TONY BLAIR INSTITUTE FOR GLOBAL CHANGE

Principles of Tax Reform: A Post-Covid Opportunity to Build a Fairer System

JAMES BROWNE

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Executive Summary

With a third wave of Covid-19 infections in full flow, it appears increasingly likely that the pandemic will inflict lasting damage on the economy. This spells bad news for the public finances, as tax revenues will be hit just as pressure for more spending on health and social care, and from the costs of an ageing society, increase. Tax rises in the order of the tens of billions seem inevitable, but the impact of tax rises will depend critically on how they are designed. In this report, we outline some key principles for tax reform in the decade ahead.

The pandemic will lead to record-breaking deficits and a big jump in debt levels this year, but ultra-low interest rates mean that the cost of servicing debt will remain low by any historical standards. But if it causes permanent damage to the economy of the scale the Office for Budget Responsibility (OBR) envisages – it has made the working assumption that the UK economy would be 3 per cent smaller in the long run than it had anticipated in March – tax revenues will be more than £55 billion lower in 2025–26 than had previously been expected. At the same time, there will be pressure to spend more on health and social care and to maintain increases in benefit generosity that have been introduced during the pandemic. And in the longer term, the pressures of an ageing society remain, and are set to grow stronger as we move into the 2030s. The OBR expects that health spending will have to more than double as a share of GDP from 7.2 per cent last year to 14.8 per cent in 2069–70, and that pensions spending will increase from 4.5 per cent to 6.9 per cent of GDP. As this will not be matched by higher tax revenues, deficits and debt will explode in the absence of any policy action.

We argue that this calls for both large-scale public-sector reform and additional tax revenues. The government will need to embrace the technological revolution to automate routine processes and free up staff time for hands-on service delivery. But additional tax revenue will also no doubt be required – technology cannot reduce the cost of pensions (a transfer of a pound will always cost a pound), and advances in health care in the past have tended to increase costs as new treatments have become available.

The choices on tax that are made in the aftermath of the pandemic will set the path for the next decade, just as those made in the wake of the global financial crisis did for the 2010s. In the last decade, short-run, tactical reforms moved us further away from a fair, efficient and simple tax system. Austerity benefit cuts hit the poorest hardest and weakened the link between benefit entitlement and family needs. Measures to raise additional revenues from the richest have been poorly designed, causing unnecessary economic distortions and greater complication to the system. Inequities in the taxation of earned and unearned income have increased. The taxation of land and property is in desperate need of reform, and the taxation of carbon emissions has become ever more incoherent. Overall, the tax-benefit system increasingly divides people into two groups: put-upon contributors, and recipients who are taking advantage and whose benefit entitlements need to be tightly controlled.

Taking a strategic approach to tax reform over the next decade could avoid these pitfalls and ensure that revenue is raised and redistribution achieved in the most efficient way. We argue that the three key areas of reform should be: to shift the balance of taxation away from earned income towards unearned income and land and property; to address climate change by increasing carbon taxes; and to address intergenerational unfairness. The inequitable treatment of earned and unearned income in the tax system has built up over many years as income tax and capital-gains tax have been cut and National Insurance contributions increased, mainly to the benefit of the wealthy. With the challenge of net zero ahead, a comprehensive tax and coherent approach to taxation of carbon emissions will be an important tool. The tax system should also seek to address the inequitable impacts of falling global interest rates that have benefitted older asset holders but made it more difficult for younger generations to own their own homes and save for retirement. This approach will not only raise revenue but will also assist with other challenges we face in the years ahead.

Introduction

Although Covid-19 is primarily a health crisis, it is now increasingly clear that it will also have long-term economic effects. With the pandemic showing no signs of abating, a short, V-shaped recession seems much less likely than it did a few months ago. With activity in many sectors of the economy still shut down or at reduced capacity, unemployment is likely to rise as support schemes for workers are wound down in the months to come and more firms likely go bankrupt. This will have ongoing effects for years to come as workers' skills are degraded from periods out of work, and the organisational and physical capital and supply chains of existing firms are lost.

As previous work at TBI has shown, if there is long-term damage to the economy, that would be bad news for the public finances just at a time when they are already under pressure from the costs of an ageing society, and as the pandemic itself exposes weaknesses in health and social-care provision. [1] All of these point to a need to raise significant additional tax revenues – almost certainly multiple percentage points of GDP, or in the tens of billions – in the years ahead.

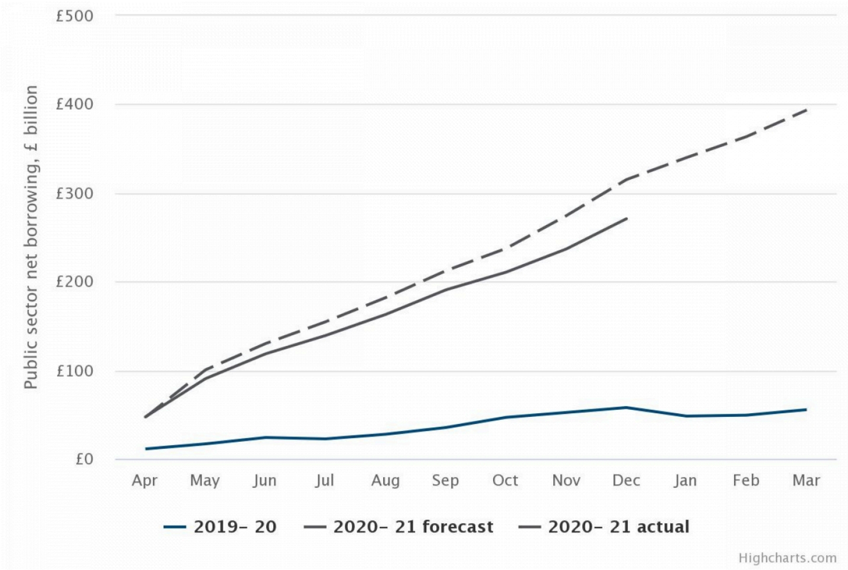
Just as the decisions made on how to close the deficit that emerged after the global financial crisis of 2008 shaped tax policy during the 2010s, the decisions that are made following the pandemic will shape tax policy during the 2020s. Short-run, tactical decisions made in the aftermath of the global financial crisis raised revenue but ultimately made the tax system more complicated and less efficient than it had been at the start of the decade. Making the same mistake again or simply increasing tax rates within a flawed system would be economically costly. What is different this time is that there is time to think about the measures that should be introduced to form a coherent tax strategy for the next decade. Sensibly, there is a growing consensus that immediate action to tighten fiscal policy is unnecessary and undesirable. Although budget deficits are running at record levels, extremely low interest rates mean that the burden of this additional debt is small. Indeed, even with debt levels in the future being much higher than was previously expected, total debt interest payments are forecast to be lower in the future than the OBR anticipated in March. Moreover, experience following the 2008 global financial crisis warns us of the dangers of premature fiscal tightening at a time when the economy is still weak and monetary policy is unable to fully offset any tightening of fiscal policy because interest rates are at their zero lower bound.

In this paper, we analyse the current state of the public finances and examine the choices facing the chancellor in his March budget in light of updated projections produced by the OBR. We then consider what has gone wrong with the tax policy before outlining the principles that we believe should underpin a tax strategy for the decade ahead.

The Scale of the Challenge

In preparing the next budget, the chancellor is faced with a fiscal situation that looks very different in the short, medium and long term. In the short term, budget deficits will continue to be very high. The OBR forecasts net public-sector borrowing close to £400 billion for the current fiscal year. Although spending has so far been somewhat lower than the OBR expected as central government spending has been less than anticipated, it seems certain to exceed all peacetime records.

Figure 1 – Cumulative monthly public-sector net borrowing, 2019-20 and 2020-21 (forecast)



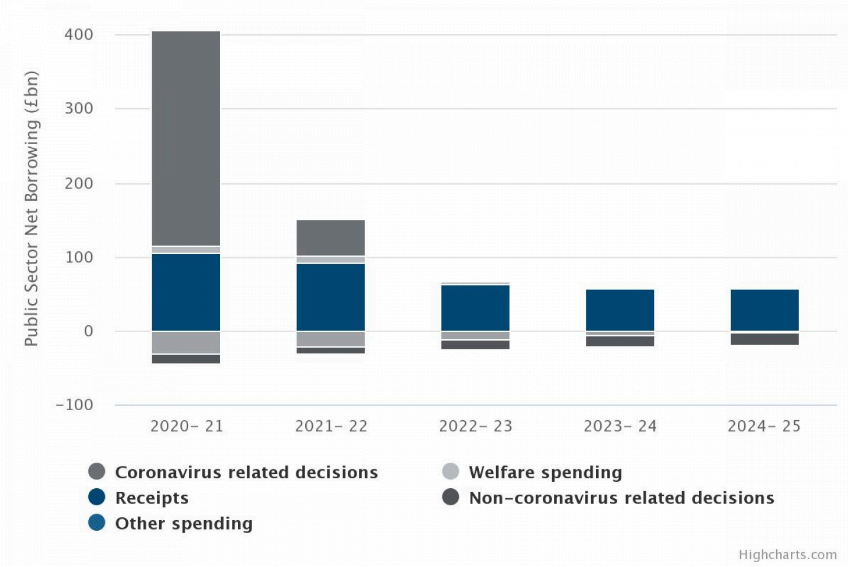
Source: ONS, OBR

If vaccine rollout in 2021 allows a relatively swift return to normality, the deficit could fall very quickly as tax revenues increase and emergency spending measures such as the Coronavirus Job Retention Scheme and the Self-Employed Income Support Scheme can be switched off. This is the OBR's central scenario, under which public sector net borrowing falls from 19 per cent of GDP in 2020–21 to 7.4 per cent in 2021–22 and 4.4 per cent the following year. But there are downside risks if vaccines are not effective against new variants of the virus. The OBR also produced a downside scenario where vaccines are ineffective and lockdowns have to be extended further. In this case, deficits fall much more slowly, falling only to 12.7 per cent of GDP next year. In reality deficits would likely be even higher than this as the government would also have to extend emergency support measures.

But some of the support that has been offered to those negatively impacted by the pandemic may be less easy to roll back. For example, a number of changes to social-security benefits and tax credits have been made to make them more generous during the pandemic: The basic amounts of Universal Credit and Working Tax Credit have been increased by £1,000 a year and Local Housing Allowance (LHA) rates (the maximum amount of housing benefit that can be claimed for private sector tenants) have been increased to the 30th percentile of local rents. These will increase spending by £9.3 billion in 2020–21. Most of these are due to expire next April, but this is likely to prove politically challenging: Temporary giveaways have a habit of becoming permanent, especially in a context where the real value of benefits has fallen significantly over the past decade following a series of below-inflation increases and then a four-year freeze. Indeed, the government has already confirmed that LHA rates will not be cut back to their previous amounts, so this will be a permanent increase in benefit spending of around £1 billion a year. This increase in benefit rates is very welcome – past analysis at TBI has shown that the failure of LHA rates to keep up with rents has led to claimants facing growing shortfalls between the Housing Benefit they receive and the rent they pay [2] – but this unbudgeted spending will place greater pressure on the public finances going forward.

It is the medium-term prospects for the economy and the public finances that the chancellor will thus no doubt be focusing much of his attention on as he comes to make his budget judgement. The OBR's November Economic and Fiscal Outlook gives us a good idea of the choices that will confront him. The chart below summarises nicely how the OBR's projections for their five-year forecast period have changed since the March budget. As described above, most of the additional public spending planned to support households and businesses through the pandemic is expected to be tapered away by the end of this fiscal year. The main changes in the deficit for the following years arise from a downgrade in forecast tax revenues, which are themselves driven by a smaller economy than expected in March. Tax revenues are not expected to be any lower as a share of national income, it is simply that the economy is expected to be smaller than was forecast in March and thus expected to generate less tax revenue. Moreover, the economic damage caused by the pandemic is by no means only temporary: The OBR expects that the economy will be 3 per cent smaller in 2025 relative to its March forecast.

Figure 2 – Contributions to changes in public-sector net borrowing 2020–21 to 2024–25 (forecast)



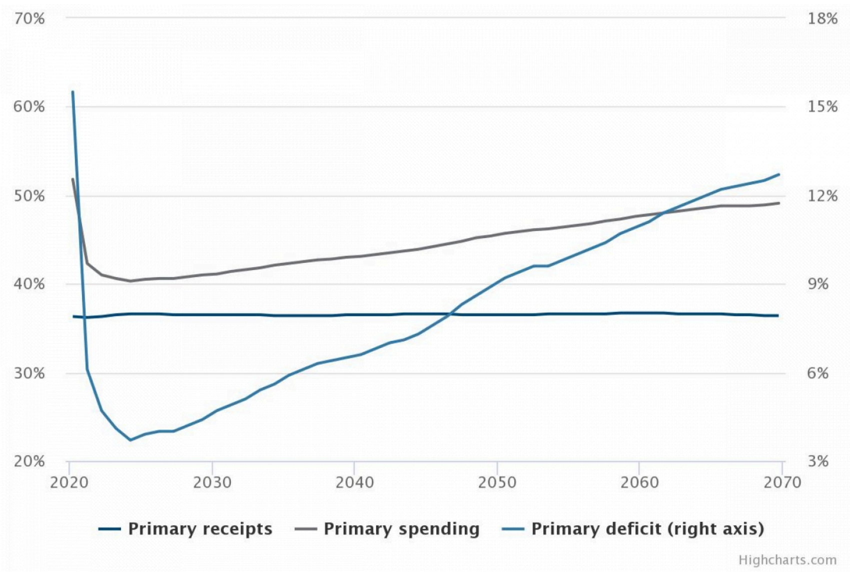
Source: OBR

However, the key factor that is generating the reduction in tax revenues in the OBR's model – this permanent reduction in the productive capacity of the economy of 3 per cent from the pandemic – is highly uncertain. The OBR has based this estimate on the impact of previous epidemics, including the 1918 flu pandemic. But this assessment must be considered highly uncertain given the unique nature of the Covid-19 pandemic and the associated policy response. Recognising this, the OBR has produced an upside and downside case, where the impact is zero or twice as large (6 per cent), and it acknowledges that the downside could be even worse than this.

It is also interesting to note that the OBR expects lower debt interest payments over the forecast period despite the huge level of borrowing in 2020–21 making debt much higher. (The OBR expects debt to increase above 100 per cent of GDP this year). The new debt incurred is being financed at very low interest rates, which also allow existing debt that has to be rolled over to be refinanced at these historically low rates. This will no doubt ease any fears the chancellor has over the debt that has been incurred over recent months, as it will not place a significant burden on the public finances for many years to come.

Reading the Fiscal Sustainability Report, the chancellor will also have had an eye on the long-term projections for the public finances, which show that the challenges of an ageing population have not gone away. The OBR expects that health spending will have to more than double as a share of GDP from 7.2 per cent last year to 14.8 per cent in 2069–70, and that pensions spending will increase from 4.5 per cent to 6.9 per cent of GDP. As a result, primary deficits are forecast to start rising again as spending increases as a share of national income while tax revenues only grow in line with growth in the economy. By the mid-2050s, non-interest spending is expected to exceed tax revenues by more than 10 per cent of national income (Figure 3). Ever-rising deficits would not be sustainable in the long run.

Figure 3 – Forecast primary receipts, spending and deficits as a share of GDP, 2020–21 to 2069–70



Source: OBR

Summary

The challenge the chancellor faces is not immediate, but potentially large nonetheless. If there is long-term economic damage of the scale envisaged by the OBR from the Covid-19 pandemic, there will be a current budget deficit of around 2.5 per cent of national income – somewhere between £55 and £60 billion in today's terms – even once the economy has returned to full capacity. This level of budget deficits would lead to debt continuing to grow as a share of national income. [3] It would be likely that the government would want to take action to reduce the debt-GDP ratio in those circumstances to avoid the risk of rising interest rates rapidly increasing debt interest payments. Moreover, the costs of an ageing society are expected to ramp up from the 2030s onwards, which will require further additional tax revenues. Allowing higher deficits in the short term and hoping that it will be possible to restrain growth in public spending in the future will not be an effective strategy.

How Should the Chancellor Respond in the Budget?

If we were in normal times, the choice facing the chancellor would be stark, as he would be on course to miss two of his three fiscal targets. The current budget is projected to be in deficit in 2022–23, and planned investment spending is now expected to average more than 3 per cent of national income over this period as a result of national income being lower than expected. To meet these targets, the chancellor would have to either announce some rapid and severe fiscal tightening of between £55 and £60 billion a year in today's terms over a three-year period, or suffer the consequences of breaking his fiscal rules.

The unique circumstances of these times suggest a different approach, however. The size of the current budget deficit in 2022–23 without any policy changes and the appropriate policy response to this will in reality depend on how quickly the economy bounces back from the pandemic and the extent to which the damage to the economy from the pandemic is permanent. If it were to become apparent that the economy has already reached, or still has the capacity to reach, the same levels that existed before the pandemic, there would be no need for any fiscal policy tightening. Similarly, if the economy were operating a long way below its potential capacity – which would be clear if unemployment remained elevated – there would be a strong case for delaying any fiscal tightening that was required until it had fully recovered, as we and other commentators have recently argued.

It is therefore highly likely that the chancellor will not attempt to meet his current fiscal rules in the budget. The current fiscal rules do not give enough flexibility to support the economy through the recovery phase, as they require the current budget to be balanced within three years. Instead, the chancellor will likely give himself longer to bring budget deficits back to more normal levels.

On the other hand, doing nothing in the budget and waiting to see whether the OBR's gloomy predictions come to pass is likely neither politically realistic nor economically sensible. Voters and investors will rightly want to know how the chancellor intends to respond to whatever negative impacts on the public finances come to pass. Therefore, it is likely that some form of fiscal tightening, to be implemented in the medium term, will be announced in the budget. This could be with the caveat that it will not be implemented (or an offsetting giveaway introduced) if it turns out to be unnecessary, or even as the Institute for Government recently suggested, [4] just a placeholder for a certain amount of tax rises or spending cuts.

Assuming that a fiscal tightening of some sort is announced in the budget, it is highly likely that this would take the form of tax rises rather than spending cuts. We have already seen the pressures on existing spending simply from maintaining health, social-care and pension provision in the context of an ageing population. Moreover, as the country becomes richer over time we would expect people to demand more health and education as these are so-called "superior" goods where demand rises more than proportionally with income. The pandemic has also produced demand for additional spending on health and social care on an ongoing basis by highlighting weaknesses in public-health provision and the problems faced by social care providers. Nor can spending be shifted towards health and pensions from other areas, which have faced severe cuts over the last ten years and are facing problems of their own – the government recognised this by increasing spending for all departments in the 2019 spending round.

Thus, alongside additional tax revenue, there is a clear need for reform of public services to maximise efficiency in order to achieve service improvements. At TBI, we have argued that these will require new technologies to be applied to the delivery of public services. For example, in health care, artificial intelligence can be used for diagnosis and optimising treatments for individual patients, leaving clinicians with more time for human contact. In education, digital platforms, online classes and AI tuition can give more students access to world-class learning resources and more personalised learning. More generally, government needs fast, interoperable systems to handle data, identity, transactions, notifications, payments and other functions that can be applied at scale across public services to reduce duplication and inefficiency, freeing up public servants to focus on service delivery.

But tax rises will be necessary too. It is unlikely that technology will do much to relieve the two biggest pressures on the public finances from health and pensions: It cannot reduce the cost of pensions (a transfer of a pound will always cost a pound), and innovations in health care have tended to increase costs as more treatments have become available.

The obvious way to raise tax revenues would be to simply increase tax rates. But doing so would ignore the many flaws with the existing tax system, many of which have got worse since the global financial crisis. A better approach would be to seek to redesign the tax system to raise revenue and achieve redistribution in the most efficient way. All taxes distort economic activity in both desirable and undesirable ways, but it is possible to minimise undesirable distortions and discourage harmful activities through careful design of the tax system. Reforming the tax system could then potentially allow more revenue to be raised without affecting either the amount of redistribution performed by the tax system or increasing its distortionary effects on economic activity. By contrast, simply increasing tax rates within an unreformed system would undoubtedly be economically costly.

Fortunately, there is now time for policymakers to think strategically about the shape of the tax system rather than following the pattern of short-run, tactical decisions that have characterised tax policy since the global financial crisis. In the remainder of this paper, we examine the evolution of the tax system since 2010 and suggest some principles that should underlie tax reform over the next decade. We then outline particular areas of reform to move the tax system closer to fulfilling these principles.

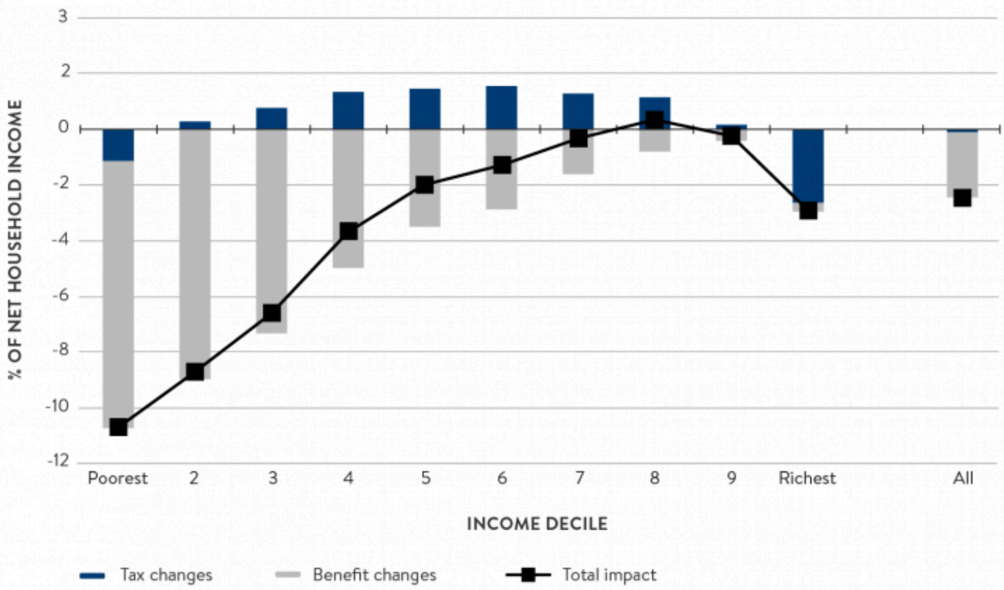
What Has Happened Over the Past Decade?

Before considering how we should approach the next decade, it is worth taking time to review what happened the last time a significant fiscal tightening was needed, in the aftermath of the global financial crisis. Although most of the fiscal tightening took the form of spending cuts, there were also significant tax rises. But it is also notable and perhaps surprising that there were also three major tax cuts introduced during this period, with a big increase in the income tax personal allowance, and significant real reductions in the value of fuel duty and cuts in corporation tax rates. These changes reshaped the tax system: It was not the case that tax rates were simply increased. Below we outline the main trends in tax reform during this period.

Austerity Hit the Poorest Hardest

Reforms introduced since 2010 have tended to increase income inequality (relative to a no-reform scenario where benefit rates and tax thresholds had been increased in line with inflation, see Figure 4). This arose because the poor bore the brunt of benefit cuts that were introduced as part of the austerity programme. Those living in private rented accommodation and large families have been particularly badly affected by benefit changes. Cuts to Local Housing Allowance have left private renters with big shortfalls between their rent and the maximum amount of housing benefit they can claim, [5] and policies such as the household benefit cap and the two-child limit in tax credits, as well as Universal Credit have reduced the support available for large families. At the same time, those on middle incomes benefited from increases in the income tax personal allowance and real reductions in fuel duty (Figure 4), while increases in VAT shifted the tax burden to those lower down.

Figure 4 – Distributional impact of tax and benefit changes, 2010

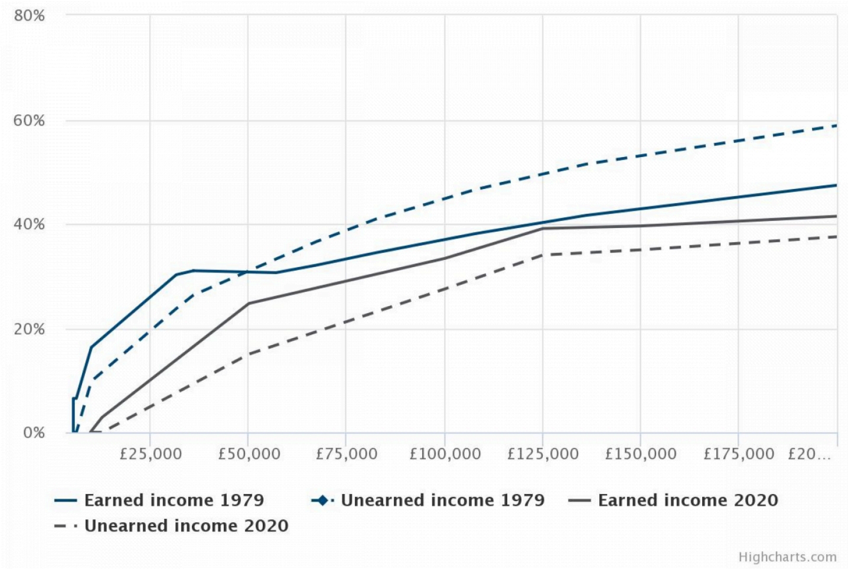


Source: Pascale Bourquin, Agnes Norris Keiller, and Tom Waters, "The Distributional Impact of Personal Tax and Benefit Reforms, 2010 to 2019," IFS Briefing Note 270, 2019

Inequalities Between Treatment of Different Income Sources Have Not Been Corrected

Reforms since 2008 have not only failed to address inequalities between rich and poor but also failed to address situations where the tax system treats people with the same amount of income differently because their income comes from different sources. Indeed, in some cases reforms have made this inequitable treatment worse. Capital gains remain much less highly taxed than income, despite being just another form of return to capital or, in the case of owner-managed incorporated businesses, labour. And the continuation of a trend for National Insurance contributions (NICs) to be increased while income tax is reduced [6] has furthered the shift in the tax burden from unearned to earned income (Figure 5). In 1979, there was an investment income surcharge in income tax which led to unearned income being more highly taxed than earned income, at least at very high income levels. Since then, though, increases in NIC rates accompanied by reductions in income tax rates and the abolition of the investment income surcharge have switched this around: unearned income is now taxed less heavily at all income levels.

Figure 5 – Tax rates on earned and unearned income, 1979 and 2020, constant prices



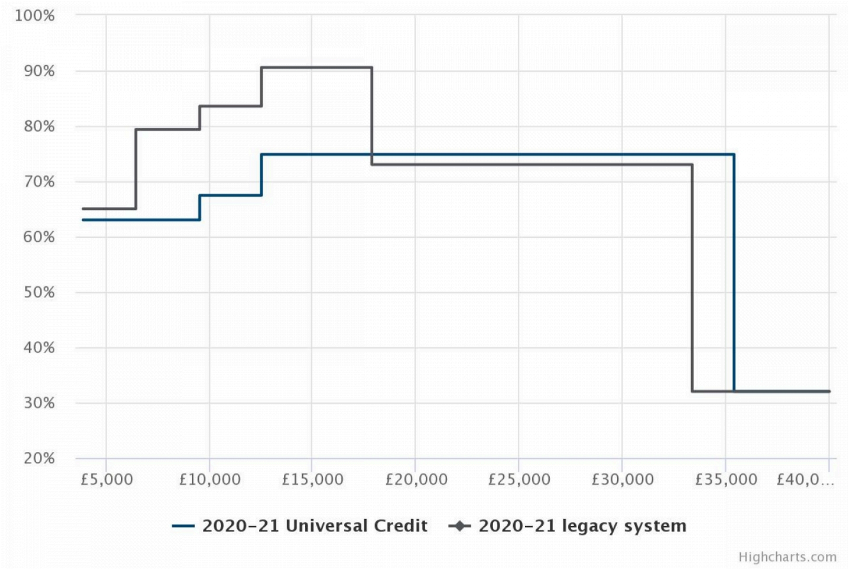
Note: Chart compares tax liability of someone with only employment income with that of someone with only income from unearned sources that are subject to normal income tax rates and the investment income surcharge in 1979.

Source: TBI calculations using HMRC and IFS tax rate data

Benefits Have Been Rationalised but Taxes Are a Mess

Greater rationalisation and simplification of the benefits system over the past decade has been accompanied by changes that have made the tax system more cumbersome and complex. The introduction of Universal Credit to replace six legacy means-tested benefits and tax credits has removed the very high effective tax rates that were faced by many people who were entitled to multiple benefits. Around 1.4 million people faced losing at least 80p of each additional pound they earned to higher taxes and lower means-tested benefits and tax credits under the legacy benefit system, but these are removed under Universal Credit. [7] Removing these extremely high effective tax rates has improved the efficiency of the tax-benefit system. This is because the distortion created by a tax increases more than proportionally to the tax rate: It is better to have two people facing a 50 per cent tax rate than one person facing a 60 per cent rate and another with a 40 per cent rate, for instance. But Universal Credit will also weaken work incentives for second earners in couples, [8] who are known to be among the most responsive to these incentives. It is a general principle of optimal taxation that stronger incentives should be focused on those who are most responsive to them, in order to minimise the distortionary effect of the tax system. Therefore, an improvement to the design of Universal Credit would be to strengthen work incentives for this group, perhaps by introducing an individual level earnings disregard (that is, allowing each member of a couple to earn a certain amount before benefits start to be withdrawn).

Figure 6 – Universal Credit removes the very highest effective tax rates



Note: Example for a lone parent with two children in rented accommodation with rent of £100 per week

Source: TBI calculations

The opposite has happened for those with higher incomes, though, for whom effective tax rate schedules have become unnecessarily complex. Income bands with high marginal tax rates have been introduced at higher income levels. The withdrawal of the income tax personal allowance above £100,000 has created a high marginal income tax rate of 60 per cent that applies over a small range of income, and the High Income Child Benefit Charge has done something similar between £50,000 and £60,000 (Figure 7). Increasing effective tax rates by less over a wider range of incomes would have been less distortionary. These two policy changes have also increased compliance burdens: Everyone whose income is above £100,000 or who has to pay the High Income Child Benefit Charge must now fill in a tax return, which was not the case previously. As a result, 11.7 million taxpayers had to submit a tax return in 2020, up from around 9 million a decade earlier.

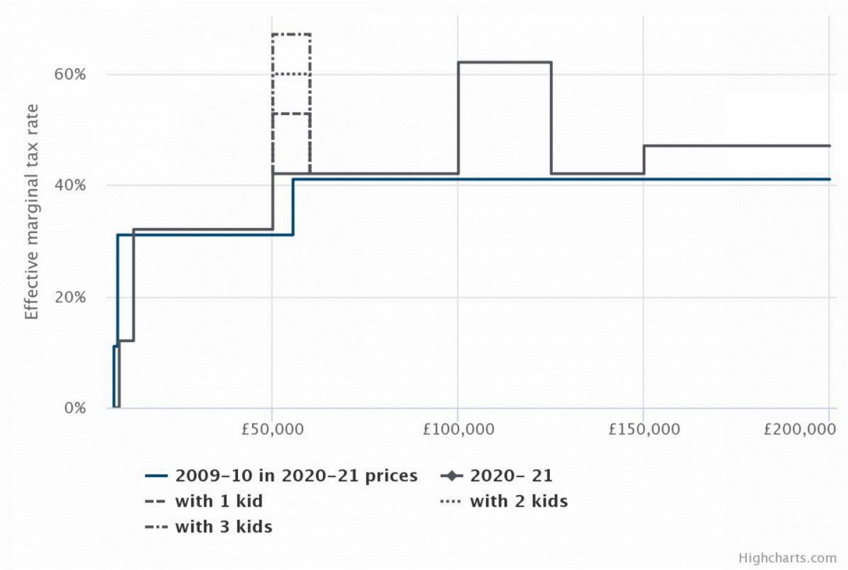
There are a number of other ways in which the tax system has been made more complex for little apparent gain:

- Increases in the income tax personal allowance have taken it out of alignment with the thresholds at which National Insurance contributions become payable, creating a small band of income where workers have to pay National Insurance contributions but not income tax.
- The marriage allowance in the income tax system – the possibility for a non-taxpayer to transfer £1,250 of their personal allowance to their spouse, so long as their spouse is a basic rate taxpayer – is hardly simple to describe. It does not seem to be simple to claim, either: HMRC thinks that fewer than half of those who are entitled to the allowance actually claim it. [9]
- Reforms to pensions tax relief, with the annual limit on pensions tax relief now reduced for those

whose income including pension contributions exceeds £240,000 have complicated the system compared to the old system of a fixed annual allowance for everyone.

- A new allowance in inheritance tax for the primary residence that is gradually withdrawn from estates worth more than £2 million has complicated the system compared to a single zero-rate allowance that existed previously. More generally, inheritance tax remains easy to avoid for the very wealthy, causing resentment among the merely well-off who feel that they bear a disproportionate burden, while failing to raise any significant revenues – it raised only around £5 billion or 0.2 per cent of GDP in 2019–20.

Figure 7 – High effective tax rates have been introduced at some higher income ranges



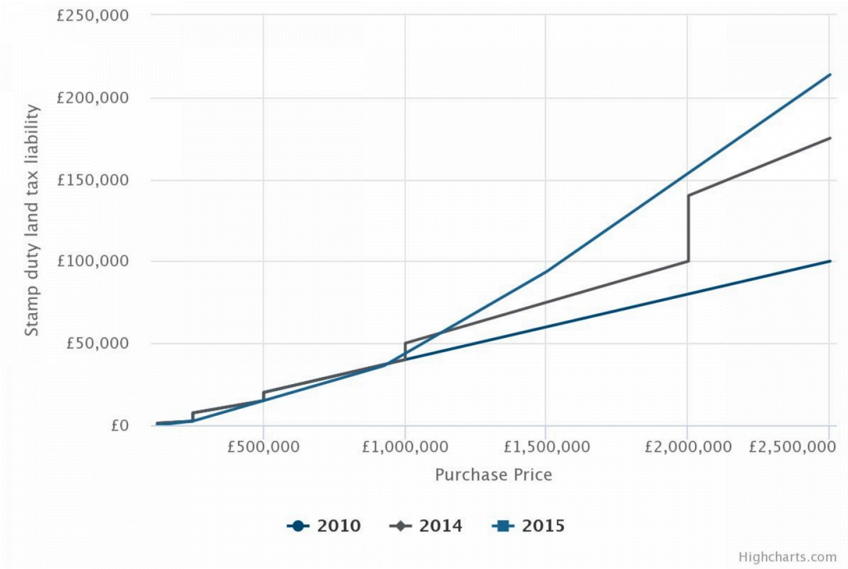
Note: Assumes all income from employment and that the individual has a higher income than their partner

Source: TBI calculations using HMRC, ONS

Property Taxation Is Still in Need of Reform

Reforms to the taxation of land and property have failed to address their design problems. Stamp duty, one of the most inefficient taxes that discourages mutually beneficial property transactions from occurring, has been increased. However, the design of the tax has at least improved: The 'slab' structure – whereby higher rates were charged on the full purchase price when it exceeded a threshold rather than just the portion above the threshold – has been abolished (Figure 8). At the same time, council tax has remained unreformed and so it is still assessed based on property values in 1991 in England and Scotland. [10] This has led to properties worth similar amounts today facing significantly different tax rates as property prices have increased at different rates in different parts of the UK over the past 30 years. Properties can thus be in the same council tax band and facing similar tax liabilities despite having wildly different values. [11] For example, property prices in Hackney are more than nine times higher than they were in 1991, whereas those in County Durham are only 2.6 times higher. [12] Therefore, to achieve the same level of local authority spending, County Durham has to impose the same level of council tax on one property that Hackney has to impose on one worth three times as much. Although this is an extreme example, the pattern by which properties in the north of England now attract a higher tax burden than similarly valued properties in London and the south-east as a result of differential house price inflation also holds more widely.

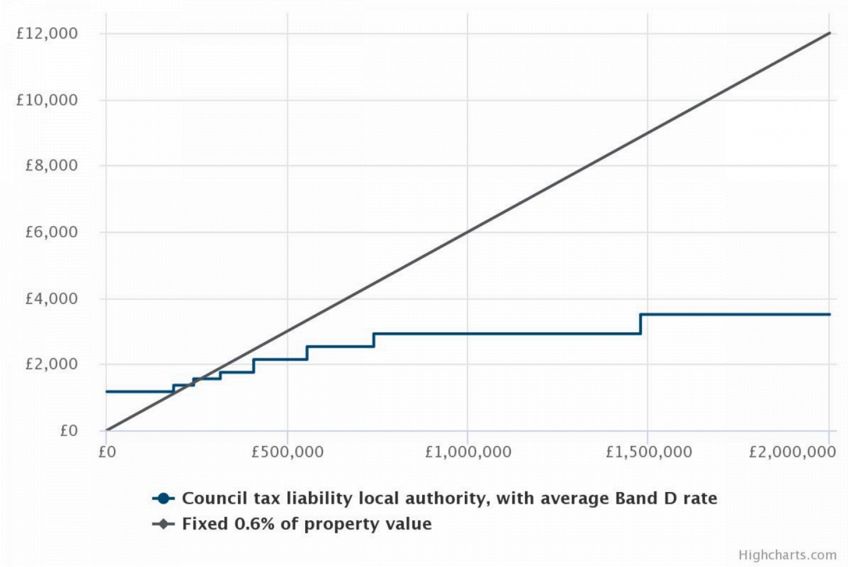
Figure 8 – Stamp duty schedule, 2010, 2014 and 2015



Source: TBI calculations

Furthermore, the original problems with the design of council tax remain, with high-value properties being taxed very lightly relative to their value. The banded rate structure leads to more and less valuable properties within bands being charged the same tax rate – at the top end, all properties worth more than £320,000 in 1991 are charged the same amount, for example – but more importantly the tax charged in each band does not rise in proportion to the increase in property values (see Figure 9, which compares actual council tax liabilities in a typical English local authority with a flat percentage charge set such that the tax liability for the average English property is unchanged). There is little justification for low tax rates for higher-value properties: It means council tax is regressive, [13] and it is inefficient. As the supply of land is fixed and so is not affected by taxation, there is a strong case for taxing land and property *more* heavily to minimise the extent to which the tax system distorts economic activity.

Figure 9 – Council tax liability by property value



Source: TBI calculations

Carbon Taxation Remains Incoherent

Finally, recent reforms have not provided us with a coherent system of carbon taxation. Indeed, in some respects we have moved further away: freezing fuel duty in cash terms for a decade has reduced it in real terms by nearly 30 per cent, reducing taxation on a major source of carbon emissions significantly. Other problems that create environmentally damaging subsidies remain, most notably the fact that domestic electricity and gas remain less heavily taxed than most other goods despite their high carbon emissions. The ideal of a coherent approach to carbon taxation, applied appropriately across all sources of carbon emissions is still a long way off.

Fewer Income Tax Payers; Benefits Less Related to Contributions and Needs

Taking a more holistic view, the tax-benefit system seems to have moved further away from the principle that everyone should make a contribution towards the cost of public services (to the extent that they are able) and then receive support in return to insure them against risks and for additional costs that they may face. Instead, the system seems to have been designed from the perspective that some people are put-upon contributors and others are net recipients who should have their entitlements strictly limited to prevent them abusing the system. This has occurred on both the payments and the benefits side. The increase in the income tax personal allowance has also led to fewer people paying income tax – less than 60 per cent of adults are expected to pay income tax in 2020–21. Although those who are not paying income tax are likely to be paying other taxes, most notably VAT and in some cases NICs, fewer income tax payers can give the impression that public services are paid for by an ever-shrinking number of contributors, while others are getting a free ride.

Moreover, the link between contributions made and benefits received has got even weaker since 2010: Employees no longer receive a higher state pension the more NICs they pay, and contributory Employment and Support Allowance is now time-limited for those in the work-related activity group (those who are expected to be able to return to work at some point in the future). The benefit system also takes less account of households' circumstances than it did ten years ago. The introduction of the High Income Child Benefit Charge has led to better-off families not receiving any support for the costs of children, and cuts to housing benefit in the private sector have led to renters facing large shortfalls between the benefits received and their rents. [14] Similarly, the two-child limit in tax credits and Universal Credit and the household benefit cap partly remove the link between a family's benefit entitlement and its needs.

The perspective that some people are net contributors to the system while others are net recipients has some validity when examining taxes paid and benefits received in a particular year. [15] But this ignores the fact that peoples' circumstances change across the lifecycle. Someone in work one year may be unemployed or disabled the next, and people have children or are retired for only a portion of their life. Redistribution is thus at least in part between the same individual at different life stages rather than purely between individuals. [16] The support provided by a comprehensive social-insurance system is thus valuable to everyone, and it is worth making this explicit through the design of the system.

Summary

It is clear that additional tax revenues will be needed at some point in the not-too-distant future. Yet the tax system has numerous flaws, which reforms since 2008 have done little to address and in some cases even exacerbated. As a result, simply increasing tax rates would be economically costly and an inefficient way to raise the revenue required. Therefore, policymakers should use the time that exists before tax rises need to be introduced to think strategically about the future shape of the tax system and the principles that should underline tax reform over the next decade. If we don't have this discussion now, there is a risk that we will end up with a series of tactical, ill-considered measures similar to those we saw after the global financial crisis. In light of the problems existing within the tax system and the reforms that have been introduced since 2008, we would argue that tax reforms should be constructed with the following design principles in mind:

- **Fairness:** The tax system should be progressive by transferring resources from the better off to the needy, but should also treat those with similar levels of resources similarly and be based as far as possible on the level of resources available to the taxpayer and not on extraneous factors. This means that tax rates should not differ according to the source of income or the legal form one uses, and that there should not be large jumps in tax liability or benefit entitlement at particular income levels.

- **Economic efficiency:** The tax system should seek to achieve progressivity in the most efficient way, that is by minimising any undesirable distortions to people's behaviour such as them working or investing less, but using the tax system to discourage undesirable behaviours such as carbon emissions where appropriate. This means that although the system should be redistributive overall, not every aspect needs to be redistributive. In practice, this would lead to tax bases that are relatively unresponsive to taxation, such as land, being taxed more heavily, while those who are more responsive to taxation face lower effective tax rates. Extremely high marginal tax rates should be avoided everywhere: On the whole, it is better for a larger number of people to face a moderately high marginal tax rate rather than some facing a lower rate and others facing a higher one.
- **Simplicity:** The tax system should be easy for people to understand and avoid unnecessary complications. In practice, this would suggest that the number of tax bands should be limited, and the number of different programmes people have to interact with should be kept as low as practically possible. Moreover, interactions with the authorities should be kept to a minimum and be as easy as possible.
- **Citizenship:** Although the tax system should be progressive, everyone who is able to do so should be seen to make a contribution towards public services. Similarly, everyone should receive some support if they face additional costs through having children or a disability, and everyone should be given some insurance against the risks of unemployment and disability.

Table 1 shows that reforms after the global financial crisis of 2008 generally moved the tax system away from these principles. In the next section, we outline a series of revenue-raising measures that can be relatively easily introduced within the current system and deal with at least some of these problems. They do not represent the wholesale replacement of the direct tax system that would be necessary to deal with them more comprehensively, but by bringing the treatment of different income sources closer into alignment, these reforms would make it easier to do so in a revenue-neutral way, without creating large numbers of losers (and winners) that would make such far-reaching reform so politically challenging at present.

Table 1 – Have reforms since 2008 moved us closer to the principles of a good tax system?

Tax area	Fairness	Efficiency	Simplicity	Citizenship
Direct taxes	Personal allowance	Personal allowance withdrawal at	Personal allowance withdrawal, pensions tax	Fewer income tax payers

Tax area	Fairness	Efficiency	Simplicity	Citizenship
	increase a big giveaway to middle-income groups, but tax rises at the top	£100,000 creates small income band with very high tax rate	relief taper and marriage allowance increase complexity. Thresholds for income tax and NICs not aligned	gives impression of fewer contributors to the system
Indirect taxes	Increase in VAT shifts tax burden lower down	Fuel duty freezes have undermined carbon taxation	Little change	Little change
Cash benefits	Benefit cuts hit poorest hardest	Universal Credit removes some of the very highest effective tax rates, but High Income Child Benefit taper introduces high rates elsewhere	Universal Credit integrates multiple benefits into a single payment	Weakening link between benefits received and both taxes paid and family circumstances
Taxation of land and property	Lack of council tax revaluation means properties now worth different amounts face same tax burden	Stamp duty (a very inefficient tax) increased, but slab structure removed	Little change	Little change

Tax area	Fairness	Efficiency	Simplicity	Citizenship
Capital taxes	Capital gains tax rates reduced relative to income tax rates	Little change	Additional inheritance tax allowance for primary residence increases complexity	Little change

Note: Red = worse than 2008, Yellow = mixed or no change, Green = better than 2008

Reshaping the Tax System for the 2020s

We have seen that recent tax reforms have left the tax system in a situation where different types of income are treated differently, and where land and carbon emissions are taxed too little and in a haphazard way. The main beneficiaries of this state of affairs are those with more assets and who own their own home: that is, primarily the wealthy and older generations who are property owners and have benefited from asset prices rising as global interest rates have fallen. [17] We therefore argue that the key themes for tax reform over the next decade should be as follows:

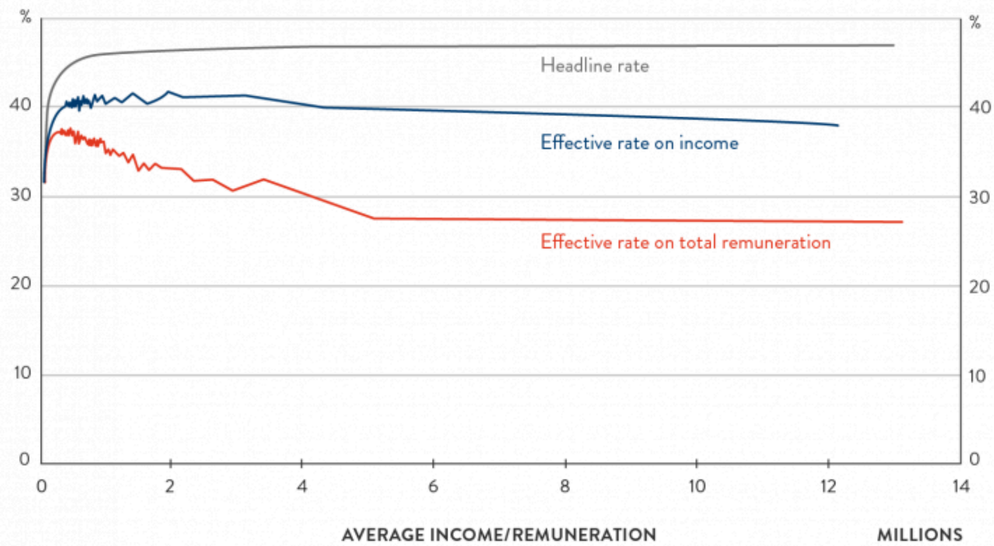
1. To shift the balance of taxation away from earned income towards land and capital;
2. To address the challenge of climate change by increasing carbon taxes; and
3. To address intergenerational unfairness by taxing windfall gains received by older generations.

Shift the Balance of Taxation From Earned Income to Land and Capital

We saw in the previous section that the combination of increases in the rates of National Insurance contributions and cuts to income tax have increased the gap in tax rates between earned and unearned income. Reversing this trend, which has largely arisen because governments have felt that income tax is more salient to voters than NICs, rather than a deliberate decision to tax earned income more heavily, should be a focus for the next decade. But there are also differences in how different types of earned and unearned income are taxed. Among unearned income sources, capital gains are the least-heavily taxed form of income anywhere in the tax system. Whereas most forms of income are taxed at rates of 20 per cent, 40 per cent and 45 per cent and may be subject to NICs as well, capital gains are taxed at rates between 10 per cent and 28 per cent, depending on the type of asset. There is therefore a strong incentive for those who are able to do so to receive remuneration in this form. This is particularly the case for the self-employed who are able to claim a lower rate of 10 per cent on up to £1 million of assets through Business Assets Disposal Relief on capital gains on shares and other business assets. There is little evidence for any beneficial effects of this relief: Encouraging the self-employed to retain capital in their own businesses does not appear to increase investment, [18] and few of the entrepreneurs who may be eligible for the relief in the future are aware of it. [19] Any favourable treatment to encourage particular groups of entrepreneurs – tech startups, for example – should be tightly targeted on policy objectives rather than a blanket giveaway to the self-employed, as Business Assets Disposal Relief is at the moment.

Low rates of tax on capital gains relative to other forms of income are a source of unfairness not only between people with the *same* level of income but a different income composition, but also between people with *different* levels of income. If we examine the overall effective tax rate on income, we find that it increases as income rises, as we would expect, before levelling off at around 40 per cent from around £300,000 upwards. [20] But capital gains are taxed much more lightly than this, with the highest capital-gains tax rate being 28 per cent. And since capital gains are disproportionately received by the very richest – 90 per cent are received by those with total income and capital gains above £100,000 – when income and capital gains are considered together, the overall tax rate is lower on average for those with incomes of around £10 million than for the median earner.

Figure 10 – Effective tax rate by income (£ million), 2015–16



Source: Advani and Summers (2020)

The self-employed not only benefit from being able to take some of their remuneration as capital gains, but also through facing a lower NICs burden than employees. Their main NICs rate is 9 per cent as opposed to 12 per cent for employees, and their remuneration is not subject to employer NICs at all. [21] This disparate treatment is not justified by differences in entitlements to contributory benefits: since the introduction of the single-tier pension in 2016, these groups now have almost exactly the same entitlements. The only benefits that the self-employed are not entitled to are contributory job seeker's allowance and maternity and paternity benefits, the cost of which can justify at most a 1 percentage point difference in contribution rates. [22] The self-employed have also received equivalent or even more generous support during the pandemic than furloughed employees. [23] Moreover, the oft-heard argument that employment rights for employees justify lower taxes for the self-employed is fundamentally flawed. Employment rights are a cost to the employer, not a benefit received from the state. Economic theory would predict that the wages for an employee should be lower than the fee received by a contractor to do the same job, as workers value employment rights and these are costly to the firm. If this happened, there would be no need for the tax system to offset anything to make the treatment of employees and the self-employed equal: This would already have been done by the market. But even if this were not the case – because contractors have lower bargaining power, for example – there would be little justification for the current system. To offset the lack of employment rights for the self-employed would require an additional tax on those who engaged a self-employed worker alongside lower taxes on the self-employed to mimic the transfer from employer to employee. But without any tax on engagers, the system simply encourages them to engage workers on a self-employed basis even when they would prefer to be employees. Bringing the tax treatment of employees and the self-employed closer into line should therefore be a priority – by taxing the self-employed less, the current system encourages the use of non-employment contracts when workers may well prefer the security of an employment contract.

Taxing land more heavily should also be a focus for reform over the next decade. In particular, council tax is in dire need of reform. Reforms should align tax liability more closely to current property values. Increasing property taxes in this way would undoubtedly be politically challenging, but reform might become more feasible if asset-rich, income-poor groups such as pensioners were exempt or homeowners were given the option to defer paying the tax until they sell their property. These reforms would make the tax system both fairer – property taxes would become more progressive, and property tax rates would become more consistent across the country, taking into account differential property price inflation over the last 30 years – and more efficient, since the supply of land is not responsive to taxation.

Address Climate Change by Increasing Carbon Taxes

Little progress has been made on carbon taxation since the global financial crisis. In light of the government's commitment to reaching net-zero carbon emissions by 2050, urgent action is required on all fronts, including taxation. Carbon taxes are an efficient way of reducing carbon emissions – they encourage people and businesses to reduce emissions when it is relatively easy to do so, and if it is believed that they will be permanent and increasing, encourage investment in alternative technologies. In recent years, however, the government has not been able to even keep fuel duty rising in line with inflation, let alone extend carbon taxes to areas that are untaxed such as domestic gas.

Carbon taxes are often rejected on distributional grounds: Taxing domestic fuel will hit poorer groups harder because it represents a larger share of their spending, for example. But since the UK has a well-developed system of income taxes and means-tested benefits, other instruments can be used to offset any undesirable distributional impacts. [24] Recycling at least some of the revenue raised by higher taxes on carbon emissions back to lower-income groups through transfers or reductions in other taxes will likely be necessary to ensure that these are politically sustainable.

Address Intergenerational Unfairness

Falling global interest rates over the past 25 years have led to big increases in asset prices, giving windfall gains to asset holders, who are generally among the older generations. [25] Younger generations have been disadvantaged, as they have to save a greater share of their income from work to pay for a deposit on a property and to save enough for a comfortable retirement. Income growth among pensioners has been faster over the last 20 years, too. [26] The tax system has not responded to this challenge. On the contrary, most of the capital gains in pensions, ISAs and primary residences that older generations have received have not been taxed at all. And although there have been some attempts to help younger generations accumulate assets – through Help to Buy, and Lifetime and Help to Buy ISAs, for example – the scale of these efforts has been small. Addressing these inequities by both re-examining the favourable tax treatment given to pensions, ISAs and primary residences and assisting younger generations to accumulate assets should therefore be the third priority of tax reform over the decade ahead.

Conclusions

The pandemic will leave the public finances in a bad way. Although there is little need to be immediately concerned about high levels of debt racked up during the acute phase of the crisis in a very low interest rate environment, in the medium term any permanent damage to the economy will hit tax revenues, and there will be calls for higher public spending to address the shortcomings in health and social care that have become evident. And the longer-term challenges of an ageing society have by no means diminished; indeed, they are likely to become even more acute in the 2030s.

This challenge will require a two-pronged response. First, reform of public services will be required to ensure maximum value for each pound spent. In particular, government will need to embrace the technological revolution to automate routine processes and free up staff time for hands-on service delivery. But additional tax revenue will also no doubt be required – technology cannot reduce the cost of pensions (a transfer of a pound will always cost a pound), and advances in health care in the past have tended to increase costs as new treatments have become available.

However, simply increasing tax rates in the existing system would not be the right way to respond to the revenue raising challenge. As it stands, the tax system is riddled with unfairness, inefficiency and complexity and divides people into contributors and recipients rather than encouraging a sense of citizenship with everyone contributing when they are able and receiving support according to their needs. This has been exacerbated by a decade of short-sighted and tactical reforms in response to changing public finance forecasts. We can ill afford a repeat of this pattern in the decade ahead. Given that there is time before tax rises have to be introduced, policymakers have the chance to think strategically about the shape of tax reform in the 2020s. We would argue that the priorities should be to correct the policy errors of the past and respond to the wider challenges we face by shifting the balance of taxation from earned income towards unearned income and land and property, using carbon taxation as part of the response to net zero and to seek to address the intergenerational inequalities that have built up since the global financial crisis. Following this path would not only ensure the sustainability of the public finances going forward, but make us better prepared for other challenges that lie ahead.

Footnotes

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2. ^ https://institute.global/policy/our-response-chancellors-2020-budget
3. ^ See Browne.
4. ^ https://www.instituteforgovernment.org.uk/blog/rishi-sunak-must-build-public-support-introducing-tax-changes
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6. ^ NICs rates were all increased by 1 percentage point in 2011 whereas increases in the income tax personal allowance have reduced the income tax burden.
7. ^ James Browne, Andrew Hood, and Robert Joyce, “The (Changing) Effects of Universal Credit,” in The IFS Green Budget: February 2016, ed. Carl Emmerson, Paul Johnson, and Robert Joyce (London: Institute for Fiscal Studies, 2016).
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9. ^ See https://www.gov.uk/government/news/spoil-your-loved-one-with-hmrcs-valentines-day-cash-boost?utm_source=f464828d-6205-49d4-926d-1c97761284ff&utm_medium=email&utm_campaign=govuk-notifications&utm_content=immediate.
10. ^ In Wales, properties were revalued in 2005 and an extra tax band added. The inequities outlined in this section thus less acute in Wales than in England and Scotland. Northern Ireland has a different system of taxation, domestic rates, that is more directly related to property values.
11. ^ See Stuart Adam et al., “Revaluation and Reform: Bringing Council Tax in England into the 21st Century,” 2020, https://www.ifs.org.uk/uploads/R168-Revaluation-and-reform-bringing-council-tax-in-England-into-the-21st-century-updated.pdf.
12. ^ Source: Adam et al.
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21. ^ Although employer NICs are formally paid by employers, they have the same effect as employee NICs in creating wedge between the cost of employment to the employer and the take-home pay of the employee. The economic effect should therefore be the same.

22. ^ Source: Judith Freedman and Helen Miller, “Tax and Employment Status: Myths That Are Endangering Sensible Tax Reform,” Tax Law Review Committee Discussion Paper, 2020, https://www.ifs.org.uk/uploads/TLRC Tax and employment status.pdf.

23. ^ The self-employed could claim full entitlement to the Self-Employed Income Support Scheme even if they continued to work, which in some cases would lead to them being better off than they would have been had the pandemic not occurred.

24. ^ https://www.jrf.org.uk/sites/default/files/jrf/migrated/files/carbon-taxation-income-full.pdf

25. ^ https://www.wealthandpolicy.com/wp/122.html

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