Recent tax reforms: moving in the right direction?

Stuart Adam

What is ‘the right direction’?

• See *The Mirrlees Review*, [www.ifso.org.uk/publications/mirrleesreview](http://www.ifso.org.uk/publications/mirrleesreview)
  – No view on how high or redistributive taxation should be
  – Asks how to raise revenue and redistribute more efficiently
  – A progressive, neutral system...

• Consider the system as a whole
  – Use the right tools for the right objectives

• Achieve progressivity as efficiently as possible
  – Personal taxes and benefits are the best tools for redistribution
  – Target incentives where they matter most
  – Take a lifetime perspective, considering income and expenditure

• Neutrality as an important benchmark
  – Tends to be simpler, fairer and less distortionary
  – Not always – but should have a high hurdle to justify exceptions
The coalition government’s priorities for tax

• Current government has increased tax overall
  – Biggest contributors: VAT increase and anti-avoidance measures

• Yet still found money for big tax cuts in its three priority areas
  – £12bn – income tax personal allowance
  – £8bn - headline rate of corporation tax
  – £6bn - fuel duty

• Two of these three were ambitions clearly stated in advance
  – Fuel duty more piecemeal

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Recent reforms to the income tax schedule

- Personal allowance to reach £10,500 in 2015-16
  - £2,855 higher than plans govt inherited – costs over £12 billion per year
  - Basic-rate taxpayers gain £571 a year; 2.4 million taken out of income tax
Increasing the personal allowance
Distributional impact of an increase from £10,000 to £12,500

Assumes higher-rate threshold held constant.
Source: Figure 7.4 of The IFS Green Budget: February 2014
Recent reforms to the income tax schedule

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• Higher-rate threshold will be £5,560 lower than plans inherited
  – 1.4m more higher-rate taxpayers
Number of higher-rate taxpayers

Note: includes additional rate taxpayers.
Source: HMRC Statistics and IFS projections
Recent reforms to the income tax schedule

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• 50% rate above £150,000 reduced to 45%
  – The 1% of taxpayers affected provide 30% of income tax revenue
  – Best guess is little revenue effect, but no-one really knows

• But bizarre 60% band above £100k remains in place
Income tax schedule for earned income, 2014-15

Marginal income tax rate

Income

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Other recent income tax reforms

Income tax now starting to depend on family circumstances again

- Being used to withdraw child benefit from those with high incomes
- 10% of tax allowance transferable to basic-rate spouse from 2015

- Both complicate the tax system
- Both withdrawn in strange ways
- No clear principle for how tax should depend on individual/joint income

Real-Time Information (RTI) reporting introduced in April 2013

- Greater use of technology must be right direction of travel
- But must also be ready to use the technology
  - HMRC systems not yet set up to make full use of extra data
  - ‘Temporary’ easing of requirements needed for many small firms
National Insurance contributions (NICs)

- NICs thresholds not increased in line with income tax allowance
- Hard to see an economic rationale for this
- Highlights absurdity of having two similar but separate taxes
  - Link between ‘contributions’ and benefits small and shrinking
  - NI could be transformed into a true social insurance scheme
  - Otherwise should be merged with income tax: a major simplification
  - Differences that do exist could mostly be kept in a merged tax if desired
Tax treatment of saving

• Income tax starting rate cut to zero and band widened

• ISA limit increased to £15,000 a year and cash/shares division ended

• Pension contribution limits reduced
  – But subsidies (NICs exemption of employer contributions and 25% withdrawn tax-free) still badly designed, and make even less sense with more flexible withdrawal options

• Re-introduced a higher CGT rate (28%) for higher-rate taxpayers...
  – Reduces the incentive to convert income into capital gains

• ...but made entrepreneur’s relief even more generous
  – Precisely where most scope to convert income into gains!
Tax treatment of saving

• CGT policy has gone round in circles
  – Tension between not penalising saving and not facilitating avoidance

• Many unsolved problems in the current system for taxing saving
  – Saving in many forms discouraged
  – Effective tax rate fluctuates absurdly with inflation
  – Distorts asset allocations (e.g. owner-occupied vs rented housing)
  – Distorts choice between dividends, capital gains and salary
  – Distorts choice of employment vs self-employment vs incorporation

❖ Create complexity and anti-avoidance struggles as well as distortions

• Mirrlees Review proposed solution: exempt a ‘normal’ return; apply full labour income tax rates above that
Inheritance tax

- Threshold frozen from 2009-10 to 2017-18: 22% real-terms reduction
  - Despite Prime Minister’s stated desire to increase the threshold
Inheritance tax

Note: estates subject to inheritance tax, or capital transfer tax before 1986-87
Source: authors’ calculations based on data from HMRC, OBR and ONS
Inheritance tax

• Threshold frozen from 2009-10 to 2017-18: 22% real-terms reduction
  – Despite Prime Minister’s stated desire to increase the threshold

• No structural reform

• Still unpopular and economically unsatisfactory
  – Easier to avoid for the very wealthy than the moderately wealthy?

• Does the government believe there is a principled case for this tax?

• Should either abolish or transform into tax on lifetime receipts
  – At the very least, remove some of most obvious avoidance opportunities
Corporation tax

• Unusually, government published a ‘corporate tax roadmap’ soon after taking office and has largely stuck to it
• Broadly sensible direction of reforms to taxation of foreign profits
• Cut main rate from 28% to 20%, at cost of £8bn
  – End of separate small profits rate is especially welcome
  – Introduction of Patent Box more questionable
• Policy on capital allowances less sensible
  – Main allowances cut: these are an efficient way to promote investment
  – Annual investment allowance has been a model of instability
Annual investment allowance

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Corporation tax

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  – Main allowances cut: these are an efficient way to promote investment
  – Annual investment allowance has been a model of instability
• Concern over debt-equity bias, but done little about it
• Mirrlees Review proposed an Allowance for Corporate Equity
  – Addresses debt-equity bias, discouragement to investment, distorted asset choices, and much more besides!
  ❖ Must it be a choice between a lower rate and an ACE?
Anti-avoidance

Pursuing three approaches in parallel:

1. A raft of targeted measures in each Budget and Autumn Statement

2. General Anti-Abuse Rule (GAAR) introduced in July 2013

3. OECD project to counter base erosion and profit shifting (BEPS)
   – Tension with measures designed to attract profits to UK
   – Likely to make some progress but not solve fundamental problem
   - How much of a multinational’s profit derives from UK production?
   - ‘Arm’s-length’ prices often not measurable
The bank levy

- Better designed than bank bonus tax or financial transactions tax
- But seven rate changes since 2010 can’t be sensible!
- Why set a revenue target?
VAT

• Main rate increased from 17.5% to 20%, raising £13bn this year
• Not regressive as often claimed
  – Should look at VAT as % of current spending, not income
Distributional impact of increasing main VAT rate to 20% by income decile

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VAT

- Main rate increased from 17.5% to 20%, raising £13bn this year
- Not regressive as often claimed
  - Should look at VAT as % of current spending, not income
- But magnifies distortions caused by narrow tax base...
- Zero & reduced rates are a complex and inefficient way to redistribute
  - 5% rate on domestic fuel particularly bad given environmental concerns
  - Better alternatives are available!
- Exemptions are the most damaging aspect of VAT
  - Mostly mandated by EU rules
- No sign of serious reform of the VAT base
  - ‘Pasty tax’ became a hot potato and failed
  - Does this show impossibility of widening base, or need for more comprehensive change?
Real duty on a litre of petrol
Pence, April 2013 prices

Current policy
Policy inherited

£6bn per year

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## Fuel duty: to uprate or not to uprate?

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Property taxes

Stamp duty land tax

- Higher rates for sales >£1m; fundamental design flaws untouched
  - ‘Slab’ structure absurd: £1 higher price can mean £40,000 higher tax bill
  - More fundamentally, transactions should not be taxed at all
  - Should replace with better-designed property taxes
Property taxes

Stamp duty land tax
• Higher rates for sales >£1m; fundamental design flaws untouched

Council tax
• Paid councils to freeze rates; fundamental design flaws untouched
  – Still based on 1991 property values in England and Scotland
  – Wide bands
  – Regressive
  – 25% discount for single occupancy
Property taxes

Stamp duty land tax
- Higher rates for sales >£1m; fundamental design flaws untouched

Council tax
- Paid councils to freeze rates; fundamental design flaws untouched

Business rates
- Abandoned long-run stability...
  - 5-yearly revaluation delayed for the first time
  - Rate failed to keep pace with inflation for the first time
  - ‘Temporary’ doubling of small business rate relief, extended 4 times
  - Temporary relief for retail properties introduced
- ...while fundamental design flaws untouched
  - Discourages development and use of business property
  - Taxing value of land (excluding buildings) would not do this
Room for improvement
Ideas from the Mirrlees Review

• Strengthen work incentives at responsive points of the life-cycle
• Merge income tax and National Insurance
• Broaden the VAT base (with appropriate compensation package)
• Major overhaul of property taxation
• More consistent carbon price; target motoring taxes on congestion
• Reform the taxation of savings and profits
  – Give full allowance for amounts saved/invested
  – Apply same overall statutory rates to income from all sources
Tax policy-making

• Some recent improvements in institutional arrangements
  – Set up Office for Budget Responsibility and Office of Tax Simplification
  – More transparency re policy costings
  – Somewhat better consultation

• But many long-standing problems remain
  – Hyperactivity: perceived need to pull rabbits out of the hat in Budgets, Autumn Statements and party conferences (as well as before elections)
  – Short-termism: focus on fire-fighting and headline-grabbing rather than long-term strategy
  – Centralisation: tax policy-making very concentrated in HMT and HMRC, with few checks within government, little parliamentary scrutiny, and consultation mostly restricted to technical detail
Conclusions

• Small overall tax rise; significant shift in tax mix
  – VAT increased; income tax, corporation tax and fuel duty cut

• Changes mostly to tax rates – little change in tax base
  – Missed opportunity to address fundamental inefficiencies in tax structure

• Some improvements in institutional arrangements
  – But still problems with the way tax policy is made
  – So lack of clear strategy in many areas and for the tax system as a whole
Recent tax reforms: moving in the right direction?

Stuart Adam