to excise duties. Figure 5 shows how real levels of excise duties have changed over time: between 1979 and 2000, taxes on cigarettes rose steadily, while those on petrol and diesel increased much more sharply. Both these commodity groups were covered by government commitments to substantial annual real increases in excise duty in the 1990s. From 2000 to 2008, however, duty on cigarettes barely kept pace with inflation, while fuel taxes fell by around a fifth in real terms. Since 2011, cigarette duty has increased above inflation while fuel duties have continued to fall considerably in real terms. Nevertheless, real duty rates on cigarettes and fuel remain substantially higher than 35 years ago, in addition to the increase in VAT from 8% to 20% since 1978 – although the pre-tax price of cigarettes has also increased sharply, so tax as a percentage of price has not increased as much as might be expected.

Table 15. Total tax as a percentage of retail price

Year[a]	*Cigarettes*[b]	*Beer*[c]	*Wine*[d]	*Spirits*[e]	*Petrol*[f]	*Diesel*[g]
1978	72	30	45	78	47	49
1988	77	35	48	69	68	63
1998	81	30	50	63	76	82
2008	79	29	55	60	62	58
2015	76	30	65	64	68	65

[a] Figures are for April of each year, except that wine and spirits figures for 1998 are for January.
[b] Packet of 20.
[c] Pint of bitter (3.9% abv) in licensed premises.
[d] 75cl bottle of table wine (not exceeding 15% abv) in a retail outlet.
[e] 70cl bottle of whisky (40% abv) in a retail outlet.
[f] Litre of fuel: leaded (4*) in 1978 and 1988, premium unleaded in 1998 and ultra-low sulphur in 2008 and 2015.
[g] Litre of fuel: ultra-low sulphur in 2008 and 2015.
Source: Duty (and VAT) rates as for Figure 5. Prices – cigarettes and beer from National Statistics, 'Consumer price indices', http://ons.gov.uk/ons/rel/cpi/consumer-price-indices/index.html, except that the 1978 prices are estimated by downrating the prices for 1987 using the relevant sub-indices of the RPI; wine and spirits from HMRC Alcohol Factsheet, https://www.uktradeinfo.com/Statistics/Statistical%20Factsheets/AlcoholFactsheet1013.xls, with the wine and spirits 2015 prices uprated from 2012 prices using the wine and spirits sub-index of the RPI, except that 1978 prices come from HM Treasury (2002), *Tax Benefit Reference Manual 2002–03 Edition*, with the wine price downrated from the 1979 price by the wine and spirits sub-index of the RPI; petrol and diesel from HM Treasury (2002) for 1978 and 1988 and table 4.1.1 of Department of Energy and Climate Change, 'Quarterly energy prices', https://www.gov.uk/government/collections/quarterly-energy-prices for 1998, 2008 and 2015.

Figure 5. Real levels of excise duties (1978 = 100)



Note: Assumes beer at 3.9% abv, wine not exceeding 15% abv and spirits at 40% abv; petrol is leaded (4*) up to 1993, premium unleaded from 1994 to 2000 and ultra-low sulphur from 2001 onwards; diesel is ultra-low sulphur from 1999 onwards. Calculations are for April of each year, except that wine and spirits are for January from 1995 to 1999.
Source: Duty rates – HMRC website, https://www.gov.uk/government/organisations/hm-revenue-customs; HM Treasury, *Tax Benefit Reference Manual 2002–03 Edition*, 2002; various HMRC / HM Customs and Excise Annual Reports. RPI from National Statistics, http://ons.gov.uk/ons/rel/cpi/consumer-price-indices/index.html.

The pattern for alcoholic drink is very different. The tax rate on beer has changed little, while the real level of duty on spirits has fallen steadily and is now little more than half what it was in 1978. Duty on wine fell in real terms through the 1980s and has changed little since; but as the pre-tax price of wine has fallen sharply over time and VAT has risen, tax makes up more of the price of a bottle now than it did 35 years ago. As shown in Table 16, implied duty rates per litre of pure alcohol are now much closer together than they were in 1978, but some variation persists. Budget 2008 increased all alcohol duties by 6% above inflation and announced further real increases of 2% a year until 2013,[60] but did not change the relativities between different forms of alcohol. Since 2013, all alcohol duties have fallen in real terms. This is especially pronounced for beer duty, which was reduced in nominal terms in three successive Budgets from March 2013.

[60] These real increases were extended to 2013 and 2014 in the March 2010 Budget.

Table 16. Implied duty rates per litre of pure alcohol (April 2015 prices)

Item	*1978*	*1988*	*1998*	*2008*	*2015*
Beer	£17.61	£20.80	£17.67	£18.03	£18.37
Wine[a]	£31.16	£20.81	£19.13	£19.52	£22.78
Spirits	£54.55	£38.49	£31.03	£25.74	£27.66

[a] Wine of strength 12% abv.

Source: Authors' calculations from duty rates sourced as for Figure 5.

The existence of relatively high tax rates in the UK on some easily portable commodities could lead to loss of revenue through cross-border shopping. While it is possible that the UK tax rates are so high that reductions in those rates would encourage enough additional consumption to produce a net increase in revenue, the available evidence suggests that this is unlikely.[61] Only in the case of spirits is it likely that the current tax rate is high enough for a reduction to have little or no revenue cost, which might help explain why duty on spirits was frozen in nominal terms (cut in real terms) every year between 1997 and 2008.

Environmental taxes

Environmental taxes are difficult to define precisely, since all taxes affect economic activity and almost all economic activity has some environmental impact. However, a classification is attempted in the ONS's *Environmental Accounts*; on that basis, environmental taxes raised £44.6 billion in 2014, some 7.5% of revenue from total taxes and social contributions in the UK or 2.5% of GDP.[62] These percentages are somewhat reduced from a peak in the late 1990s. Over 60% of this revenue is accounted for by fuel duty, and the other sizeable chunk is vehicle excise duty. Thus taxes on motoring account for about 75% of environmental tax revenues. Since 1994, several new environmental taxes have been introduced, including air passenger duty (1994), landfill tax (1996), climate change levy (2001), aggregates levy (2002) and the carbon price floor (2013). These are described in Section 3.4, but even air

[61] See I. Crawford, Z. Smith and S. Tanner, 'Alcohol taxes, tax revenues and the Single European Market', *Fiscal Studies*, 1999, 20, 305–20, and C. Walker and C.-D. Huang, *Alcohol Taxation and Revenue Maximisation: The Case of Spirits Duty*, HM Customs and Excise Forecasting Team Technical Note *Series A*, 10, 2003.

[62] See http://www.ons.gov.uk/ons/rel/environmental/uk-environmental-accounts/2015/stb-environmental-accounts-2015.html.

passenger duty – by far the largest of them – is forecast to raise only £3.1 billion in 2015–16.

The amount of revenue raised is rather limited as an indicator of the environmental impact of a tax. The more successful the tax is in changing behaviour, the less revenue it will raise. It also matters how well the tax targets environmentally-damaging behaviour rather than some broader activity. For example, differential fuel duty rates have been used extensively to encourage a switch to cleaner fuels. Vehicle excise duty changed in 1999 from a flat-rate charge to one dependent on engine size, and then in 2001 to one based on vehicle emissions; since then, the differential between high-emission and low-emission vehicles has repeatedly been widened. Similarly, since November 2009, rates of air passenger duty have depended on distance travelled rather than on whether the destination is within the EU. Such reforms can be designed either to increase or to reduce revenues while encouraging less environmentally-harmful activities. Nevertheless, it remains fair to say that environmental taxation in the UK is dominated by taxes on motoring.

4.5 Taxes on companies

In the 18 years of Conservative government prior to 1997, the biggest reform to corporation tax was the 1984 Budget. This announced a series of cuts in the main corporation tax rate, taking it from 52% to 35% (further reduced to 33% by 1991–92), and a very generous system of deductions for capital investment (100% of investment in plant and machinery could be deducted from taxable profits in the year the investment was made) was replaced by a less generous one (25% of the remaining value each year for plant and machinery). The 1984 reform was intended to be broadly revenue-neutral.

The taxation of company profits changed significantly after 1997. The incoming Labour government changed the way that dividend income was taxed: dividend tax credits – a deduction from income tax given to reflect the corporation tax already paid on the profits being distributed – ceased to be payable to certain shareholders (notably pension funds) that were already exempt from income tax. In its first five years in office, the Labour government also cut the main corporation tax rate from 33% to 30% and the small profits rate from 23% to 19%.

In April 2000, a 10% lower rate was introduced for companies with less than £10,000 of taxable profits, and this lower rate was cut to zero in April 2002. This last tax cut came as a surprise, with costs potentially running into billions of pounds if self-employed individuals registered as companies to reduce their tax liabilities.[63] Having apparently failed to anticipate this effect, the government swiftly reversed the reform. In April 2004, the zero rate was abolished for distributed profits, removing much of the tax advantage but at a cost of greater complexity; and so in December 2005, the zero rate was abolished for retained profits as well. This took us back to precisely where we were before April 2000, with the standard small company rate applying to all firms with profits up to £300,000, regardless of whether the profits were paid out as dividends or retained by the firm. These changes caused unnecessary upheaval in the tax system, and thousands of individuals incurred effort and expense to set up legally incorporated businesses that they would not otherwise have set up. This episode provides a clear lesson in how not to make tax policy.

The 2007 Budget cut the main rate further to 28% and reduced capital allowances for most plant and machinery from 25% to 20%; but, at the same time, it departed from the previous trend by announcing that the small profits rate would rise in stages from 19% to 22% and that an annual investment allowance would be introduced, which would allow the first £50,000 (later increased to £100,000) of investment in plant and machinery each year to be immediately deductible from profits. However, the final stage of the increase in the small profits rate was repeatedly delayed, and then cancelled by the incoming coalition government in June 2010, who instead cut the small profits rate to 20% in 2011–12, where it was aligned with a substantially reduced main rate. The coalition government also announced large reductions in the annual investment allowance from £100,000 to £25,000 from 2012–13, though subsequently increased this temporarily to £250,000 from January 2013, and then to £500,000 from April 2014.

As noted in Section 3.8, banks are increasingly taxed differently from other companies. The bank levy was introduced at a rate of 0.05% in January

[63] More information about these changes can be found in L. Blow, M. Hawkins, A. Klemm, J. McCrae and H. Simpson, 'Budget 2002: business taxation measures', IFS Briefing Note BN24, 2002, http://www.ifs.org.uk/bns/bn24.pdf.

2011, and has been subject to repeated change since: on current plans, by 2021–22 there will have been 13 rates in 11 years. While there may be a good rationale for having a tax like the bank levy – designed to discourage risky leverage (with mixed success) – changing it so frequently introduces potentially damaging uncertainty into the tax system. Further adding to the uncertainty have been a series of other changes: the last Labour government levied a temporary tax on bankers' bonuses in 2010, the Conservative–Liberal-Democrat coalition government restricted banks' ability to use past losses to offset profits from 2015, and the current Conservative government is introducing a new corporation tax surcharge on banking profits from 2016. It is hard to guess what banks should expect next, and a clear and consistent exposition of exactly what tax measure is appropriate to tackle exactly what perceived problem would be welcome.

4.6 Local taxation

Thirty years ago, local taxes in the UK consisted of domestic rates (on residential property) and business rates (on business property). However, this was changed dramatically in 1990 when business rates were taken from local to national control and domestic rates were replaced by the community charge (poll tax), a flat-rate per-person levy.[64] The poll tax was introduced in April 1990 in England and Wales after a one-year trial in Scotland, but was so unpopular that the government quickly announced that it would be replaced. The tax was based on the fact that an individual lived in a particular local authority, rather than on the value of the property occupied or the individual's ability to pay (subject to some exemptions and reliefs). In the 1991 Budget, the government increased VAT from 15% to 17.5% to pay for a large reduction in the poll tax, with a corresponding rise in the level of central government grant to local authorities. The poll tax was abolished in 1993 to be replaced by the council tax, which is based mainly on the value of the property occupied, with some exemptions and reliefs (outlined in Section 3.9).

The result of these changes, and particularly the centralisation of business rates, was that during the 1990s and 2000s, local services were largely financed by central government, with the only significant local tax left –

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[64] These reforms were not introduced in Northern Ireland, which retained a system of locally-varying business and domestic rates.

the council tax – financing only around one-sixth of total local spending.[65] However, substantial reductions in central government grants to local authorities and moves towards the local retention of business rates revenues mean that the proportion of local government spending that is locally financed has increased in recent years and is due to increase further. This means that local government spending will be more closely linked to local revenues than at any time since at least the 1980s. Running against this is the requirement contained in the Localism Act 2011 for councils wishing to implement increases in council tax that the central government deems 'excessive' to have these approved in a local referendum.

[65] See chart 2.1b in Department for Communities and Local Government, *Local Government Financial Statistics England No. 25*, 2015, https://www.gov.uk/government/statistics/local-government-financial-statistics-england-2015.

5. Conclusions

Despite clear attempts to reform various aspects of the UK tax system over the last 35 years or so, with varying degrees of success, there remain many areas still in need of attention. This briefing note has set out the features of the current UK tax system, described the major changes in those features over time and highlighted some of the areas potentially in need of a reformer's beady eye.