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Breaking barriers

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Gemma Tetlow considers the barriers to tax policymaking

What is the issue?

There are long-standing problems with the UK's tax system. But tax reform is not an easy area and governments of all stripes have long struggled to overcome the barriers.

What does it mean to me?

Some of the difficulties facing modern tax systems will require international coordination, such as effectively taxing multinational digital service providers. But others are firmly within the control of the UK government.

What can I take away?

The barriers to reform are real but – we believe – not all insurmountable.

This might seem an odd time to be talking about tax reform. Working out how to leave the EU is consuming most of politicians' attention, leaving little space to think about domestic issues – let alone the unglamorous question of how to reform the tax system.

But it will become increasingly difficult for politicians – if they want to govern effectively – to avoid this question over the next decade or so.

There are long-standing problems with the UK's tax system. There is growing pressure to prop up revenues in the face of increasing demands on public spending from an ageing population and economic trends that are undermining the tax base. These could provide the impetus needed to address some of the failings in the tax system. But tax reform is not an easy area and governments of all stripes have long struggled to overcome the barriers.

Some aspects of taxation are inherently political. Setting tax rates is the most obvious one. It should always be for elected politicians to decide how much the tax and benefit system should redistribute and between whom.

But there are other elements of the tax system on which there should be cross-party agreement. For example, most politicians should have a desire – all else equal – to have a stable tax system that raises revenues in a simple and efficient manner. It should also be uncontroversial that the tax system should treat similar individuals, carrying out similar activities, the same.

But on these measures the current UK tax system falls short. Stamp duty on the sale of properties seizes up the housing market and means the amount of tax levied on a property depends – perversely – on how frequently it changes hands. VAT is charged on an unusually small share of goods sold in the UK, compared to other countries. This creates incentives for businesses to expend time and effort trying to prove that their goods should not pay VAT – as the infamous Jaffa Cake case demonstrates – it reduces government revenues and is a poorly focussed way of supporting lower-income households.

The fact that many people think that national insurance still pays for their pension or the NHS makes it easier for politicians to raise this tax. This puts a greater tax burden on earned income than unearned income, bearing disproportionately on those on lower and medium pay than if the same revenue was raised through income tax. The list goes on and on.

These shortcomings have significant costs. For example, the Mirrlees Review showed that the Government could raise tax revenues by £11 billion a year (equivalent to just under 2% of the UK's annual tax take at the time it was written) by widening the VAT base, even after allowing for a targeted package of support to compensate lower income families. Eliminating all reduced rates of VAT may be an unfeasibly radical proposal. Current political discourse – advocating for further exemptions for sanitary products, for example – certainly makes reform in this direction less likely. But these calculations demonstrate that there are significant costs from failing to address these issues.

Many of the problems are widely acknowledged and have been comprehensively analysed. Despite this, successive governments have either avoided making reforms or have tried but failed to do so. For example, George Osborne attempted marginally to widen the VAT base in 2012 – applying VAT to pasties and static homes – but both proposals were quickly reversed. Philip Hammond attempted to increase tax paid by the self-employed in 2017 – bringing it slightly closer to the tax paid by employees – but also quickly had to reverse.

Both of these attempts underline the difficulties of making reforms that are unpopular with the public and the media. In both cases there was little public discussion of the reforms in advance, meaning there was scant public understanding of the rationale for reform. This was despite there being a community of experts – particularly in the case of the proposed reforms to class 4 National Insurance contributions for the self-employed – who had been advocating for similar reform.

Future governments will need to reform the tax system not only to deal with these historic shortcomings but also to address ongoing economic trends that are undermining the revenue-raising capacity of the tax system.

An increasing number of people – for example, in construction and professional services – now work for their own companies and so can receive their income through dividends. Profits and dividends are more lightly taxed than employment income, when account is taken of employers' national insurance contributions. The benefits of incorporation have grown as the corporation tax rate has fallen, though more recent cuts to annual dividend allowances have substantially reduced the attractiveness of incorporation. The Office for Budget Responsibility estimated in 2016 that faster than expected growth in incorporations would cost the exchequer £4.4 billion a year by 2021-22, equivalent to 0.5% of total expected revenues in that year.

Increasing fuel efficiency of cars – coupled with the Government's unwillingness to raise the rate – is undermining revenues from fuel duty. At the moment this tax raises £28 billion a year, or 3.6% of all government revenues. As people switch to electric vehicles, fuel duty will become a thing of the past. If the Government still wants to raise revenues from drivers – and to tackle better the negative externalities of driving – it will need to prepare for some form of road charging. That is likely to be easier to implement at a time when it could be announced alongside a cut in fuel duty than it would be once fuel duty revenues have dwindled further.

It will be increasingly difficult for future governments to duck the question of tax reform when revenues are under pressure because this will come at the same time as upward pressure on public spending grows. Growth in public spending on pensions and pensioner benefits has been held in check over the past decade by increases in the state pension age: there are roughly the same number of pensioners now as in 2010. But by 2030 there will be 1.5 million more.

Growth in spending on pensioner benefits will be accompanied by further demands for more spending on health and long-term care. The OBR estimates that, if age-related demands for higher spending on health and social care are met, the UK government may need to devote an extra 1.9% of national income (or around £40 billion in today's terms) to health and long-term care spending by 2030.

Some recent successful tax reforms demonstrate how the barriers can be overcome. Mr Osborne successfully managed to reform stamp duty in 2014, replacing the slab structure with a new marginal rate schedule. This removed one of the more egregious aspects of the previous system, though left in place a fundamentally flawed tax on property transfers.

Two features of that reform perhaps allowed the proposal to pass without much public outcry. First, the changes were such that sales of property worth less than £937,500 incurred a lower tax charge than before – this covered around 98% of all property transactions. Second, the reform reduced total revenues from stamp duty land tax by around £800 million a year. It is always easier to sell reforms when many people gain. The reforms, however, also created new problems. The large increase in stamp duty rates on the very highest value properties has likely contributed to sluggishness in the prime London housing market. It has also made stamp duty revenues much more heavily dependent on what happens to prices and transaction volumes in this narrow segment of the UK housing market.

Mr Osborne also made fundamental reforms to corporation tax – lowering the headline rate but widening the base on which it is charged. Again, the reform was done in such a way as to reduce total revenues, meaning a giveaway to many companies even if they lost access to previous tax reliefs.

Overall, however, efforts at tax reform have been limited over the past 30 years. The last Labour party manifesto was notable for promising a significant tax increase. But this was mainly intended to come from raising the rates of existing taxes, rather than changing the structure of the tax system. A majority of the additional revenues was expected to come from raising the rate of corporation tax and increasing income tax rates for those with income over £80,000 a year. There was little mention of a desire to address long-standing structural inefficiencies.

History suggests that making significant reforms without cash to give away is harder. But it will become increasingly important for future governments – whatever their political persuasion – to address this question.

Some of the difficulties facing modern tax systems will require international coordination, such as effectively taxing multinational digital service providers. But others are firmly within the control of the UK government. The barriers to reform are real but – we believe – not all insurmountable. That is why we, at the Institute for Government, are carrying out work to look more closely at the barriers – from political difficulties to the lack of public understanding, from practical challenges to Parliamentary ones – and develop recommendations for how they could be overcome. Our objective is to ensure that tax changes, if – and likely when – they come, are done in the most effective way rather than simply the least politically costly way. We are interested in hearing from anyone with views on these issues.
