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Introduction

Modern states could not exist without tax systems which raise large amounts of revenue to pay for public services. Most take in excess of 30% of national income in tax. Some take nearly half. The way in which these systems are designed matters enormously to economic welfare. Yet policymakers rarely step back to consider the design of their national tax systems as a whole. Public understanding of taxation is limited. And the political and public discussion of tax design is woefully inadequate.

Tax by Design is both an imperative and a description of our approach in this review. Our aim is to set out the principles on which a 21st century tax system should be based and then to apply them in suggesting concrete policy recommendations to improve the UK tax system. To that end, we use insights from economic theory and empirical research to discuss the impact that the tax system has on people's behaviour, and the resulting trade-offs that policymakers have to make between the various and often conflicting objectives that they might wish the tax system to achieve.

In doing so, we follow in the footsteps of the Nobel laureate James Meade, who chaired a previous review of the tax system for the Institute for Fiscal Studies three decades ago. The Meade Report[1] focused on the structure and reform of direct taxation and has been influential in debates over tax policy ever since. Dauntingly, our canvas is wider than that, covering the whole tax system and some areas of interaction with the social security and tax credit systems.

[1] Meade, 1978.

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Recognizing the importance of law, accountancy, politics, psychology, and other approaches, we nevertheless approach these issues through the prism of economics. This provides us with a framework that allows us to ask, for example: What are we trying to achieve? How does the structure of the tax system influence people's behaviour? What are the economic costs and benefits of particular policy choices? And who gains and loses from them?

The tax system is, of course, both enormous and fearsomely complex. Tax legislation in the UK runs to over 8,000 pages, and the books that lawyers and accountants use to interpret it run to millions of words. Confronted with that size and complexity, we try to be as detailed in our analysis and recommendations as is necessary to guide real policy decisions, without getting tangled in the undergrowth that is comprehensible only to specialists. This means that there will always be further avenues to explore and difficult special cases to consider. But these difficult cases should not drive the overall design of the system, even if they need to be accommodated by it.

The primary task we have set ourselves is to identify reforms that would make the tax system more efficient, while raising roughly the same amount of revenue as the current system and while redistributing resources to those with high needs or low incomes to roughly the same degree. Our motivation is not to achieve textbook tidiness for its own sake, but to unlock significant potential welfare gains. To the extent that these gains show up as higher national income, they would also allow the government that achieves them to loosen the constraints under which the tax system operates—in other words, to spend more on public services or to redistribute more without lowering post-tax incomes in aggregate.

Reforming the tax system may not be easy or popular in the short term, but it holds out the prospect of significant economic gains and hence the promise of higher living standards in the long term.

Our conclusions on reform are guided by three key considerations. First is the importance of taking account of the actual economy and population on which the tax system operates. Taxes apply to people and businesses in the world as it is, not as we might wish it to be. A tax system that might have been ideal in the middle of the 20th century will not be ideal for the second decade of the 21st century. Second is the crucial insight that the tax system needs to be seen as just that—a system. While we will often address the impact of each tax separately for simplicity of exposition, we focus

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throughout on the impact of the system as a whole—how taxes fit together and how the system as a whole achieves government's goals. Third, we base our analysis on the modern economics of taxation. This allows us to develop a systematic conceptual approach that joins together our thinking across the whole range of taxes. What we do is rooted in economic theory that models the constraints people face and the way they behave when taxes change. Our approach is also determinedly empirical, drawing upon the best available evidence on the effects taxes have in practice.

While we have a very broad canvas, there are some important issues on which we deliberately do not take a stance. For example, we do not recommend what the overall level of taxation should be. The economic issues involved in this decision are huge, and in many ways fundamentally different from those involved in designing a tax system. The choice also involves political judgements about the appropriate role and scope of the state. Similarly, we do not take a view on the extent to which the state should seek to redistribute income and wealth from rich to poor. That again is a primarily political choice, although it does of course have economic consequences. But we do try to suggest how the state might best use the tax system to raise more or less revenue—or to redistribute more or less income and wealth—if the government of the day wished to do so.

We go about this by looking, chapter by chapter, at how to tax earnings, spending, savings, wealth, housing, and companies. In the next chapter, though, we consider the economic approach to tax reform and, specifically, some of the issues in designing the tax system as a whole. And we conclude by putting forward a long-term strategy and package of reform in Chapter 20.

In this introductory chapter, we provide just a little context which it is important to understand before we get on to the economic arguments and the analysis of each type of tax. First, there is a very high-level overview of the UK tax system and how it has evolved. Second is a quick look at some of the key changes to the economic environment in which the tax system has to operate. And third, because tax policy is made in a deeply political environment, we briefly address some of the political context and constraints on policymaking.

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1.1. THE EVOLUTION AND STRUCTURE OF THE UK TAX SYSTEM

Many features of the UK tax system today would be familiar to a visitor from the late 1970s. The government still raises the bulk of its revenue from taxes on income, spending, and corporate profits and from local property taxes. At this level of generality, there are important similarities across most industrial countries.

Nevertheless, there have been some dramatic changes. Value added tax (VAT) has gained in importance relative to excise duties, the main rate having more than doubled. The income tax system has moved from joint assessment of married couples to independent assessment of individuals. Income tax rates have come down dramatically. The infamous top levels of 83% on earned income and 98% on unearned income have fallen to 50%—and in fact stood at 40% for most of the period. The basic rate of income tax has fallen from 33% to 20%. Rates of National Insurance (NI) contributions have risen, the ceiling for employer contributions has been abolished, and the structure of NI has become more closely aligned with the income tax system. Tax credits have been introduced and expanded on a grand scale. Taxation of savings has been reformed and somewhat improved. The structure of corporation tax has been overhauled: the main rate has been cut from 52% to 26% in 2011 with further cuts to 23% due by 2014; tax credits have been introduced for research and development (R&D) spending. Capital transfer tax has been replaced by inheritance tax. Domestic rates have been replaced by council tax, via the brief and disastrous experiment with the poll tax (or community charge).

Table 1.1 summarizes UK revenue forecasts for 2011–12. Nearly two-thirds of all tax receipts come from just three taxes—income tax, NI contributions and VAT. Corporation tax accounts for nearly another 9%. Fuel duties, council tax, and business rates raise just under another 5%

Notes and Source for Table 1.1:

[a] Most of the cost of tax credits is counted as government spending rather than a reduction in income tax revenue and so is not included in this table.

[b] Consists of Carbon Reduction Commitment, social tariffs, feed-in tariffs, and Renewables Obligation.

Note: Figures may not sum exactly to totals because of rounding.

Source: Office for Budget Responsibility, 2011, table 4.7 and supplementary tables 2.1 and 2.7 (available at http://budgetresponsibility.independent.gov.uk/category/topics/economic-forecasts/).

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Table 1.1. Sources of UK tax revenue, 2011–12 forecasts

Source of revenue	Revenue (£bn)	Percentage of taxes (%)
Income tax (gross of tax credits)	157.6	28.0
Tax credits counted as negative income tax[a]	–4.7	–0.8
National Insurance contributions	100.7	17.9
Value added tax	100.3	17.8
Other indirect taxes		
Fuel duties	26.9	4.8
Tobacco duties	9.3	1.7
Alcohol duties	9.7	1.7
Vehicle excise duties	5.9	1.0
Air passenger duty	2.5	0.4
Insurance premium tax	2.9	0.5
Betting and gaming taxes	1.6	0.3
Climate change levy	0.7	0.1
Landfill tax	1.2	0.2
Aggregates levy	0.3	0.1
Environmental levies[b]	1.8	0.3
Customs duties	3.3	0.6
Capital taxes		
Capital gains tax	3.4	0.6
Inheritance tax	2.7	0.5
Stamp duty land tax	5.8	1.0
Stamp duty on shares	3.3	0.6
Company taxes		
Corporation tax (net of tax credits)	48.1	8.6
Petroleum revenue tax	2.0	0.4
Business rates	25.5	4.5
Bank levy	1.9	0.3
Council tax (net of Council Tax Benefit)	26.1	4.6
Licence fee receipts	3.1	0.6
VAT refunds to public sector bodies	15.0	2.7
Other taxes	5.6	1.0
National Accounts taxes	562.4	100.0

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apiece, with a range of other taxes accounting for the remainder. These include indirect taxes on cars, alcohol, tobacco, betting, and various polluting activities, which between them raise around 6% of government revenues.

These shares have not changed a great deal over time. For example, at just under 30%, income tax raises much the same proportion of total tax revenue now as in the late 1970s, despite the cuts in rates. The most significant changes have been in the composition of indirect taxes, with VAT raising a larger proportion and excise duties a smaller proportion of total revenue.[2] Similar trends can be observed internationally. Between 1975 and 2008, the proportion of OECD tax revenues coming from 'general' consumption taxes rose from 13% to 20% while the proportion coming from 'specific' consumption taxes fell from 18% to 10%.[3]

By international standards, the UK raises more than most countries from income taxes—30% against an OECD average of 25%—and less than average from social security contributions—19% in 2008 against an OECD average of 25%.[4] One feature of the UK system that is unusual by international standards is its degree of centralization. In the UK, only council tax, which accounts for less than 5% of total revenue, is collected locally. Only Ireland has a smaller proportion of taxes administered below the national level. Local government in the UK is, therefore, funded to an unusually large degree by central government grants, with local taxes playing a comparatively limited role.

So, at the macro level, tax systems have many similarities in terms of how they evolve over time and between countries. But structures differ a great deal, especially in their details. It is with these structures and design features that we are concerned—what is the measure of income on which income or corporate taxes are levied; how are savings treated; how do personal and corporate tax systems fit together; how progressive is the system; what is the base for indirect taxes and how are they designed?

By getting these design features right, all countries can reap very valuable dividends in terms of both increased economic efficiency and greater

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[2] Details of changes over time can be found at http://www.ifs.org.uk/fiscalFacts/taxTables.

[3] OECD tax revenue statistics, table C, http://www.oecd.org/document/60/0,3746,en_2649_34533_1942460_1_1_1_1,00.html#A_RevenueStatistics.

[4] OECD comparative tables, http://stats.oecd.org/Index.aspx?DataSetCode=REV.

fairness. And, to be fair, within the UK there has been progress towards a better system over the 30 years since the Meade Report was published. Tax administration has improved with the use of technology. We no longer have wholly ineffective tax rates of 98% on unearned income. The taxation of savings has been much improved. Taxation of owner-occupied housing has been rationalized. National Insurance contributions and corporation tax are now more broadly based. And, for all their unnecessary administrative problems, the introduction and extension of tax credits have helped improve work incentives, at least for some groups.

By international standards, the UK system has relatively few loopholes and opportunities for avoidance. For most people, for most of the time, the tax system works: it is not overly intrusive and it does not require vast effort to comply with—although some people on tax credits, in self-employment, or with complex financial affairs may disagree. We would certainly not characterize the British system as brutally as some characterized elements of its US counterpart back in 1995: 'The federal income tax is a complete mess. It's not efficient. It's not fair. It's not simple. It's not comprehensible. It fosters tax avoidance and cheating. It costs billions of dollars to administer. … It can't find ten serious economists to defend it. It is not worth saving.'[5]

But the UK system is still unnecessarily complex and distorting. Tax policy has for a long time been driven more by short-term expedience than by any long-term strategy. Policymakers seem continually to underestimate the extent to which individuals and companies will respond to the financial opportunities presented to them by the tax system. They seem unable to comprehend the importance of dealing with the system as a whole. And real and effective reform remains politically extremely difficult.

The litany of poor (and expensive) tax policy decisions is a long one. It includes successive changes to the structure of capital gains tax, the introduction and abolition of a 10p starting rate of income tax, the introduction and abolition of a 0% rate of corporation tax for small companies, tax breaks for film-making (which were estimated by HM Treasury to have cost an astonishing £480 million in 2006–07), and the introduction and abolition of the 'poll tax'. Moreover, the failure of political

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[5] Hall and Rabushka, 1995, 2.

will means that council tax bills in England and Scotland in 2011 still depend on estimates of the relative values of different properties in 1991.

These are the issues on which the rest of this book concentrates. But before focusing down on tax design, it is important also to raise our sights towards the economic context in which tax design must occur.

1.2. THE CHANGING ECONOMIC CONTEXT

Tax systems need to be designed for the economies in which they are to operate. Developing economies often need to put a very heavy weight on collectability of taxes. Economies rich in natural resources need a tax system designed to reflect that. Highly federalized countries will have tax systems in which the setting of taxes at the sub-national level is a major concern. In the UK context, two changes have been so profound over the past three decades that they really do deserve some special attention. The first is the great increase in inequality and associated changes to the labour market. The second is the change in the structure of the economy—the move from manufacturing to services and the changing international context.

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1.2.1. Inequality and Labour Market Change

Income and wealth are much less equally distributed across the population than they were 30 years ago. It is rarely understood quite how dramatic that change has been, nor how important it is for the formulation of public policy in general and tax policy in particular. The increase in income inequality over the past 30 years—concentrated in the 1980s—has been without historical precedent.

In 1978, when the Meade Report was published, someone at the 90th percentile of the (household) income distribution (in other words, richer than 90% of the population) had an income three times that of his or her contemporary at the 10th percentile of the distribution. Now, he or she has five times as much as that person. In 1978, 7.1 million people had incomes

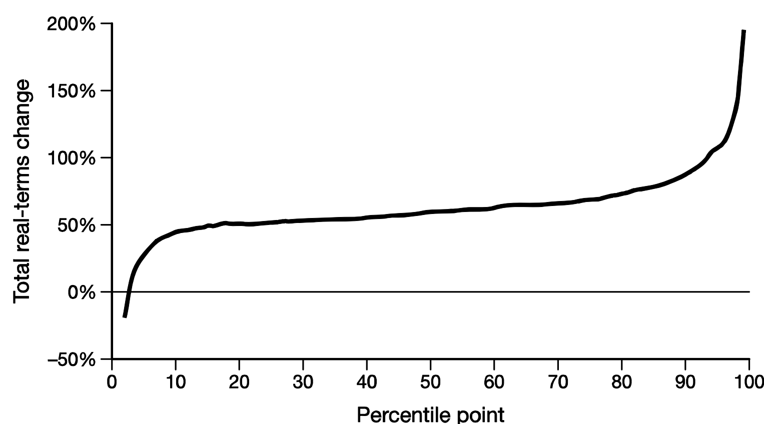

Figure 1.1. Real income growth by percentile point, 1979 to 2009–10 (Great Britain)

Notes: The change in income at the 1st percentile is not shown on this graph. Incomes have been measured before housing costs have been deducted.

Source: Authors' calculations using 1979 Family Expenditure Survey and 2009–10 Family Resources Survey.

below 60% of the contemporary median—the person in the middle of the income distribution from rich to poor. By 2009–10, that figure stood at 13.5 million.[6]

The change is perhaps best illustrated by a chart such as Figure 1.1, which shows how real income levels changed at each percentile (i.e. in each successive 1%) of the overall income distribution between 1979 and 2009–10. The continuous upward slope of the graph shows that the higher up the income distribution we go, the higher was the rate of income growth. The real income of someone at the 5th percentile of the distribution (poorer than 95% of people) was about 30% higher in 2009–10 than that of the equivalent individual in 1979. Increases were around 50% at the 25th percentile, 70% at the 75th percentile, and more than 100% at the 95th percentile.

The incomes of the very richest have risen very fast indeed and well away from those of the rest of the population. Of the 30 million or so people who pay income tax, about 200,000 are expected to record incomes of over £200,000 a year in 2011–12, with a further 160,000 having incomes between £150,000 and £200,000.[7] And the richest taxpayers pay a large portion of

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[6] All figures are measured *after* housing costs and *net* of tax payments and benefit receipts, and are drawn from IFS analysis available at http://www.ifs.org.uk/fiscalfacts.php.

[7] HM Revenue and Customs income tax statistics, table 2.5, http://www.hmrc.gov.uk/stats/income_tax/table2-5.pdf.

total tax revenues: in 2011–12, the top 1% of income tax payers are expected to pay nearly 28% of all the income tax revenue received by the government,[8] more than double the 11% contributed by the richest 1% back in the late 1970s. The poorer half of income tax payers pay just 10% of all income tax. This extraordinary level of, and increase in, the contribution of the richest is not down to a more progressive income tax structure—quite the reverse, as higher rates of income tax are much reduced. Rather, it is down to the very high levels of income enjoyed by the richest relative to those received by everyone else.

Table 1.2. Weekly net household incomes in the UK, 2009–10

	Mean	10%	25%	50%	75%	90%	Percentage in the UK
Families with children							
Lone parent, working	£471	£269	£325	£410	£520	£723	4.2%
Lone parent, not working	£318	£179	£230	£287	£375	£497	3.9%
Couple, both working	£867	£409	£531	£703	£954	£1,356	21.7%
Couple, one working	£737	£299	£380	£496	£683	£1,010	11.0%
Couple, not working	£390	£130	£256	£347	£465	£610	2.9%
Families without children							
Single, working	£653	£215	£328	£520	£826	£1,205	11.1%
Single, not working	£437	£97	£166	£316	£562	£898	6.4%
Couple, both working	£840	£393	£523	£700	£941	£1,312	13.4%
Couple, one working	£578	£225	£322	£459	£689	£988	5.4%
Couple, not working	£372	£111	£221	£310	£470	£698	2.5%
Pensioners							
Single	£294	£134	£175	£237	£335	£507	7.2%
Couple	£487	£225	£293	£388	£563	£818	10.4%
All	£637	£207	£320	£500	£755	£1,098	100.0%

Source: Authors' calculations based on 2009–10 Family Resources Survey.

[8] HM Revenue and Customs income tax statistics, table 2.4, http://www.hmrc.gov.uk/stats/income_tax/table2-4.pdf.

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To provide a better understanding of the overall distribution of income, Table 1.2 provides a detailed snapshot of how *net* household incomes vary by family type. It also provides a picture of the distribution of different family types and of how incomes vary within family types. It illustrates, for example, the preponderance of two-earner couples, both with and without children.

Of course, one cannot directly compare the incomes of different family types to understand relative living standards—couples with children need more money to live on than the single childless. As one would expect, couples where both are in work have higher average incomes than any other group, and single pensioners have lower incomes. But there are big overlaps between all the groups—no group is universally poor, none is universally rich. Differences within family types are generally greater than differences between family types. The tax and welfare systems need to be designed with all these aspects of the shape of the population and their incomes in mind.

Returning to the question of how the income distribution has become more dispersed over time, much of this change has resulted from a more dispersed distribution of wages. In large part, this reflected a rise in the financial pay-off people received from achieving higher levels of skills and education, though inequality has also increased dramatically within groups of people with similar skills. Changes in labour market institutions—for example, falls in trade union membership—have also played a part. Levels of unemployment and non-employment also rose rapidly, and whilst official measures of unemployment fell back from the early 1990s, levels of labour market participation for men are still well down, reflecting greater numbers giving illness or disability as the main reason for not working. Over 90% of working-age men were in employment or self-employment in the mid-1970s; only 76% were in 2009.[9]

As we shall see in Chapter 3, and as illustrated in Table 1.3, most of the reduction in the proportion of men in work occurred among younger and older age groups. This fact matters enormously in thinking about tax design.

Nobody should argue that the tax and benefit system alone *created* these extraordinary changes in participation. Recessions in the early 1980s and

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[9] Office for National Statistics, *Social Trends 2010*, figure 4.4, http://www.statistics.gov.uk/downloads/theme_social/Social-Trends40/ST40_2010_FINAL.pdf.

Table 1.3. Percentages of men and women in work by age, 1979 and 2008

Age group	Men (% in work)		Women (% in work)	
	1979	2008	1979	2008
16–24	75	58	60	56
25–54	93	88	60	75
55–64	80	67	38	49
All, 16–64	87	78	56	67

Source: Calculations from Labour Force Survey (with thanks to Antoine Bozio).

early 1990s changed the labour market beyond recognition. But the incentives in the tax and benefit system can prolong or ameliorate the impact of such shocks. The recovery after recession in the employment rates of older workers in the UK is very different, for example, from that in France, where responses to the recession of the 1980s included generous pension and layoff arrangements that have not been unwound. Only 19% of men aged 60–64 in France were in work in 2009 compared with 57% of such men in the UK.[10]

Another profound change has been in the role of women in the labour market. Their employment rates have risen—with particularly big increases among married women with children. As more families with children have, and aspire to have, both parents working, the impact of tax rates and benefit withdrawal rates on the potential second earner becomes more important. A tax system that encourages a primary earner to work by providing tax credits, which are then withdrawn as *family* income rises, may discourage a second earner from working. There is powerful evidence that it is women with children whose work patterns tend to be most sensitive to the structure of the tax and benefit system. Making working a bit less attractive relative to not working tends to have little impact on whether men (at least those aged 25–50) work, but rather more impact on the behaviour of women.[11]

But there has also been a divergence in the experience of different types of women in the labour market. While employment rates have increased for

[10] Blundell, Bozio, and Laroque, 2011.

[11] See Meghir and Phillips (2010) and Brewer, Saez, and Shephard (2010).

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women in general, they fell to a very low level for the rapidly growing group of single mothers, recovering somewhat after 1997. The tax and benefit system has responded to, and also helped to shape, these social changes, with the introduction and subsequent extension of tax credits doing much to increase the incentives for single parents to move into work. These sorts of issues were much less salient on the policy agenda at the time of the Meade Report in the 1970s. Tax system design needs to be robust to social and labour market changes. A system that provided generous benefits to non-working lone parents has, perhaps unsurprisingly, helped facilitate a great increase in their numbers when economic opportunities for the low-skilled dried up and social norms changed.

Overall levels of inequality in incomes are also important. In the first place, of course, we might want to design the tax system to do more work to ameliorate the underlying growth in inequality. Second, with relatively high levels of non-employment and low-wage employment, the impact of the tax and benefit system on both incentives to work and the incomes of low earners will matter a lot. We come back to this issue in some detail in Chapter 4. Third, and more generally, a given tax system will have very different effects depending upon the distribution of incomes among the population on which it is imposed—the effects of a higher rate of income tax on earnings over £100,000 are likely to matter more if there are more people earning over £100,000.

Similarly, the distribution of wealth naturally has consequences for our views about taxing wealth. If, for example, the distribution of inheritances were reasonably equal, then the argument put by many for taxing inheritance on equity grounds would fall away. If, as has indeed happened, the distribution of wealth and inheritances becomes more unequal, then the case for a progressive inheritance tax becomes stronger.

1.2.2. Structural Change and Globalization

Changes to incomes and in the labour market themselves, in part, reflect structural changes in the economy. These have, of course, been considerable over the period since the publication of the Meade Report. Financial and

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business services accounted for 32% of national income in 2008 compared with just 15% in the late 1970s.[12]

One very salient example of a change that has mattered enormously to the tax system has been the increased role of financial services. Their share in gross value added increased by more than half between 1980 and 2007. This makes their exemption from VAT an increasingly important tax design issue—one to which we devote Chapter 8. It also increased the government's reliance upon them for corporate and income tax revenues—a fact that has been painfully underlined in the subsequent financial crisis. The banking, finance, and insurance sector was responsible for £12.3 billion of corporation tax in 2007–08—27% of all corporate tax revenues and nearly three times what might be expected on the basis of its share in the economy. That total fell to £7.5 billion in 2008–09, just 17% of that year's corporation tax.[13] The Treasury's own analysis confirms that the 'increased importance of the financial sector' is one of the factors responsible for 'increased sensitivity of receipts to the cycle'.[14] It estimates that fully half of the total increase in tax receipts enjoyed by the government in the five years running up to 2007–08 was due to taxes raised on the housing and financial sectors.[15] Unfortunately, the sensitivity of these sectors to the economic cycle meant that annual tax receipts from them fell by a full 1½% of GDP[16] (over £20 billion) in the two years from 2007–08 to 2009–10.

The shape of the economy affects the appropriate tax policy. Tax structures may also help shape the economy, possibly in unwelcome ways. The public finances suffered as a result of the financial crisis. But the tax system may itself have played at least some, albeit minor, role in creating or facilitating the crisis. The tax treatment of housing and financial services, the very low taxes on capital gains, and the incentives in the corporate tax system for debt

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[12] Measure refers to gross value added at current basic prices. Data from *The Blue Book*, ONS. For the most recent statistics, see table 8.3, *The Blue Book*, 2010 edition. Time series available in OECD STAN database (variable id 'VALU').

[13] Source: HM Revenue and Customs corporation tax statistics, tables 11.4 and 11.5, http://www.hmrc.gov.uk/stats/corporate_tax/menu.htm.

[14] HM Treasury, 2008, 17.

[15] Including corporate taxes, stamp duties, and income tax and National Insurance raised from earnings from financial sector employees.

[16] Source: HM Treasury, 2010a, box C3.

funding over equity funding are all possible culprits. We address all these issues in the relevant chapters.

Meanwhile, technological advances have transformed the productive economy from which taxes are raised, while at the same time making it easier to administer the tax system and easier to structure activities to avoid tax. The role of technology in cross-border transactions and the implications of this for the tax system are touched on in Chapters 7 and 18. This and other aspects of globalization mean that cross-border issues more generally are now much more important than they were 30 years ago, and this has undoubtedly placed new constraints on what is possible within the tax system. Real complexities are also created by increased globalization—for example, regarding the appropriate treatment of companies by national tax systems. How does one think of taxing a Swiss company that develops a drug in a research facility in the UK, manufactures it in Belgium, and mainly sells it in the US?[17]

But despite some predictions to the contrary, countries are not being forced inexorably to tax less in an increasingly globalized and competitive world economy. Between 1975 and 2008, taxes rose as a proportion of national income in virtually every OECD country. On average, the tax take rose from 29.4% to 34.8% of national income. In no OECD country was there a significant fall in the tax take over this period. And the variation between countries is striking. Denmark, Sweden, the US, and Japan are all rich countries. In Denmark and Sweden, taxes accounted for 48% and 46% of GDP respectively in 2008. In the US and Japan, they accounted for only 26% and 28%.[18] There is no straightforward relationship between the total tax burden and economic performance.

It clearly remains possible for a successful economy to raise 40% or more of national income in tax despite the pressures of globalization. But, within the total tax take, we might expect that governments would find it more difficult to raise taxes from internationally mobile companies and people. In fact, revenue from corporation taxes has more than held up over the past 40 years—corporate income taxes accounted for 9% of tax revenues across the

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[17] Example used by John Kay at a conference at the London School of Economics in May 2011.

[18] All figures from OECD tax revenue statistics, table A, http://www.oecd.org/document/60/0,3746,en_2649_34533_1942460_1_1_1_1,00.html#A_RevenueStatistics.

OECD in 1965, 8% in 1985, and 10% in 2008.[19] As we have already seen, the richest—and probably most mobile—1% of taxpayers in the UK are expected to contribute 28% of income tax revenue in 2011–12, compared with just 11% in 1979.

This is not to imply that there are no problems. The fact that some people and companies may be able to avoid taxes because of their international mobility might mean that the burden is in some respects now borne more unequally, and inefficiently, than before. In addition, if there is a sense that some individuals or companies can avoid paying tax because of their domicile or ability to shift profits around, then acceptance of the system and belief in its equity may be damaged.

However, the resilience of these revenues highlights the fact that while it has certainly become easier and cheaper to cross national borders—and it may well continue to become so—it is far from costless. Policymakers must therefore decide whether to design the tax system in readiness for the day when globalization does indeed make it much harder to raise revenue from mobile individuals and businesses, or whether to collect the revenue while they can and reform the system once these pressures have materialized. Either way, for the time being, as we discuss in Chapters 4 and 18, globalization certainly affects the rates at which we can reasonably hope to tax high incomes and the feasible structure of corporate taxes.

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1.3. THE POLITICS OF TAX REFORM

Of course, it is not just the economic context that matters for tax policy. Politics matters too. It is not possible to understand the structure or development of the tax system outside of a political context—not least because making people obviously, or apparently, worse off is rarely good politics, at least in the short term. And almost all tax reforms make some people worse off.

This makes much reform rather harder to put into practice than to design. Worse, when governments need money they tend to look to raise revenue in

[19] Source: OECD tax revenue statistics, table C, http://www.oecd.org/document/60/0,3746,en_2649_34533_1942460_1_1_1_1,00.html#A_RevenueStatistics.

ways that make the losers relatively hard to identify. This results in complexity and poor policy. A classic example is the way in which governments have often used *fiscal drag* to increase income tax revenues whilst cutting the basic rate of income tax. Fiscal drag occurs where tax bands and allowances are raised more slowly than the incomes on which the tax is levied. Fiscal drag was largely responsible for an increase in the number of income tax payers from fewer than 26 million in 1996–97 to a peak of 32.5 million in 2007–08.[20] The number paying the higher (40%) rate of income tax roughly doubled from 2 million to nearly 4 million over the same period. These are big changes that mean that some people have gained less from higher wages and salaries than they would otherwise have done—a fact that appears to get little play in the policy debate.

For similar reasons, rates of National Insurance contributions have risen while income tax rates have fallen. Compared with income tax, NI taxes a narrower range of income, does less to redistribute resources from rich to poor, and is less transparent to the citizen, especially that part which is levied formally on employers. As we will see in Chapter 4, its original function as a payment for rights to contributory benefits such as the state pension has been almost entirely eroded, although governments exploit the lingering belief that the link is still a strong one. Indeed, a remarkable number of people believe that NI in some way pays for the National Health Service—a misapprehension played upon in 2002 when an increase in NI rates was announced purportedly to pay for higher spending on the NHS.

Raising revenue through more radical reform has proved difficult. The attempt in the early 1990s to impose VAT at the full rate on domestic energy consumption created a political backlash strong enough to see the policy partially abandoned, and then further reversed by the next government. This reform was to have been accompanied by measures that left most poorer people better off, while still raising revenue overall. But people who spend unusually large proportions of their income on energy would still have been left worse off. That makes the change difficult to achieve in political terms. But suppose we started, as some countries do, in a world where VAT was already levied on fuel. To abolish it would not look like an attractive policy. The rich spend more in absolute terms on fuel than do the poor. Hence,

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[20] HM Revenue and Customs income tax statistics, table 2.1, http://www.hmrc.gov.uk/stats/income_tax/table2-1.pdf.

abolishing an existing tax would look like subsidizing the well-off to increase their consumption of a polluting good. But we rarely think of the fact that failing to tax something is, in effect, subsidizing its usage. This thought experiment is also valuable in demonstrating the extent to which tax is one area of public policy where the 'tyranny of the status quo' is strongest. Changing it substantively is difficult. We hope to challenge some of that tyranny here.

Whilst the attempt to place full VAT on domestic energy consumption was unsuccessful, weakness in the public finances can sometimes facilitate beneficial tax reform. If people accept that there is a need to raise money, then there is no escaping the need to leave some people worse off. The period after 1992—the last significant episode of fiscal consolidation—saw the final phasing-out of mortgage interest relief and the married couple's allowance as well as big increases in petrol and tobacco duty, policies that might have been hard to implement in the absence of a widely recognized need for fiscal policy to be tightened. The recent crisis has seen less reform—increases to rates of NI, to higher rates of income tax, and to the VAT rate have been used to raise money. That is something of a shame. As Rahm Emanuel observed when he was President Obama's Chief of Staff, one should never let a crisis go to waste.

Some poor policymaking can be understood, if not excused, by reference to straightforward political pressures. The complexity of the tax system and lack of public understanding make poor policy, and indeed explicit misrepresentation by government, much too easy. They can lead to an undesirable narrowing of public debate and a fixation on a few easy-to-understand elements, such as the basic rate of income tax. This then drives out wider considerations. Governments have also been accused of relying on so-called 'stealth taxes', taxes where the incidence on individuals is unclear. The use of such taxes can itself undermine trust in the tax system.

The significant and growing complexity of business taxation makes public debate in this area very limited indeed. Corporation tax and business rates between them raise almost as much as VAT, nearly half as much as income tax, and nearly three times as much as fuel duties. And, of course, they must all be paid by individuals in the end. Their lack of salience and the lack of debate are regrettable. The increasing complexity of corporate taxes also leaves room for a great deal of corporate lobbying to introduce and extend

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special treatments and allowances. The story of the R&D tax credit is a good example, as commented on by Alt, Preston, and Sibieta (2010, 1205):

> Enacting tax policy can create interest groups and constituencies in favour of that policy. Even when they did not lobby for the policy in the first place, … they will lobby both for persistence and extensions that allow policy to drift from its original motivation. Therefore, any potential tax reformer should remember that any new allowances enacted or favourable tax treatments provided to particular groups could prove difficult to remove and may be distorted into something different over time.

Good tax policy requires an open, transparent, and well-informed public debate based on credible data. Poor public understanding is a constraint on good tax policy. It allows poor-quality analyses of policy reforms to gain prominence.

Good tax policy also requires effective processes within government. At present in the UK, there is arguably a more limited level of discussion and debate about tax policy within government, and as part of the legislative process, than in other areas of policy. The Treasury is a remarkably powerful institution and, as far as tax policymaking is concerned, has become more powerful in recent years, as it has taken on much of the policymaking capability of HMRC. There are no checks and balances within the executive. The Chancellor effectively takes sole responsibility for his Budget.[21] The legislature—parliament—also effectively has a rather weak oversight role, particularly when it comes to some of the more complex areas of tax policy.

Finally, we should not forget one very important change to the political and institutional environment for tax reform over the past 30 years: the growing integration of the European economies and the increased influence of the European Union (EU). Thirty years ago, the main role of the European Union (then the European Economic Community, EEC) was to bring down trade barriers. Since then, it has grown in importance and it now exerts an important influence on UK tax policy, both directly and indirectly. Member states of the EU retain sovereignty over direct taxation, but are nevertheless required to exercise it in accordance with EU law. In recent years, there have been a number of successful legal challenges to elements of national corporate income taxes at the European Court of Justice (ECJ). This has prompted a variety of reforms—for example, changes to anti-avoidance

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[21] In the UK, it has always been *his* Budget. We have had women Foreign Secretaries and Home Secretaries and most famously a woman Prime Minister, but never a female Chancellor.

rules designed to limit the ability of multinational firms to shift their taxable income between countries with different tax rates.

The EU has greater formal influence over indirect tax policy, including explicit limits on the ability of countries to alter their VAT rates. This reflects the fact that an open market in goods requires some kind of system for dealing with differential tax treatment of goods across country borders. Issues of dealing with VAT and excises within the EU are central to our discussion in Chapter 7.

1.4. CONCLUSIONS

Taxes, like death, are unavoidable. But we can design our taxes. We are not bound to have a tax system as inefficient, complex, and unfair as our current one. To improve things, we need to see the system as a whole, we need to design the system with a clear understanding of the population and economy on which it operates, and we need to apply economic insights and evidence to the design. We also need a much more informed public debate and a much better set of political processes than the ones we currently have.

Our purpose in this book is to create a framework and directions for reform. In the next chapter, we explain in more depth what we mean by an economic approach. We then look in turn at taxes on earnings, taxes on consumption, environmental taxes, taxes on savings, taxes on wealth, taxes on land and property, and taxes on companies. In the final chapter, we draw all this together to propose an overall set of reforms to the tax system which, we believe, has the potential to make us all better off and free us from at least some of the shackles created by the complexities and inefficiencies of the current system.

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