

Taxing times

The need to reform the UK tax system



About this report

This report outlines the UK tax system and how it compares internationally. It also sets out the growing case for tax reform, driven by increasing spending pressures and threats to existing tax revenues.

About this series

This report is the first written output of a programme of work examining why successive governments have found it so difficult to reform the tax system and how this might be overcome. The programme builds on the Institute's previous work on the budget-making process in Better Budgets.

Find out more at:

[www.instituteforgovernment.org.uk/
our-work/policy-making/better-tax-policy](http://www.instituteforgovernment.org.uk/our-work/policy-making/better-tax-policy)

Contents

List of figures	4
Foreword	5
Summary	6
1. Introduction	7
2. The UK tax system: a system in need of reform	11
3. Pressure to raise revenues	30
4. Economic change is undermining the tax system	37
5. Conclusion	44
References	47

List of figures

Figure 1	
Comparison of tax revenues across advanced economies, % GDP (2017)	11
Figure 2	
Tax revenues across G7 countries, % GDP (1965–2017)	12
Figure 3	
UK tax and total revenues, % GDP	13
Figure 4	
Composition of UK tax revenues (2018/19)	14
Figure 5	
International comparison of the composition of tax revenues, % GDP (2016)	15
Figure 6	
Impact of taxes and benefits on UK household income by income deciles (2016/17)	19
Figure 7	
Composition of tax revenues over time (UK)	21
Figure 8	
Composition of tax revenues over time (OECD average)	21
Figure 9	
Number of income tax bands	22
Figure 10	
Maximum income tax rate	23
Figure 11	
Projected age-related spending as a share of UK GDP (Index, 2017/18=100)	31
Figure 12	
Health spending, % GDP (UK)	32
Figure 13	
Long-term projections for non-debt interest spending, % GDP (UK)	35
Figure 14	
Projected and actual fuel duty revenues (UK)	38
Figure 15	
Numbers of people in employment and self-employment in the UK	40
Figure 16	
Tax due on £50,000 of income (2017/18)	41

Foreword

Good policy making is crucial for effective government and has been a core focus of the Institute for Government's work since we were established 10 years ago. Tax policy is a prime case. Raising revenues through tax is essential for government, including funding public services such as health, education and defence, as well as any redistribution of income. But the way in which UK tax policy is made is far from ideal.

In *Better Budgets* (2017), the Institute for Government (with the Institute for Fiscal Studies and the Chartered Institute of Taxation) examined the way in which the Budget is put together. We identified a need for fewer, better thought-out tax measures that could be implemented efficiently without imposing unreasonable burdens on taxpayers. Despite some improvements since then, more still needs to be done to improve tax policy making.

In the near future, tax policy is going to have to move up the political agenda. Growing pressures on public spending – including those highlighted in the Institute for Government's *Performance Tracker* – are going to require governments of all political stripes to make a stark choice: raise more revenue through taxation or additional borrowing, or revisit the scope and scale of public services.

It is not only the amount of money raised that matters. How it is raised is also important. Decades of piecemeal changes to the tax system have left it complicated, inefficient and beset with perverse incentives that do little to raise revenue or meet the Government's wider economic objectives. Changes in the economy also risk making the system outdated and threaten to undermine revenue. The system is ripe for reform.

But change has proved difficult. The political risks are high, public understanding of tax is poor and some aspects of tax policy making militate against improvements. Previous governments have sometimes managed to overcome these barriers; future ones will need to do so if they are to address the fiscal challenges ahead.

Successive administrations have taken tax policy for granted. In these taxing times, we need to start taking tax policy seriously.



Bronwen Maddox
Director, Institute for Government

Summary

Governments of all political colours are likely to face more calls over the coming years to increase public spending, as an ageing population puts additional pressure on publicly funded health and adult social care, and increases pension costs. It is going to cost more just to maintain the quality and scope of services that the state currently provides.

Yet the UK's current tax system is not up to the job of meeting these demands. Total tax revenues have remained broadly flat as a share of national income in recent years, and will come under pressure as economic trends undermine existing tax bases and the system struggles to capture revenue from new forms of potentially taxable economic activity. The current tax system is also not well designed, creating greater economic distortions and raising tax in a less efficient manner than it might.

Over recent decades, politicians have tended simply to tweak the current system, making piecemeal and often opportunistic reforms without a clear strategy. This is a not a good way to improve the efficiency of the tax system, to shore up the existing tax take or to raise additional revenue – and it adds complexity and stores up problems for the future.

Instead, politicians should acknowledge that it is not just the amount of revenue that is raised that matters, but also how it is raised. Sensible, principled reforms to the tax system could allow governments to raise revenues with fewer detrimental side effects, and render the system more resilient to fiscal pressures.

However, important political and practical barriers stand in the way of making major change. If future governments are to grasp the need and opportunity for tax reform, it is important that we better understand these barriers and how to overcome them. This report sets out why tax reform is likely to become a pressing issue. The second report in this series will identify the obstacles standing in the way of change and draw on domestic and international experience to suggest how these could be addressed.

1. Introduction

A combination of public spending pressures and threats to existing revenues mean that tax reform needs to move up the political agenda. These challenges cannot be addressed through further piecemeal and opportunistic reforms that entrench or exacerbate the existing inefficiencies and distortive effects of the tax system. Instead, politicians should see this as an opportunity to review, not just the amount of tax raised, but how it is raised.

Why is tax reform needed?

For decades, UK governments have struggled to balance a desire among much of the electorate for European levels of public services and welfare, and US levels of tax. Faced with that challenge, previous governments' tax reforms have often lacked a coherent strategy or long-term vision. Politicians have often sought to raise additional revenue by stealth, in a piecemeal and unsustainable fashion. UK governments are not alone in having behaved in this way; governments around the world have responded to similar constraints in similar ways. But that does not diminish the need for a different approach.

Over time, these piecemeal tax reforms have shifted the tax burden onto particular activities and individuals in a way that is neither economically sensible nor sustainable in the long term. And these changes have usually been the result of an explicit strategy by politicians that was backed by the electorate.

The current tax system contains both existing and emerging inefficiencies, which are detrimental to economic growth and productivity. Future spending pressures – driven largely by an ageing population – will give governments of all political colours cause to want to increase public spending if they want to maintain anything like the current quality and scope of public services and welfare. Meanwhile, threats to existing tax bases (such as fuel duty), the emergence of new taxable activities (such as digital services) and the expansion of existing lightly taxed ones (such as self-employment) mean the tax system will need to be reformed even to maintain current levels of spending as a share of gross domestic product (GDP).

This is not merely a problem for future generations, but one that will become increasingly acute over the next decade.* Without the ability to make fundamental

* The pressure in 2018 to increase NHS spending, which led Theresa May to announce a significant boost to NHS spending over the next five years, was a clear illustration of the pressures the Government faces to increase funding for health care. This increase in spending was made possible without explicit tax increases, thanks to an unexpected upgrade to the official fiscal forecasts in October 2018. However, forecasts can deteriorate as well as improve; on the next occasion that the Government needs to announce a major spending increase they may not be so lucky.

reforms – based on sound underlying principles – governments risk finding themselves unable to raise or even maintain revenues, other than by reinforcing and increasing the distortions caused by the current system.

Tax reform: a non-partisan issue

The tax system is essential to the functioning of any modern government. Without the ability to raise revenues, governments would not be able to deliver public services, invest in essential public infrastructure, defend the nation from external threats, or maintain law and order. Without taxes, governments would not be able to redistribute resources between different groups and would have fewer tools to encourage (or discourage) activities that are socially beneficial (or harmful).

Some aspects of tax policy are inherently political: parties will take different views on how much they want to raise, how much they want to redistribute resources and between whom (a concept sometimes known as 'vertical equity'). From 1997 to 2015, the UK's main political parties took a broadly similar view on these issues. But they are now a long way apart, as was clear in the 2017 General Election. The Labour Party promised a significant tax increase focused on companies and high-income individuals,* while the Conservative Party promised not to raise the rates of most of the main taxes and promised further corporation tax cuts. Several of the candidates in the latest Conservative Party leadership race went further, promising sizeable tax cuts if they were elected.

However, there are many ways to design a tax system to achieve the same overall revenue and distributional outcomes. A more effective tax system would raise revenue in a way that is sustainable, minimises unnecessary and inefficient economic distortions and administrative costs, and would be stable and predictable so that taxpayers could plan for the longer term. There are, therefore, important non-partisan considerations in tax policy making, regardless of any government's political values and objectives.

Any tax system will reduce the economic welfare of those asked to pay the tax. But a well-designed system will minimise these costs, while maximising the revenue that can be spent on welfare-enhancing services and benefits. With the UK Government taking nearly two-fifths of annual national income in tax, the cost of tolerating a poorly designed tax system is significant, even if not easily quantifiable.

What stands in the way of reform?

The Government cannot start from a blank sheet of paper. It must start with the current complex patchwork of tax rules. The status quo creates winners and losers, and taxpayers have spent time and money working out how to navigate the system. Any government considering significant tax reform therefore faces difficulties. As Gavin Kelly, Chief Executive of the Resolution Trust (an organisation that supports work which promotes shared growth), put it recently: "only a government with a thumping majority, a zeal for reform and a taste for battle will contemplate it".¹

* It is worth noting, however, that even the tax-raising Labour manifesto of 2017 focused mainly on raising rates of existing taxes, rather than changing the structure of the tax system.

Major tax changes often create concentrated and vocal losers, while beneficiaries are usually diffuse and quiet. For example, in 2017, Chancellor Philip Hammond proposed increases to Class 4 National Insurance Contributions (NICs, which are paid by the self-employed) but was forced to make a rapid U-turn following vocal opposition from the self-employed and the media,² while attempts to remove tax reliefs have also been politically challenging.³ In times of buoyant revenues, politicians can minimise such opposition by paying off the losers through tax giveaways. But with the UK's public finances expected to remain tight, such luxury is unlikely to be afforded to governments in the near future.

Even at the best of times, however, selling tax reforms to the public is a difficult task. Tax is complex and poorly understood. Individuals and businesses spend a lot of time and money grappling with the current system and can be sceptical of change, favouring the status quo because reforms risk being costly to implement and may appear to offer little direct benefit. Convincing the public of the need for tax rises is perhaps trickier still. While tax hikes are felt quickly and visibly, promised improvements to public services can be slower to come to fruition, hard to quantify and may not be directly felt by those bearing the additional tax burden.

But, as the Mirrlees Review of the tax system, led by the Institute for Fiscal Studies, put it: "reforming the tax system may not be easy or popular in the short-term but it holds out the prospect of significant gains and hence the promise of higher living standards in the long-term."

These political barriers are not insurmountable

Previous governments have reformed the tax system, sometimes raising revenues at the same time. Laying the foundations for change well in advance, packaging reforms together, building cross-party support, ensuring a strong public justification for change, and thinking carefully about the practical aspects of implementation could all play an important role in overcoming the political hurdles.

The process of making tax policy can also help or hinder efforts to achieve a more effective system. Limited scrutiny of new tax measures, insufficient data by which to judge the effectiveness of taxes and a focus on short-term policy not strategy can all impede reforms and serve to entrench the status quo.

Outline of this report

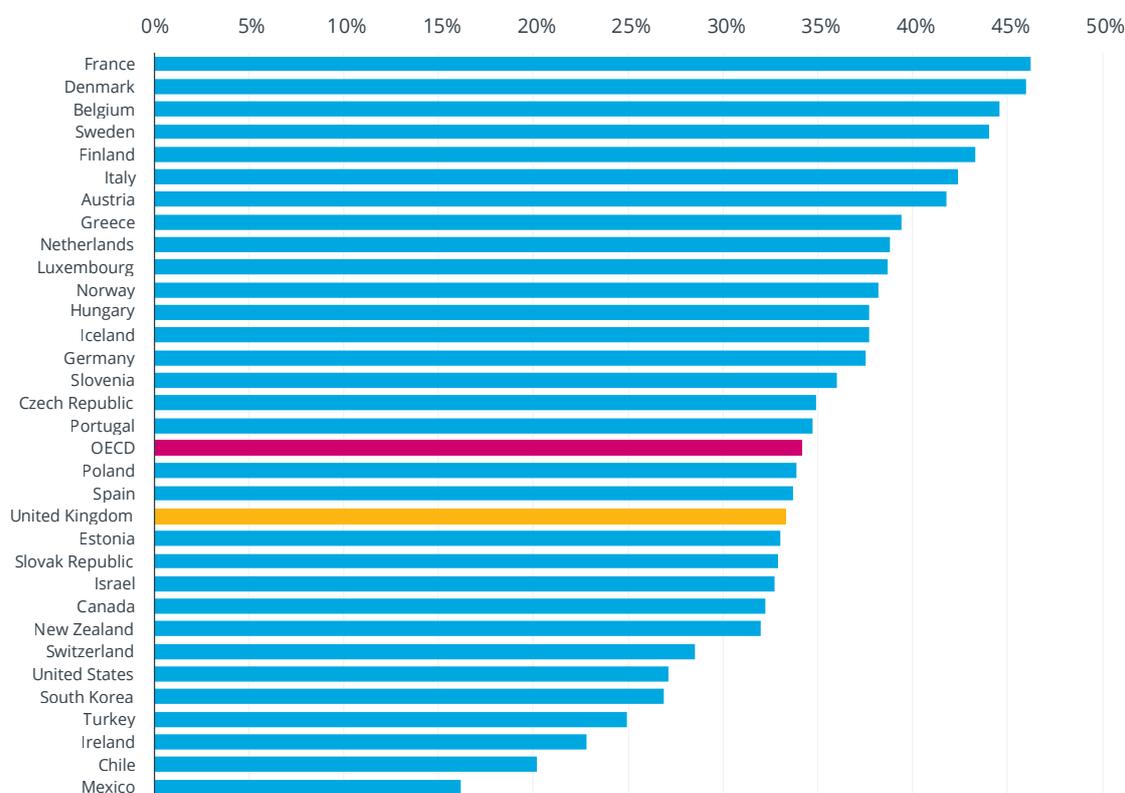
In this report, we make the case that UK governments – starting with the current one – will need to reform the tax system, irrespective of their redistributive or public spending ambitions, and despite the difficulties in making such changes. This report starts, in Chapter 2, by providing a brief overview of the UK tax system, showing how it compares with that of other countries, how it has evolved over the past 40 years and outlining some of the existing problems with it. Chapters 3 and 4 explain why the need for tax changes is likely to go up the political agenda over the next decade and beyond. The report concludes in Chapter 5.

The second report in this series will examine in more detail what has stood in the way of implementing structural reforms in the past, and how these barriers could be overcome. This project builds on earlier work carried out by the Institute for Government, which made recommendations for improvements to tax policy making.⁴

2. The UK tax system: a system in need of reform

Last year, the UK Government raised revenues totalling £786.9 billion (bn), or 36.9% of national income, of which £735.1bn, or 34.5% of national income, came from taxes and National Insurance Contributions (NICs).¹ The Government’s remaining revenues came from other streams such as interest on public sector financial assets and the gross operating surpluses of public corporations.

Figure 1: Comparison of tax revenues across advanced economies, % GDP (2017)



Source: Institute for Government analysis of OECD, *Global Revenue Statistics*.

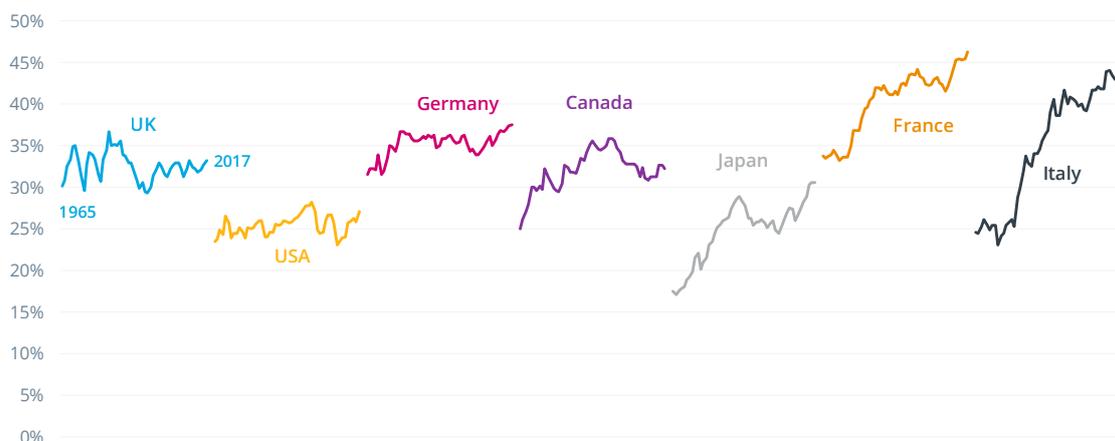
The UK ranked 20th out of 36 countries in the Organisation for Economic Co-operation and Development (OECD) group of advanced nations in 2017 – and fourth in the G7 group of the world’s largest advanced economies – when ranked by the size of tax revenues relative to national income.* On average, OECD countries raised tax revenues worth 34.2% of national income, compared to the UK’s 33.3% measured on the same basis.² As Figure 1 shows, many continental European countries have a considerably higher tax take than the UK, while the US and others raise less.

* This is the latest year for which internationally comparable figures are available. OECD, *Revenue Statistics 2018*, OECD Publishing, www.oecd.org/tax/revenue-statistics-united-kingdom.pdf

There is some evidence that these different levels of tax burden are mirrored in public attitudes to taxation. A poll conducted by YouGov in 2014, for example, presented respondents in the UK and US with a choice between two alternative 'moral' arguments about tax: "people have a right to keep money they earn" and "people have a duty to contribute money to public services". In the US, a majority (53%) of respondents felt the first argument was stronger.³ The reverse was true in the UK where nearly two thirds of respondents (63%) felt the latter argument was stronger.⁴

An interesting question is whether the different political choices made about the size of the tax burden in each country have been driven by different public attitudes, or if instead the political choices and debate shape public attitudes. We are not aware of any evidence that answers this question in an international context, but there is related evidence on how public attitudes and tax policies have changed in the UK over time. In the UK, public support for cuts to income tax rates rose (and support for redistribution fell) from the 1980s through to the early 2000s. However, analysis suggests that – rather than political parties having chosen policies that fit with prevailing public attitudes – "voters seem to have followed rather than led the changing content of party manifestos".⁵

Figure 2: Tax revenues across G7 countries, % GDP (1965–2017)



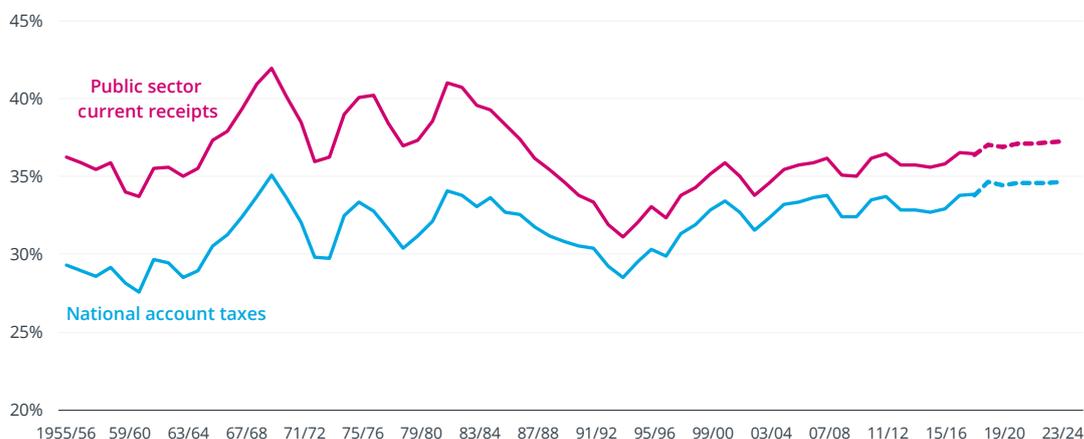
Source: Institute for Government analysis of OECD, *Global Revenue Statistics*.

As Figure 2 shows, the level of tax raised as a proportion of national income has increased across the world's largest advanced economies over the past 50 years. However, this growth has not been uniform. Among the G7, the UK has had the smallest increase in tax burden, from 30.1% of national income in 1965 to 33.3% in 2017 – an increase of only 3.2% of GDP. In contrast, Italy has had a 17.7% of GDP increase over the same period, while tax revenues have increased by an average of 9% of GDP across the G7.

The latest official forecasts from the Office for Budget Responsibility (OBR) suggest UK tax revenues are on course to rise marginally from 34.5% of national income last year to 34.6% by 2020/21 (using the UK Government's preferred measure) and then to

remain at that level. As Figure 3 shows, this would be the highest level of tax as a share of national income since 1969/70 and would take the total level of government revenues as a share of national income back to a level last achieved in 1986/87.

Figure 3: UK tax and total revenues, % GDP



Source: Institute for Government analysis of OBR, Public Finances Databank.

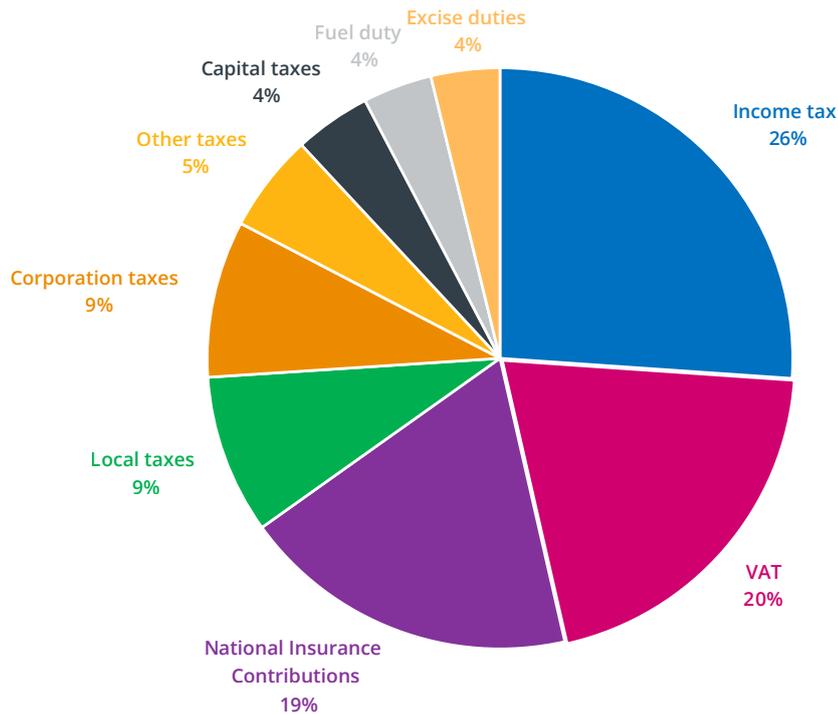
As a result, some have argued that tax revenues cannot be increased any further. For example, Conservative MP Jacob Rees-Mogg told the audience of *BBC Question Time* in September 2016 that: “we are already taxed to broadly the historic limit of taxation in the economy. If you look at figures going back to the 1970s, the tax take to GDP varies between 34% and 38%. If you look at the Treasury Red Book [annual Budget document] we are heading towards the 38% level.”⁶ However, as Figure 1 showed, other countries raise far greater shares of national income through taxation and (as Figure 2 showed) many other countries have increased their tax burdens steadily over time.

Three large taxes contribute the majority of tax revenues

Three taxes alone contributed over three fifths (60.9%) of all the tax revenues that the UK Government raised last year: income tax, Value Added Tax (VAT) and NICs.

Income tax is the main tax on personal income in the UK, and the largest single contributor to UK revenues, accounting for 26.1% of total tax revenues.⁷ The second largest tax is VAT, accounting for 20.3% of all tax revenues.⁸ NICs generated 18.7% of all tax revenues.⁹

Figure 4: Composition of UK tax revenues (2018/19)

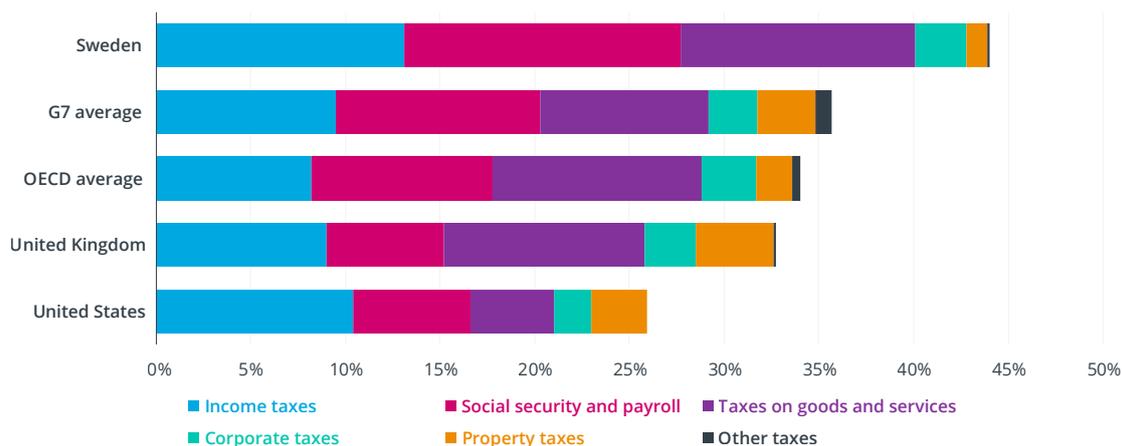


Source: Institute for Government analysis of OBR, *Economic and Fiscal Outlook*, March 2019, Table 4.3.

Compared to other advanced economies, the UK raises a relatively large share of revenues from income and property taxes, but relatively little through social security contributions.* The UK's reliance on consumption taxes is about average compared to other OECD countries. As Figure 5 shows, countries such as Sweden raise much more through taxation than the UK and rely more heavily on social security and payroll taxes than the UK does. The US has a lower tax burden and raises far less than the UK does through consumption taxes.

* OECD, *Revenue Statistics 2018*, OECD Publishing, www.oecd.org/tax/revenue-statistics-united-kingdom.pdf. For the purposes of its international comparisons, the OECD classify National Insurance as a form of social security contribution, despite the absence of a clear link between contributions and entitlements. OECD, *Social Security Contributions Explanatory Annex*, April 2019, www.oecd.org/ctp/tax-policy/social-security-contributions-explanatory-annex.pdf

Figure 5: International comparison of the composition of tax revenues, % GDP (2016)*



Source: Institute for Government analysis of OECD, *Global Revenues Statistics Database*.

Income tax

Income tax is levied on most forms of income in the UK, from earnings and interest on savings, to dividends and pension income. The income tax schedule is progressive, meaning that higher-income individuals pay a greater share of their income in tax than lower-income individuals. After individuals exhaust their tax-free personal allowance, most additional income is charged a marginal rate which ranges from 20% – for income up to the higher rate threshold of £50,000 a year – up to 45% for income above £150,000 a year. There are also various additional allowances for income from savings and dividends. In 2018/19, 31 million people¹⁰ (or 58% of adults in the UK)¹¹ paid income tax.

National Insurance Contributions

In contrast to income tax, NICs are only charged on the earnings of those aged under the state pension age,^{**} with a higher rate charged on income from employment than on income from self-employment.

When NICs were originally introduced, they were intended to fund contributory welfare benefits – such as for unemployment and disability – and the National Health Service (NHS). However, despite the UK notionally having a National Insurance Fund, this has always been a pay-as-you-go system, with current tax revenues used to meet the current costs of delivering services and paying benefits. The link between contributions and benefits received has also been gradually eroded over time and is now virtually non-existent. As a result, NICs operate like any other general tax.

Despite this, opinion polls typically suggest that the public is more likely to support an increase in NICs to pay for higher NHS spending than they are to support an increase in income tax for the same purpose. According to a YouGov poll in June 2018, 62% of

* Figure 5 has been compiled using data from the OECD's *Global Revenue Statistics* database. For the UK, income taxes include personal income taxes and capital gains; social security and payroll includes NICs; corporate taxes include corporation tax and corporate capital gains; taxes on goods and services include VAT and excise duties; and property taxes include council tax, business rates, inheritance tax and stamp duties.

** The state pension age is currently being increased for men and women in the UK. By September 2020, both men and women will have a state pension age of 66.

respondents said they would support a one percentage point increase in NICs to pay for the NHS, compared to 54% who said they would support a similar increase to income tax.¹² This suggests that the public still believe NICs are materially different to income tax.*

VAT

VAT is charged at a rate of 20% (up from 17.5% before the financial crisis) on goods and services, which amount to around half of all household expenditure in the UK.¹³

The UK's headline rate of VAT is broadly comparable to that of other European countries: 17 countries in the EU charge VAT at a higher rate, the highest being Hungary at 27%,¹⁴ while five EU countries charge a lower rate, with Luxembourg having the lowest VAT rate of 17%.¹⁵ The UK's VAT regime is currently subject to restrictions imposed by EU law, which set a minimum standard rate of 15%, mandate certain exemptions (for instance, for financial services), limit the ability of member states to expand the class of goods and services subject to reduced or zero VAT rates, and prohibit rates above the standard rate.

However, the UK's VAT regime stands out internationally in having such a large swathe of goods – such as food, children's clothes and newspapers – that are charged no VAT, while others – like domestic energy – are charged a substantially reduced rate of 5%.¹⁶ HM Revenue and Customs (HMRC) estimates that the Government foregoes £4.8bn a year as a result of VAT zero-rating, and a further £4.8bn from the reduced 5% rate.^{17,**} The UK also has the highest VAT turnover threshold in the EU or OECD – allowing businesses with a turnover of less than £85,000 to avoid accounting for VAT.¹⁸

Corporation tax

Corporation tax is the main tax on company profits in the UK. It is currently levied at a flat rate of 19% on profits (due to be cut to 17% in April 2020), after accounting for deductions and allowances. The profits of some classes of company are also subject to additional taxes. For example, the bank surcharge effectively adds eight percentage points to the rate of corporation tax on banking profit over £25 million, while the profits of the oil and gas sector are also governed by a separate tax regime.

Onshore corporation tax – that is, corporation tax revenues excluding those raised from oil and gas companies operating in the seas surrounding the UK – including the bank surcharge accounted for 7.9% of tax revenues in 2018/19 (or £58.0bn). A further £3.6bn was raised from offshore corporation tax, petroleum revenue tax and the bank levy.

* Kirsty Blackman MP told a Common Vision event, anecdotally, that she had spoken to constituents that not only believed there was a direct link between NICs and entitlements, but that their individual contributions funded their specific entitlements. Kirsty Blackman at 'Common Vision, Tax Hypothecation: An idea whose time has come', 6 November 2018, Houses of Parliament.

** These figures assume (for simplicity, but implausibly) that there would be no behavioural change if a higher rate of VAT were imposed on the goods and services that are currently subject to zero or reduced rates of VAT.

The UK's statutory rate of corporation tax is the lowest in the G7 and fourth lowest among the OECD group of developed countries.* This follows a deliberate strategy by UK governments since the financial crisis to reduce the UK's headline rate to be the lowest in the G20.¹⁹ However, recent cuts in the headline rate have been partly offset by restrictions in the use of reliefs and allowances, meaning a greater share of profits are now subject to tax.

It is important to note, however, that 'companies' are merely legal constructs. They do not in any meaningful sense 'pay' tax.²⁰ Any tax remitted by companies must ultimately be paid for by one or more of three groups of individuals: the owners or shareholders of the company (through lower dividends or capital gains); the employees (through lower wages); or customers (through higher prices). This highlights a broader issue of identifying who actually bears the cost of a tax – described by economists as the 'tax burden'. The tax burden does not necessarily fall either on the person who remits the tax to HMRC or on the person who statutorily bears the tax. It can be borne by someone else altogether. Economists refer to this as 'tax incidence'.

Other taxes

Excise duties and other consumption taxes (fuel duty, tobacco and alcohol duties, air passenger duty and insurance premium tax) raise a total of £59.2bn a year (8.0% of tax revenues). Annual local taxes (council tax and business rates) raise £65.2bn a year (8.8% of all tax revenues). These local taxes are both levied on property – resulting in the UK raising a high proportion of taxes from property by international standards. Taxes on capital (capital gains tax, inheritance tax, property transaction taxes** and stamp duty on shares) contribute £31.2bn a year (4.2% of all tax revenues).

The tax system as a whole is redistributive – but not every part is equally so

In addition to raising revenue, part of the function of the tax system – alongside the benefits system – is to redistribute resources. Economists will often talk about the 'progressivity' of the tax system (how much it redistributes resources from rich to poor)^{***} and judge new policy proposals on this basis.

There are, however, many different possible ways of defining and measuring redistribution. Do we want to define rich and poor based on current individual incomes, current household incomes, total lifetime earnings, current expenditure, household wealth or some other definition? Do we want to look at redistribution in a particular year or take account of all the taxes someone will pay over their lifetime? The reason that these distinctions make a difference is, for example, that low-earning people can have high-earning partners, and all individuals' incomes will fluctuate over

* Based on the combined corporate income tax rate. Hungary, Ireland and Lithuania have lower rates than the UK. See OECD, *Global Revenue Statistics Database: Statutory corporate income tax rate 2019*, retrieved 30 May 2019, https://stats.oecd.org/index.aspx?DataSetCode=Table_111

** Property transaction taxes comprise stamp duty land tax, annual tax on enveloped dwellings (ATED) and property transaction taxes devolved to Scotland and Wales

*** When economists refer to progressivity, they specifically mean that the average tax rate increases as income increases – that is, the rich pay a greater share of their income (as opposed to simply a larger cash amount) in tax than the poor.

time, meaning they may have temporarily low income one year but still be able to spend more than this by drawing down on their savings.

One easily available measure of the progressivity of one part of the UK tax system is the figures published each year by HMRC based on income tax payments.²¹ These show, for example, that in 2018/19 the top 1% of income taxpayers received 12.2% of income but paid 27.9% of income tax revenues. In contrast, the poorest half of income taxpayers received more than twice as much income (25.3% of the total) but paid only around a third of the amount in tax (9.5% of all income tax revenues). A further 42% of adults paid no income tax at all.

However, these figures do not provide a comprehensive picture of the degree of redistribution in the UK tax system. Income tax is one of the most progressive taxes – with a more generous tax-free allowance and more progressive rate structure than, for example, NICs or VAT. Therefore, another regularly used measure of redistribution looks at how the tax system affects the cross-sectional distribution of income across households in the UK.* This sort of analysis has become a staple part of post-Budget analysis for the Institute for Fiscal Studies (IFS) and Resolution Foundation, leading think tanks in this area, to show the impact of new policy announcements.²² These organisations use this measure not only because it is a metric the public and policy makers are likely to care about, but also because the data required to carry out this analysis is fairly readily available – at least compared to the data that would be required to judge the impact of the tax system over someone’s lifetime.

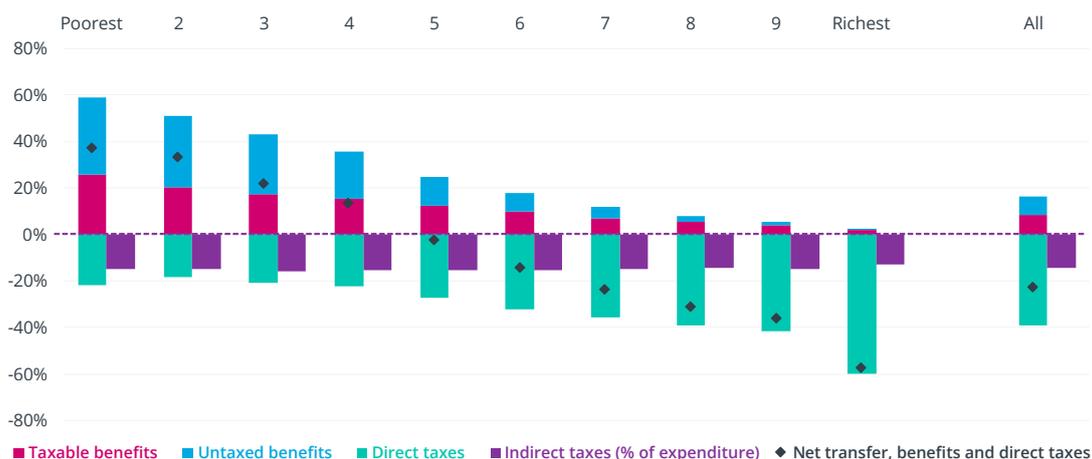
Figure 6 shows the results of an analysis of this type carried out by the IFS.^{23,**} The figure shows the impact of benefits and direct taxes on the incomes of richer and poorer individuals. These figures show the percentage increase/decrease in individual income as a result of benefits received and taxes paid, for individuals in each decile of the income distribution.

The figures show that the benefits system is more redistributive – that is, it does more to reduce inequality – than the tax system does. This is because benefits are more closely targeted at those with low incomes at the bottom than taxes are at those with high incomes at the top.

* This sort of analysis typically calculates measures of equivalised household income – that is, adjusting the incomes of different households to take account of the number and type of people living in them.

** This analysis also provides a critique of the methodology usually used by the Office for National Statistics (ONS) to produce similar sorts of figures. ONS, *Effects Of Taxes And Benefits On Household Income*, 20 June 2018, retrieved 10 April 2019, www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/datasets/theeffectsoftaxesandbenefitsonhouseholdincomehistoricaldatasets

Figure 6: Impact of taxes and benefits on household income by income deciles (2016/17)



Source: IFS, Briefing Note BN249: The effect of taxes and benefits on UK inequality, Figure 4.

The figures also show what share of total expenditure is taken through so-called indirect taxes (mainly VAT) for individuals across the income distribution. This shows that VAT and other indirect taxes do little to redistribute resources – individuals across the income spectrum pay a roughly similar share of their total expenditure in indirect taxes.*

It is important to remember that not every single tax has to be redistributive to achieve the redistributive objectives of the democratically elected government. There may be good reasons why one tax is less progressive than the system as a whole – or even regressive.** If the sole objective is to redistribute income, sometimes changes to benefits may be a more effective way of doing this than tweaking the tax system, as low-income households pay only minimal amounts of tax and many tax changes that benefit the poor will also deliver benefits to higher-income households.

The structure of the UK tax system has changed substantially since the mid-1970s

Since the mid-1970s there has been in the UK, as elsewhere in the developed world, a shift from levying taxes on income and specific goods to raising revenue instead by levying social security contributions and broad-based taxes on expenditure. The shift towards greater reliance on social security contributions (NICs in the UK) – which are only paid by those who are in work and aged under the state pension age – rather than income tax (which is levied on all forms of income) has shifted the burden of tax onto

* These figures from the IFS contrast with the ONS analysis that suggests that indirect taxes, like VAT, are regressive. This is because the IFS shows the impact of indirect taxes as a share of expenditure, while the ONS shows the figures as a share of income. The ONS approach can give a misleading impression because some households with temporarily low incomes are able to maintain higher levels of spending by drawing down on their savings – in these cases, the ONS analysis suggests low-income households are paying relatively high levels of VAT. The IFS analysis also examines the impact of taxes and benefits on individuals' income, rather than households' income. ONS, *Effects Of Taxes And Benefits On Uk Household Income: Financial Year Ending 2018, 2019*, www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/bulletins/theeffectsoftaxesandbenefitsonhouseholdincome/financialyearending2018

** A good example is tobacco duty. This tax is designed to discourage smoking, but bears most heavily on low-income people, since they are now more likely to smoke than higher-income people.

the working-age population and away from pensioners and those with capital income.* As Figure 7 shows, the composition of tax revenues today looks very different from the picture 40 years ago.**

In 1975, 40.0% of all tax revenues raised in the UK came from taxes on personal income, profits and capital gains, while 17.5% was raised from social security and payroll taxes and 8.9% from broad-based consumption taxes. By 2016, the share of revenues coming from individual income taxes had fallen to 27.4%, while the share coming from social security and general taxes on goods and services had risen to 18.9% and 20.8%, respectively. Similar changes have occurred across other OECD countries, as Figure 8 shows – albeit on a slightly different scale and with different timings.

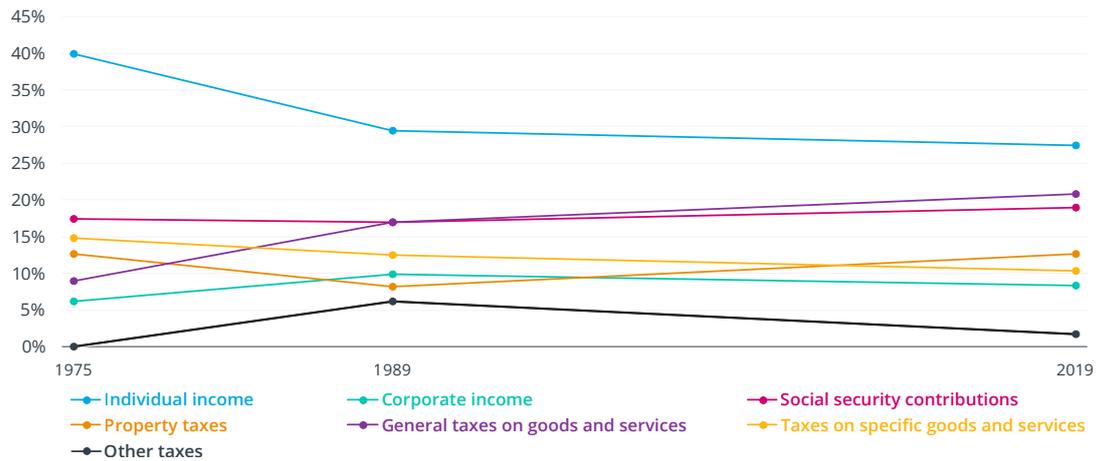
In the UK, this shift has come about through a mixture of gradual change and – less commonly – short periods of significant reform.²⁴

VAT has become increasingly important as a source of revenues over the past 40 years. Originally introduced in the UK when the country joined the European Economic Community, the main rate has risen from 8% in 1974 to 20% today. At the same time, there has been a general trend away from reliance on narrow taxes on specific goods and services, such as targeted excise duties.

* Boris Johnson MP's recent proposal to raise the higher-rate threshold for income tax and the upper-earnings limit for NICs would be a further move in the same direction, delivering a cut in income tax for high-income individuals, partly offset by an increase in NICs for higher earners, aged under the state pension age. Mason R, 'Boris Johnson promises tax cut for 3m higher earners', *The Guardian*, 10 July 2019, www.theguardian.com/politics/2019/jun/10/boris-johnson-promise-tax-cut-raise-40p-threshold

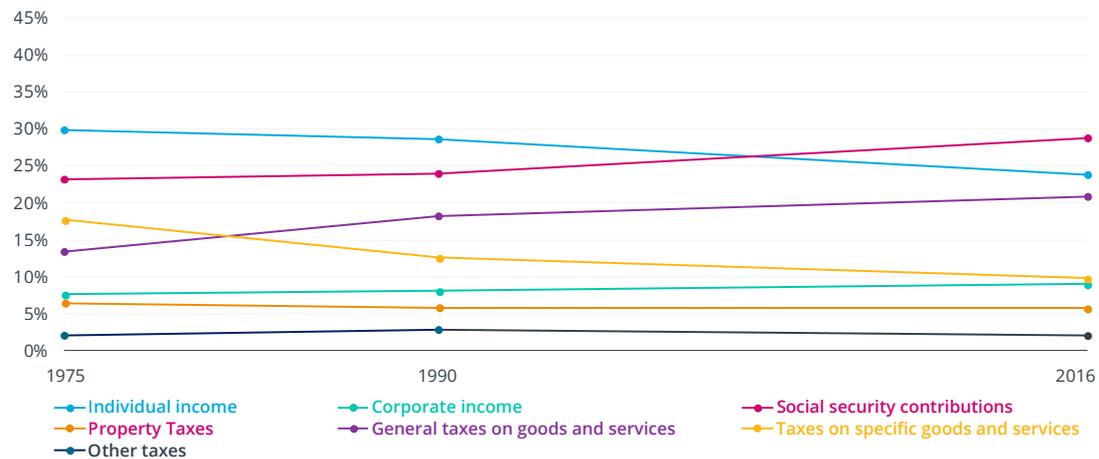
** There has also been a trend over recent years to devolve tax-raising powers to the national administrations in Scotland, Wales and Northern Ireland and to local authorities. For instance, the Scotland Act 2012 devolved powers over Stamp Duty Land Tax (SDLT) and landfill tax (both subsequently replaced by new taxes) to the Scottish Parliament, as well as further powers to vary income tax. Several tax powers, including a limited ability to vary income tax rates, have also been devolved to the Welsh Assembly. Following such changes, approximately 30% of tax revenues raised in Scotland are now overseen by the Scottish Government, with a further 10% assigned to the Scottish Government. In Wales, approximately 20% of tax revenues are overseen by the Welsh Government. A smaller proportion of tax revenues are overseen by the Northern Ireland Executive. For a fuller discussion on tax devolution, see Paun A, Cheung A, Valsamidis L, *Devolution at 20*, Institute for Government, May 2019, www.instituteforgovernment.org.uk/publications/devolution-at-20, Chapter 5.

Figure 7: Composition of tax revenues over time (UK)



Source: Institute for Government analysis of OECD, *Global Revenues Statistics*.

Figure 8: Composition of tax revenues over time (OECD average)



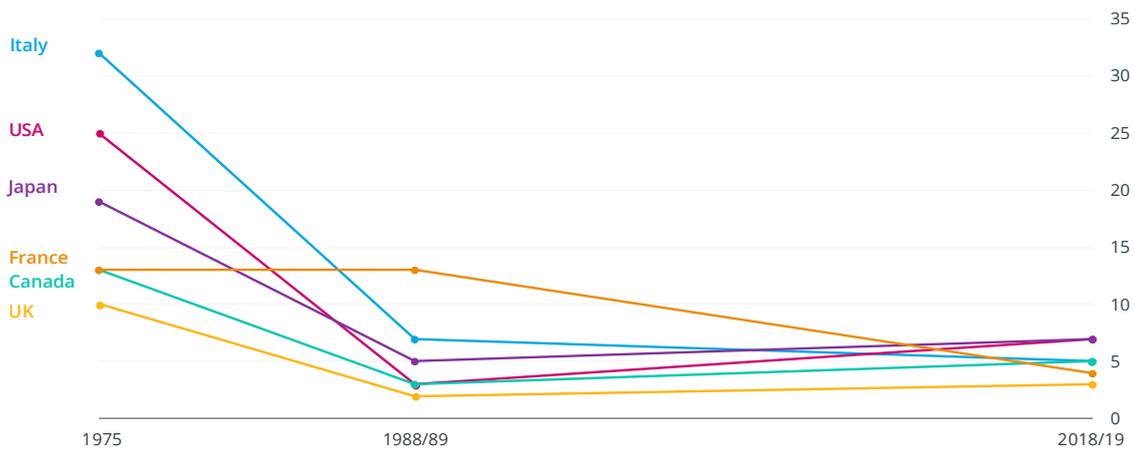
Source: Institute for Government analysis of OECD, *Global Revenues Statistics*.

Over the same period, income tax rates have been cut and the rate structure has been simplified – in the UK and elsewhere, as Figures 9 and 10 show. In 1975, the UK had 10 different rates of income tax, with the highest rate being 83% – or 98% on investment income. The UK now has only three different income tax rates: 20%, 40% and 45%.^{*} Much of this change happened over a short period of time during the first decade of Margaret Thatcher’s premiership. The basic rate of income tax was cut from 35% in 1976/77 to eventually reach 25% in 1988, when the top rate of income tax was also cut to 40%. The last time the basic rate of income tax was increased was in 1976.

In contrast, successive governments have become increasingly reliant on NICs as a source of revenue. For example, between 1976/77 and today, the main rate of Class 1 Employee NICs has risen from 5.75% to 12%. For those under the state pension age with earned income, an increase in NICs has much the same effect as an increase in income tax.

^{*} In practice, those earning between £100,000 and £125,000 face a marginal income tax rate of 60% as the benefits of the tax-free personal allowance are tapered away over this range of income.

Figure 9: Number of income tax bands

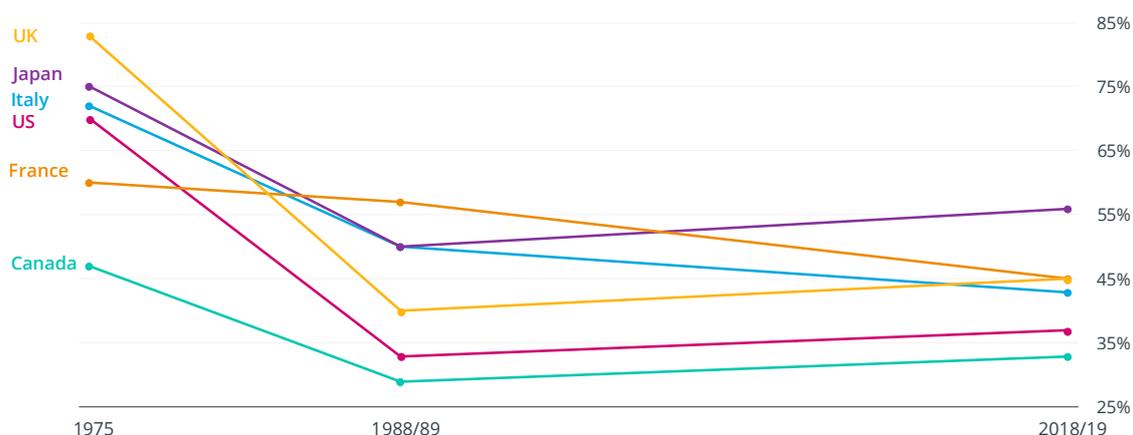


Source: Cnossen and Messere, *Survey And Evaluation Of Personal Income Tax Systems In OECD Member Countries*, 1989; John Kay at IFS at 50: The future of tax event, April 2019.

For a long time there has been concern about the growing difficulty of levying taxes on corporate profits.²⁵ The international corporate tax system currently relies on trying to pin down the location in which value is created so that the appropriate tax authority can take its cut. But as the world has become more interconnected – with products and services created from inputs across numerous countries – it has become increasingly difficult to pin down where value is created and increasingly easy for companies to structure their affairs so as to claim value is created predominantly in low-tax jurisdictions. This creates pressure for countries to compete with each other to offer ever-lower corporate tax rates.

Despite this, the share of revenues coming from corporate tax has held up remarkably well in the UK and elsewhere. In the UK, this is largely because taxable corporate profits – comprising the normal return to capital investment, returns to labour or entrepreneurial effort that are realised as dividends or capital gains, and returns to market power – have made up an increasingly large share of GDP.²⁶ Taxes on corporate income, profits and capital gains made up 6.2% of tax revenues (2.1% of GDP) in the UK in 1975, but 8.3% of tax revenues (2.7% of GDP) in 2016. There has been a similar rise across the OECD as a whole. This is despite headline rates of corporation tax having fallen – in the UK, for example, from 52% in 1975 to 20% in 2016/17, and 19% today.

Figure 10: Maximum income tax rate



Source: Cnossen and Messere, *Survey And Evaluation Of Personal Income Tax Systems In OECD Member Countries*, 1989; KPMG Individual income tax rates table, 2019.

The reduction in the headline rate of corporation tax in the UK has partly been offset by measures to widen the corporate tax base – removing some tax allowances and exemptions.* Corporate tax revenues in the UK have also been bolstered over the past 40 years by the ability to tax two industries that have exploited significant economic rents: the North Sea oil and gas sector, and the financial sector. Additional taxes have been levied on both of these sectors.

Alongside the main corporation tax regime, successive UK governments have sought to favour 'small' businesses in the tax system. A lower rate of corporation tax for small companies was in place until April 2015 – when the main rate of corporation tax was reduced to the same level as the previous small companies' rate – with a company being defined as 'small' if it had annual profits below a certain threshold.

UK politicians are not alone in using tax breaks to offer preferential treatment to small businesses.²⁷ However, despite the political rhetoric, there has been little evidence to support this tax-favoured treatment. It is not clear, for example, that companies with minimal profits disproportionately contribute to economic growth or create more jobs (which are claims often made to support these sorts of tax break for small businesses) than otherwise similar, more profitable companies. Quite the opposite may be the case, and lower tax rates for small companies could discourage successful businesses from expanding.²⁸

The 1980s was a period of relatively major structural change for the UK tax system. As described above, the corporation tax base was widened and the headline rate cut, the number and level of income tax rates were also substantially reduced, and the focus of expenditure taxes shifted from taxing individual products to the more broad-based VAT. This followed a growing awareness of the importance of what John Kay and Mervyn King described as "fiscal neutrality": a more fiscally neutral tax system is one that "avoids high marginal rates of tax and does not impose very different rates

* This occurred both in the 1980s under Nigel Lawson and more recently during George Osborne's reforms of corporation tax.

of tax on essentially similar activities”.²⁹ This was “a distinctly unfamiliar idea in the UK” in the late 1970s but had become “a political cliché” by 1990. However, as John Kay reflected in April 2019, there has more recently been a drift away from adherence to this notion of fiscal neutrality: “the idea that the tax system is there to encourage the good and discourage the bad is much more prevalent today than it was a decade or two ago”.³⁰

Making good, not making do: the challenge ahead

Despite some broad trends in the direction of tax policy over the past 40 years, the UK’s current tax system is not the result of careful design, but rather the culmination of reforms made by successive governments. This has resulted in a tax system that is far from optimal, with inefficient and distortive measures that impose greater costs on taxpayers than is necessary for the revenue raised. Were we to start with a blank canvas, few would suggest that we should end up with the tax system we have today.

Economists and others have identified various tenets or principles of a good tax system.³¹ While these lists of principles are described in slightly different terms, a review of the literature suggests there is broad agreement about the sorts of characteristics any good tax system should have. They suggest the tax system should be:

- **Sustainable:** in the sense of being resilient to changes in the economy over time (that may affect the tax base), and to some extent to changes in government (which may affect political support for some taxes). A sustainable tax system will maintain revenue to support public services and allow governments to plan ahead.
- **Horizontally equitable:** broadly speaking, those in like circumstances should be treated alike by the tax system, and activities that are alike should also be taxed the same, unless there are strong justifications for not doing so.
- **Procedurally fair:** the process by which taxes are designed, rates are set, and the system is implemented should be, and be seen to be, fair.
- **Economically efficient:** the tax system should raise revenues in a way that least affects individuals’ economic decisions. In general, this means avoiding very high marginal tax rates, having a range of broad-based taxes and taxing those least responsive to economic incentives.
- **Simple, comprehensible and transparent:** in general, people should be able to understand the tax system, which aspects apply to them, and the basis on which decisions about changes to the system are made. This promotes trust in the system.
- **Cost-efficient:** the system should, where possible, minimise administration costs for government and compliance costs for taxpayers.
- **Stable:** the tax system should be stable over time. Individuals and businesses make decisions based on their expected tax liabilities and should not live to regret the decisions they make today.

-
- **Able to effectively address market failures:** the tax system not only raises revenue but can also influence behaviour by changing the private cost or benefit of an activity. Taxes can be used deliberately to align this private cost or benefit with the wider social cost or benefit (economists refer to the difference between the private and social cost or benefit as an 'externality'). For example, sugary drinks are currently subject to a higher rate of tax than other consumer goods. In this and similar cases – such as tobacco duty – the objective and justification for the tax is to discourage the activity, rather than necessarily to raise revenues. However, the tax system is often only one of a range of possible policy responses to address externalities, and governments should make clear why tax is the best policy lever to use in any given case.
 - **Practical and possible to implement:** a tax system must not only work well in theory, but also in practice.
 - **Coherent both internally and with other areas of government policy:** the true effect of many individual taxes cannot be fully appreciated in isolation. It is only when the tax measure is combined with the rest of the system and other areas of government policy – such as welfare and regulation – that its real-world implications become clear. These interactions should be taken into account when assessing the tax system and proposing reforms.

Of course, it is unrealistic to expect any tax system to adhere perfectly to all these principles. There are times when the principles will inevitably have to be traded off against one another, and there may be disagreement as to how a principle should be applied in practice. However, with these limitations in mind, such principles are a useful starting point in the debate about tax reform and can act as a benchmark against which to assess the current tax system and proposed reforms.

The comprehensive, IFS-led Mirrlees' Review of the UK tax system, published in 2011, assessed the current system against these sorts of principles – emphasising the importance of viewing the tax system as a whole, rather than judging each individual tax in isolation.³² That analysis highlighted where the system fell short, attempted to quantify the cost of those shortcomings, and made recommendations for how the system could be better designed to raise the same revenue and achieve the same redistributive outcomes, while creating fewer distortions and inefficiencies. But the fact that there has been minimal progress towards adopting the changes that Mirrlees recommended highlights the difficulties of implementing substantial tax reform even where there is expert analysis to justify change.

There are costs in not addressing these shortcomings. A better-designed, more efficient tax system would increase the public's welfare and could boost national income, allowing the Government to raise the same amount of tax revenue while leaving individuals with higher post-tax incomes. Some of the areas where the UK tax system falls short of the principles outlined above are found below.

-
- Increasing fuel efficiency and the eventual switch to alternatively fuelled vehicles (which is discussed in more detail in Chapter 4) is a threat to the sustainability of tax revenues. Fuel duty currently raises around £28bn a year (or close to 4% of total government revenues).
 - Capital gains tax is complex and costly to comply with because the legislation changes frequently.
 - Capital gains made on investments in owner-occupied housing – unlike other assets – are exempt from capital gains tax. This, combined with the inheritance tax threshold, means a substantial part of the return individuals accumulate on their investment in property incurs no tax at all. This distorts people’s investment decisions towards investing in the UK housing market rather than other assets, and means the tax system favours owner-occupation over renting.
 - Because of its unusually narrow base, the VAT system is less efficient and more complex than it could be, and leads to costly boundary disputes.* HMRC estimates that the UK Government could have raised an additional £53bn in 2018/19 if all goods and services that currently benefit from a zero or reduced rate of VAT were instead charged at the standard 20% rate (assuming no behavioural changes in response to this, which is unlikely).³³ By changing the price that people face in the shops, zero and reduced rates of VAT distort individuals’ choices about what to buy. HMRC has also spent millions of pounds fighting court cases with businesses who have disputed the classification of their products.³⁴
 - The amount of tax someone is liable to pay on their labour income depends on their contractual relationship with the person engaging them to carry out the work. An employee will pay more tax than a self-employed person, and both will pay more than someone carrying out the work under the auspices of their own incorporated company.³⁵ This varying tax liability is horizontally inequitable, economically inefficient and complex. Although differing tax liability can sometimes be justified to address market failures, it has not been demonstrated that the tax system is the most appropriate policy lever to correct such a failure in the labour market.
 - Stamp Duty Land Tax (SDLT) – a tax on the value of property when it changes hands – discourages mutually beneficial transactions and promotes an inefficient allocation of property. For example, there is evidence that SDLT discourages older people from down-sizing to smaller properties, thus reducing the stock of larger

* The usual argument against widening the VAT base is that it is a regressive tax and thus widening the base would hit poorer families harder. As Figure 6 showed, VAT is neutral – rather than regressive – when tax is expressed as a share of expenditure across the income distribution, but it is still not as progressive as other taxes like income tax. However, this still does not provide a powerful case against widening the VAT base. This is because any widening of the VAT base could be coupled with changes to other taxes or benefits that would better target support at low-income families. Zero-rating food and children’s clothing for VAT delivers the largest cash benefit to high-income households, and so is a poorly targeted way of supporting those on low incomes. This is an illustration of why it is important to consider the tax system as a whole, rather than individual elements, when assessing whether it achieves the Government’s objectives.

family homes available to young families.* It is also likely to discourage people from taking a new job if that requires moving house.

Tax policy since the 2008 crisis: strategy, drift, stealth and complication

Since the financial crisis of 2008, the Labour, Coalition and then Conservative governments have implemented considerable tax changes. While the overall tax burden has not increased much, there have been substantial tax rises offset by tax cuts elsewhere. However, despite the scale of change, many of these tax measures were made without a clear strategy and left in place, or added to, the existing inefficiencies.

Figures from the OBR suggest that new tax rises announced since mid-2008 have raised around £124bn a year in 2018/19 terms.** The single largest of these was the announcement in the June 2010 Budget (George Osborne's first as Chancellor) to increase the rate of VAT from 17.5% to 20% from 4 January 2011; raising an estimated £15bn a year in 2018/19 terms. NICs were also increased immediately after the financial crisis, raising around £13bn a year in 2018/19 terms. Other tax increases included the introduction of the bank levy and apprenticeship levy and changes to the tax treatment of pensions, dividends and profits from North Sea oil and gas.

These tax increases were partly offset by tax cuts worth £82bn a year in 2018/19 terms, according to the OBR. These have included above-inflation increases in the income tax-free personal allowance, reductions in the headline rate of corporation tax, repeated cancellations of planned increases in fuel duties in line with inflation, and increases to inheritance tax thresholds.

The changes since the financial crisis highlight some avenues for reform readily open to politicians in the UK and routes that are closed. For instance, while the Coalition Government successfully increased the main rate of VAT, efforts to marginally widen the UK's narrow VAT base in 2012 were met with strong public resistance.³⁶ This was despite the fact that widening the VAT base would boost economic efficiency and simplify the system – reducing the opportunities and incentives for businesses to engage in costly tax avoidance. VAT is also relatively cheap and easy to collect, for both businesses and the revenue authorities.³⁷

The Government has also pressed ahead with increases in the tax-free personal allowance for income tax, and incumbent governments and opposition parties have repeatedly pledged not to raise the basic rate of income tax. Yet, simultaneously, the rates of Employee and Employer Class 1 NICs have been increased. NICs kick in at a level of earnings below the personal allowance and act much like a less comprehensive income tax – albeit one that many people believe has a connection to benefits they will one day receive.

* See, for example, Scanlon K, Whitehead C and Blanc F, 'A taxing question: Is Stamp Duty Land Tax suffocating the English housing market?', London School of Economics and Political Science, November 2017, www.lse.ac.uk/business-and-consultancy/consulting/assets/documents/is-stamp-duty-land-tax-suffocating-the-english-housing-market.pdf

** These figures are based on the authors' calculations using information from the OBR's policy measures database: *OBR, Policy Measures Database*, 19 March 2019, retrieved 8 May 2019, <https://obr.uk/download/policy-measures-database>

In a few areas, recent reforms have followed a clearly articulated strategy. The Coalition and Conservative governments set out a clear ambition to broaden the base and lower the headline rate of corporation tax. This was articulated through the corporate tax roadmap.³⁸ Those governments also followed a clear strategy of raising the income tax personal allowance, which had been a Liberal Democrat election promise in 2010, but was embraced by its Conservative coalition partners.

But in other areas – notably changes to fuel duties – tax cuts have come about without any apparent strategy. Since 2010, successive chancellors abandoned the planned fuel duty escalator and repeatedly cancelled planned inflationary increases in fuel duty, at a total cost of around £9bn a year to the Exchequer so far.³⁹ These policy changes have further undermined a tax base that is already being depleted by a shift to alternatively fuelled vehicles.

Many of the tax increases have occurred in less noticed, smaller taxes, or in ways that have added complexity and inefficiency to the system. For example, the Coalition and Conservative governments increased the rate of insurance premium tax four times between 2010 and 2016, raising an extra £3bn a year in 2018/19 terms.⁴⁰ Governments have also introduced new taxes, such as the soft drinks levy, apprenticeship levy, bank levy and bank surcharge.

Other changes – such as the introduction of higher rates of SDLT on the most expensive properties, an additional rate of stamp duty on the purchase of second and subsequent properties, and repeated reductions in the annual and lifetime tax-free allowances for pension contributions – have exacerbated inefficiencies, added complexity and in some cases distorted economic choices. For example, the reduction in the annual tax-free pension contribution allowance for higher earners has encouraged some senior doctors, who are members of the NHS' defined benefit pension scheme, to reduce their hours of work to avoid facing a substantial tax bill.⁴¹

There have also been a number of tax changes that have flattered tax revenues in the short-term, but at the cost of lower future revenues or additional future spending commitments. For example, the decision to end contracting out for defined benefit pension schemes (announced in the March 2013 Budget) increased NIC revenue by an estimated £5.5bn a year, but this came at the cost of higher future state pension promises to members of defined benefit pension schemes.

Politicians have also failed to resist the temptation to stop tweaking tax reliefs, such as Entrepreneurs' Relief and tax credits for film production companies.

Ultimately, tax reform over the past decade has been a mixture of clear strategy in some areas, drift in others and stealth tax increases. Some of these have added complexity and inefficiency to an already imperfect system; others created additional future spending commitments, or merely accelerated the payment of future taxes to flatter the figures in the short term. Successive governments have demonstrated a strong aversion to tackling political opposition to tax reform – tending instead to dither and backtrack on reforms that would create vocal losers.

As we will demonstrate in the next two chapters, growing public spending pressures and emerging threats to existing tax bases mean it will become increasingly difficult for governments to continue to extract enough revenue from the existing system. The scale of the challenge also means that continuing to rely on piecemeal tweaks to the system will not be sufficient to meet future spending needs without exacerbating the distortions and inefficiencies already present in the UK tax system.

3. Pressure to raise revenues

Official long-run fiscal projections from the Office for Budget Responsibility (OBR) suggest current UK fiscal policy is not sustainable. Public service and welfare spending promises cannot be paid for by the current tax system, and simply increasing borrowing is not a viable alternative because it would require borrowing to grow year-on-year as a share of national income.

The current level of government borrowing in the UK is, at 1.1% of national income in 2018, relatively low by historical standards. But the UK's fiscal sustainability is threatened by an ageing population, which is putting upward pressure on budgets. It is inevitable that some combination of a reduction in the ambition for services and welfare, and higher revenues, will be needed – stronger economic growth would also make the choices easier.

The UK's ageing population strains budgets in three main areas (as shown in Figure 11). An older population will impose additional pressures on both health care and long-term adult social care. It will also increase the cost of providing the state pension. These costs are exacerbated by the current policy to increase the value of the state pension in line with the 'triple lock' guarantee, which means pensions will rise faster than earnings over the long-term, but mitigated somewhat by planned increases in the age at which people can start to receive the state pension.

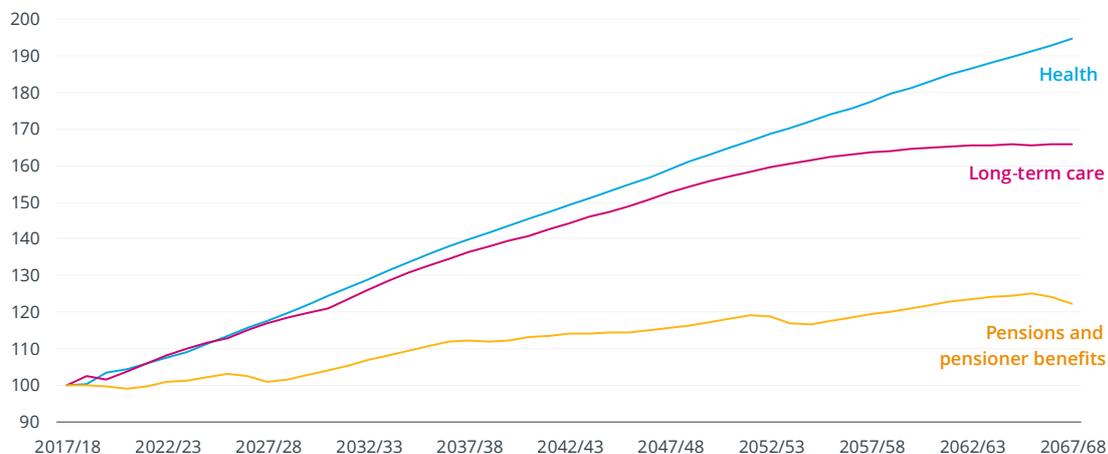
Age-related spending already accounts for a significant share of government expenditure in the UK. In 2017/18, public spending totalled 38.4% of national income.¹ Spending on state and public service pensions, and pensioner benefits, accounted for 21.6% of total spending, health care made up 19.3% and around 3% of spending went on adult social care. The other large components of spending were working-age benefits (12.5%), education (11.2%) and defence (4.9%).²

Demands on public services and state pension spending are likely to grow faster than tax revenues over the next few decades unless the tax system is reformed, or public service provision is substantially scaled back. As the International Monetary Fund (IMF) concluded in November 2018: "While the Government should continue to seek the best value for money in public spending, in many areas, identifying further efficiency gains without reducing the quality of services could become more difficult, highlighting the need for additional revenue measures."³

While these issues have been building for some time, the demographic structure of the UK population (combined with changes to the state pension age) mean demand for spending on health, long-term care and pensioner benefits is likely to grow faster

over the next decade or so than it has over the past few decades. The latest official long-term projections for public spending, published by the OBR in July 2018, are shown in Figure 11.

Figure 11: Projected age-related spending as a share of UK GDP (index, 2017/18=100)



Source: Institute for Government analysis of OBR, *Fiscal Sustainability Report*, July 2018.

Health spending will need to grow unless the Government scales back the scope or quality of NHS services

In July 2018, the OBR projected that public spending on health care would rise from 7.3% of national income in 2019/20 to 8.8% by 2030/31 (an increase of £32bn a year in 2018/19 terms). The OBR projection suggests that health spending will grow further – to 13.8% of national income (or an additional £106bn a year) – by 2067/68.

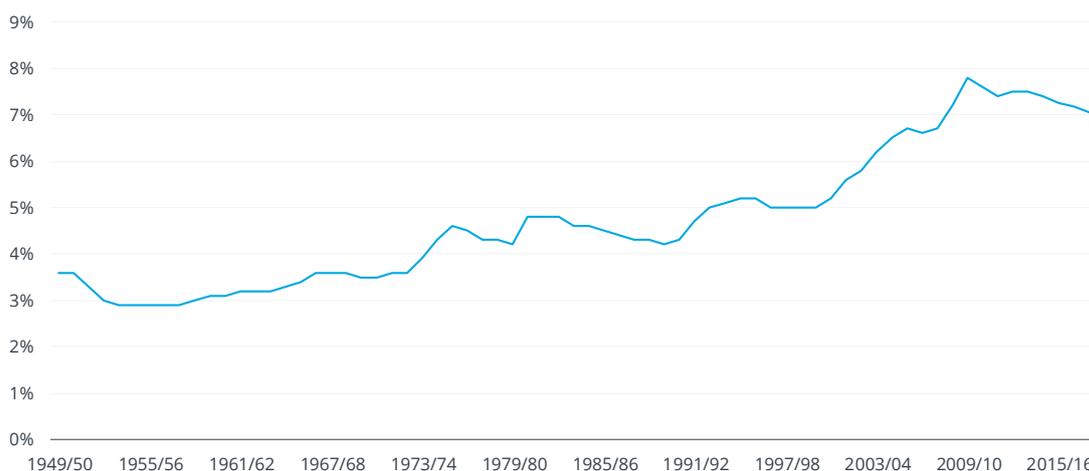
These projections assume that future governments will maintain the current scope of NHS services and that NHS spending will also rise sufficiently to meet growing non-demographic cost pressures – such as the additional costs of new health care technologies and the growing prevalence of chronic conditions.⁴ These non-demographic costs are expected to add one percentage point a year to health spending growth.⁵

Even though all permanent residents in the UK have the right to health care that is free at the point of use, actual NHS spending each year is largely determined by the government’s choices, including about the range and quality of services provided. Therefore, health spending need not keep pace with either demographic or non-demographic cost pressures.

However, in practice, over long periods of time (with the notable exception of the period since 2010), successive UK governments have tended to increase health spending faster than economic growth to help meet these pressures, as Figure 12 shows. This trend looks set to continue. Prime Minister Theresa May’s announcement in July 2018 of additional funding for the NHS is the clearest recent example of this.⁶

* As the IMF outlines, non-demographic cost pressures have been the main factor driving the increases in health spending as a share of national income over the past 20 years.

Figure 12: Health spending, % GDP (UK)



Source: Institute for Government analysis of IFS; HM Treasury, *Public Expenditure Statistical Analyses*, various years.

Spending on adult social care will also need to increase

The OBR projects that spending on adult social care will also need to rise – from 1.2% of national income in 2019/20 to 1.4% by 2030/31 (an increase of around £5bn a year in 2018/19 terms), and to 1.9% by 2067/68 (a further increase of £11bn a year).

In England, unlike health care, there is no universal right to state-funded care. Adult social care in England is provided by local authorities and funded through a mix of locally-raised property taxes and grants from central government. Eligibility is determined based on medical need and an individual's ability to pay.

This system poses several challenges. It requires individuals to manage considerable risks, since they cannot know with any certainty what their long-term care needs will be, and what financial provision – if any – they need to make. It also requires local authorities to fund care for eligible adults who are unable to meet their care costs – a risk that they have limited ability to manage or mitigate. As a result, many governments have consulted on how to reform social care funding to better allocate these risks.*

David Cameron's Government committed to implementing reforms that were recommended by a review chaired in 2011 by Sir Andrew Dilnot, former Chair of the UK Statistics Authority. However, these plans were put on hold by the July 2015 Budget⁷ and Theresa May's Government has yet to publish its long-awaited green paper on social care.⁸ As such, the Government's plans for social care are still unknown.

The OBR projections take as their baseline the levels of social care spending in 2017/18, and then assume that: the current system remains in place; funding for adult social care grows quickly enough to meet the needs of the UK's eligible ageing population (which depends on the future evolution of care needs and older households' financial resources); and the Government meets the additional costs of employing care workers as the National Living Wage increases.

* For an overview of these proposals, see Davies N, Campbell L and McNulty C, *How To Fix The Funding Of Health And Social Care*, Institute for Government, 2018, www.instituteforgovernment.org.uk/publications/how-fix-funding-health-and-social-care, pp. 43-47.

These projections assume the current system for providing and funding social care remains in place. However, as the OBR said when it set out its latest long-term fiscal projections in July 2018, “it seems highly likely that public spending on [adult social care] will be higher than assumed in these projections once new proposals [for public provision and funding of social care] are brought forward”.⁹

Reforming social care – whether capping the contribution individuals make to their care costs (as advocated by Sir Andrew Dilnot), increasing the amount of money adults would be allowed to keep before qualifying for public funding (as suggested in the 2017 Conservative Party manifesto),¹⁰ or removing the needs test for some state-funded care (as suggested recently by Damian Green MP)¹¹ – would increase demands on public spending.

The OBR’s forecasts may also understate the risk of more public spending being required in the near-term. Increasing demand and rising staff costs following the introduction of the National Living Wage have led councils to spend more on adult social care each year since 2014/15, crowding out spending on other local public services.¹² In response to these pressures, the Government has found ways to allow councils to spend more money on social care, rather than restrict the scope or quality of services.

For example, it has allowed councils to raise additional revenue through a council tax precept ringfenced for social care since 2015,¹³ and provided a series of one-off central grants to support social care.¹⁴ The Government estimates that, combined, these measures gave councils an additional £0.4bn to spend on social care in 2016/17, £2.3bn in 2017/18, £3.3bn in 2018/19 and £3.7bn in 2019/20.¹⁵

Spending on the state pension will also increase

The UK state pension system has never been overly generous and successive reforms – most recently following the 2005 recommendations of the Pensions Commission led by Adair (now Lord) Turner – have further minimised the risk of the UK Exchequer facing large future demands for pension spending.

An important part of the measures to limit future pension liabilities was the decision to legislate for future increases in the state pension age, as and when life expectancies increase further. Despite these measures, spending on the state pension is predicted to increase from 5.0% of GDP in 2019/20 to 6.9% by 2067/68 (an increase of £40bn a year in 2018/19 terms). Half of this increase is expected to happen between the late 2020s and the late 2030s.

A major factor contributing to this increase in state pension spending as a share of GDP is the Government’s commitment to ‘triple lock’ the level of the single-tier state pension – that is, to increase it each year in line with the greatest of earnings growth, consumer price inflation, and 2.5%. The 2017 Conservative Party manifesto pledged to move to a ‘double lock’¹⁶ – removing the minimum 2.5% annual rise – but this was later abandoned as part of the Confidence and Supply Agreement with the Democratic Unionist Party (DUP). The OBR estimates that state pension spending would be 1.0% of GDP lower by 2067/68 if the value of the state pension was increased simply in line with earnings.¹⁷

State spending on benefits for pensioners is also expected to increase, from 0.8% of GDP in 2019/20 to 1.3% by 2067/68 (an increase of £11bn a year in 2018/19 terms). However, these increases will be offset by a reduction in spending on pensions for former public sector workers. Spending on these is predicted to fall by 0.6% of GDP (or £12bn a year in 2018/19 terms), following significant changes to the terms for these pension schemes following a review by Lord Hutton in 2011 – including moving from using the final salary to using a career average salary to calculate pension benefits. Since these changes apply only to new pension accruals after 2015, it will take some time for these savings to manifest.

Overall, this leaves public spending on pensions and benefits for pensioners projected to rise from 7.9% of GDP in 2019/20 to 9.7% by 2067/68 (an increase of £38bn a year in 2018/19 terms).

Spending pressures pose a clear risk to the public finances

Left unaddressed in the UK, these spending pressures could pose a clear long-term risk to the UK's public finances. As we outline in the next section, if the current tax system remains unchanged, tax revenues would not be expected to grow in anything like the same way.

UK public debt remains high

The OBR estimates that future UK governments will need to announce new tax rises or spending cuts worth 1.9% of national income (or £40bn a year in 2018/19 terms)* every decade for the next 50 years in order to ensure public sector net debt falls from its current level of 83.1% of national income to stabilise at around 40% of national income – the level targeted by the Labour Government before the financial crisis. This target level is somewhat arbitrary, but the OBR also presents figures under a range of alternative assumptions about what level debt could be stabilised at, and the message is clear: if future UK governments want to avoid debt moving onto an unsustainable path, some combination of cuts to public spending promises and tax rises will be needed.

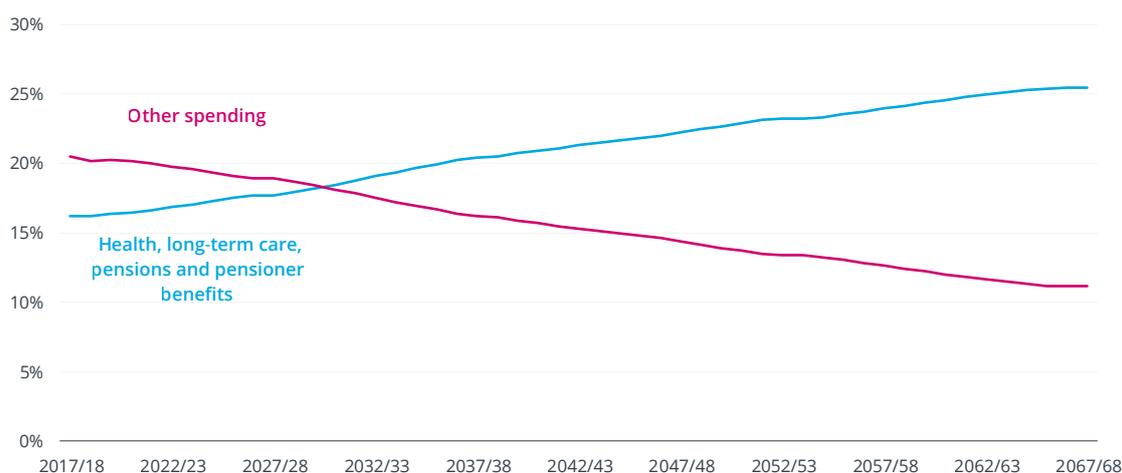
Using an internationally comparable measure of government debt, the UK's debt rose from 49.7% of national income in 2007 (before the financial crisis) to 116.3% in 2017. Before the financial crisis, the UK's level of debt was below the average across OECD countries (which stood at 55.3% of GDP in 2007), but the country now has a debt level above the OECD average (of 83.9% of GDP in 2017).¹⁸

Age-related spending is set to overtake non-age-related spending

This is not the first time in the UK's post-war history that health and pension spending is set to rise; this has happened for much of the past 70 years. However, in earlier decades, these increases have been offset by reductions in spending elsewhere – on, in particular, defence and debt interest.¹⁹

* HMRC's tax "ready reckoner" suggests that this would be equivalent to increasing all rates of income tax – the basic rate, higher rate and additional rate – by 6.5p. HMRC, 'Direct effects of illustrative tax changes bulletin', April 2019, retrieved 13 June 2019, www.gov.uk/government/statistics/direct-effects-of-illustrative-tax-changes

Figure 13: Long-term projections for non-debt interest spending, % GDP (UK)



Source: Institute for Government analysis of OBR, *Fiscal Sustainability Report*, July 2018. Note: Assumes total non-debt interest spending remains constant as a percentage of GDP after 2017/18.

Figure 13 demonstrates what would need to happen to spending outside health, adult social care and pensions as a proportion of national income if all the increases in those three areas were to be offset by reductions elsewhere over the next 50 years. This shows that those other areas of non-debt interest spending – including education, policing and defence – would need to be halved in size as a share of the UK economy.

It seems unlikely that there will be anything like that scope for further reductions in those other areas of spending without noticeably affecting the scope or quality of services and welfare provision. The current Government has committed to maintaining defence spending at its current level as a share of national income, in line with the UK's commitment to NATO that it will spend 2% of GDP on defence. As the Institute for Government's *Performance Tracker* shows, issues are also starting to emerge with the quality of some other services, such as prisons, and there are problems recruiting and retaining suitably qualified staff in many areas, including schools.²⁰ Government borrowing costs are also already very low, meaning there is limited scope for these to fall further. As a result, the gap between spending needs and revenues is likely to grow.

Most developed countries face similar pressure to spend more as their populations become older. However, the scale of the challenge varies. The European Commission estimates that across the EU as a whole, age-related spending will need to grow by 1.5% of GDP between 2025 and 2065.²¹ The UK is expected to face an increase of more than twice this size (3.2% of GDP increase). The considerable variation across European countries in the future spending pressures they face in part reflects differences in the historic generosity of publicly funded pensions and the timing of reforms. For example, France has historically had a very generous public pension system but has made reforms recently. As a result, the European Commission estimates that age-related spending in France will fall by 2.8% of GDP between 2025 and 2065, albeit from a higher initial level of age-related spending relative to GDP than in the UK.

These trends will slowly push politicians in the UK to confront an uncomfortable choice: increase taxes; charge for public services;* cut back public services or welfare provision; or adopt some combination of all three approaches. Previous attempts to address these difficult trade-offs – such as the Dilnot Commission on the funding of social care and support²² – have stalled and proved politically challenging.²³

But they cannot be ignored forever. As we show in the next chapter, threats to existing tax revenues will only make addressing the challenges more difficult.

* The IMF notes, for example, that out-of-pocket payments for health care are lower as a share of national income in the UK than in other advanced economies. IMF, *United Kingdom: Select Issues*, November 2018, retrieved 30 April 2019, www.imf.org/en/Publications/CR/Issues/2018/11/14/United-Kingdom-Selected-Issues-46354

4. Economic change is undermining the tax system

At the same time as growth in demand for public spending is likely to outstrip economic growth, tax revenues may struggle even to keep pace with it. * Two sets of issues contribute to this, which we explore in this chapter.

First, there are several economic trends and changes in how people behave that are undermining some of the UK's existing tax bases. Some of these behavioural changes are likely to have been driven, at least in part, by distortions created by the tax system.

Second, economic changes are introducing new forms of activity that currently incur minimal tax liability. The Office for Budget Responsibility (OBR) has also noted that the complexity of the UK tax system poses risks to future revenues because it creates opportunities for taxpayers to challenge legal interpretations or exploit boundaries.¹

Economic trends are undermining existing tax bases

Ongoing behavioural and technological changes are undermining some tax bases – in particular, fuel duty, tobacco duty and revenues from North Sea oil and gas production. While the Government acknowledges the threats to these tax bases,² and the need to tackle them, current reforms have fallen short of doing so.

Fuel duty

Fuel duty currently raises around £28bn a year for the Exchequer (1.3% of GDP or nearly 4% of tax revenues).³ However, these revenues depend on how much petrol and diesel vehicle users buy, meaning these revenues will come under pressure as vehicles become more fuel efficient, and would be lost entirely if the UK's vehicle fleet became fully electrified.

Current policy is to ban the sale of new diesel and petrol cars and vans from 2040,⁴ although the House of Commons Business, Energy and Industrial Strategy Committee has called for this to be brought forward to 2032 in order to achieve the Government's targets for reducing greenhouse gas emissions.⁵ Electric and hybrid vehicles currently make up just 6.4% of new vehicle sales⁶ but this share is growing.

The OBR has estimated that fuel duty revenues could fall by 0.3% of GDP by 2030/31,⁷ or a loss in revenues of around £6bn a year in 2018/19 terms.

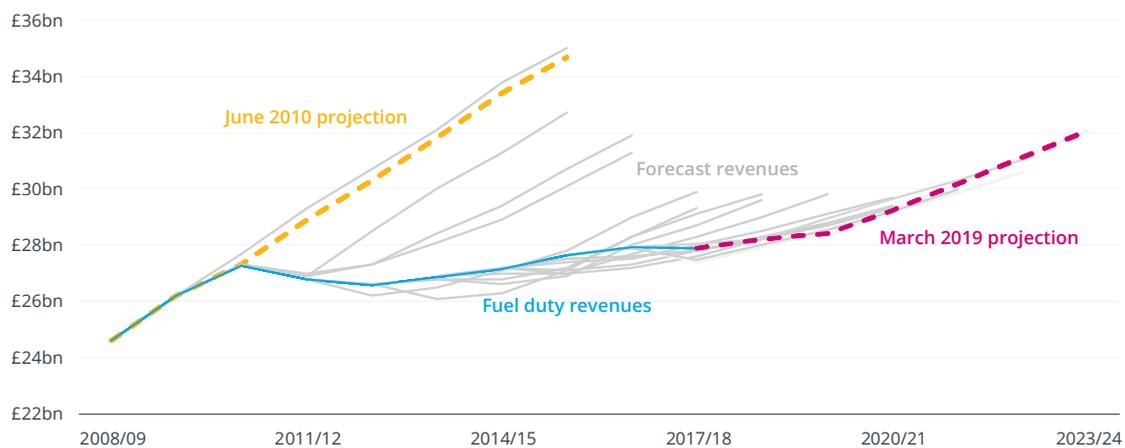
* The OBR's long-term fiscal projections suggest that tax revenues will remain roughly constant as a share of national income. However, the OBR essentially assumes that the economic and behavioural trends that we discuss here will be offset by other changes to the tax system. See Office for Budget Responsibility, *Fiscal Sustainability Report 2018*, July 2018, <https://cdn.obr.uk/FSR-July-2018-1.pdf>, page 89.

If the Government wants to continue to tax drivers – either simply to raise revenue or also to address some of the externalities caused by driving (in particular, congestion) – it will need to reform this area of taxation.^{8,9}

However, recent experience – when the Government has repeatedly failed to increase fuel duty in line with inflation (as illustrated in Figure 14) – suggests politicians find it difficult to make policy changes that require drivers to pay more (or even the same amount in real terms) in tax.

Alternative forms of tax on motorists – such as road charging – have proved unpopular in the past.¹⁰ However, changes are likely to be a lot easier to implement soon – while the Government can offer to cut fuel duties simultaneously – than they will be once fuel duty receipts have withered further.

Figure 14: Projected and actual fuel duty revenues (UK)



Source: Institute for Government analysis of OBR, Historical Forecast Database.

Tobacco duties

Tobacco duty is one of the oldest taxes in Britain, introduced by James I in 1604.¹¹ But the success of initiatives to encourage people to quit smoking – including the ban on smoking in enclosed public places – and the emergence of alternative products like e-cigarettes are reducing revenues from tobacco duties. In 1999/2000, the Government raised 0.7% of GDP (or £16bn in 2018/19 terms) from tobacco duties. But last year it raised just 0.4% of GDP (£9bn) following a steady decline in the share of UK adults who smoke.¹²

The OBR predicts that these revenues will fall by a further 0.2% of national income (or £4bn in 2018/19 terms) by 2030/31.¹³ Although this is a relatively small figure in the grand scheme of the UK's public finances, it will add to pressure on future governments to find alternative ways of raising revenues.*

Revenues from North Sea oil and gas

Oil and gas extraction has generated significant revenues for the UK Government since the first well struck gas on the UK continental shelf in 1965. Unlike Norway, which used similar revenues to build up a sovereign wealth fund, successive UK governments have largely chosen to spend these revenues, which peaked at 3.4% of national income (or £72bn in 2018/19 terms) in 1984/85.¹⁴

Last year, corporation tax paid by oil and gas companies operating in the North Sea, combined with payments of petroleum revenue tax, added only £1.1bn to the Treasury's coffers (or under 0.1% of national income). This is a sharp fall even from 10 years ago, when £10.6bn (0.7% of national income) was raised.¹⁵ This fall partly reflects declining global oil prices, but also falling production and the costs of decommissioning defunct extraction infrastructure, which can be offset against past tax payments.¹⁶

The OBR has estimated that revenues from North Sea oil and gas production will bring in a total of just £2.1bn between 2020/21 and 2040/41 (although this forecast depends on hard-to-predict oil and gas prices). This figure is so low in large part because of the costs of decommissioning.¹⁷

Successful development of shale gas extraction may offset some of this decline – albeit raising new environmental concerns. But UK governments must in the longer-term plan on the basis that they will receive little or nothing from taxing the economic rents from fossil fuel extraction on UK soil.

Growth of lightly taxed economic activities

There is also an ongoing shift in the economy towards types of economic activity that attract relatively little tax. In part this is being induced by the current structure of the tax system, which inefficiently distorts individuals' economic choices, pushing people towards carrying out their activities in a way that attracts a lower tax burden.

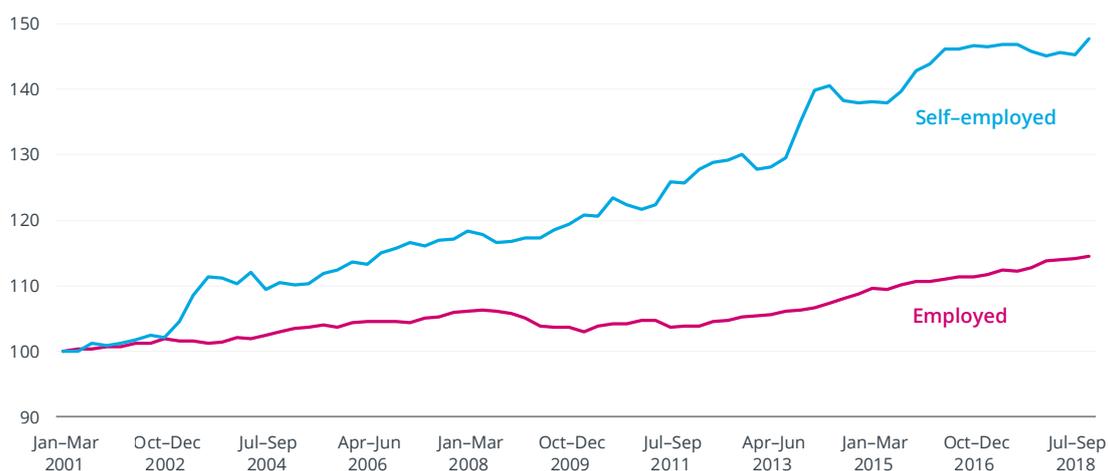
Self-employment and incorporations

There has been an increase in the proportion of people working for themselves – either on a self-employed basis or through their own owner-managed company. This trend puts downward pressure on tax revenue, as the UK tax system currently imposes lighter tax burdens on the self-employed and those working for their own companies than on employees.

* There is debate about whether taxing tobacco also saves the Exchequer money by reducing spending demands. Tobacco taxes do discourage smoking and thus reduce the costs of treating tobacco-related diseases. However, smokers tend to die earlier, which reduces the amount spent on pensions, long-term social care and age-related health problems. For a fuller discussion, see *The Economist*, '“Sin” taxes – e.g. on tobacco – are less efficient than they look', 26 July 2018, retrieved April 2019, www.economist.com/international/2018/07/26/sin-taxes-eg-on-tobacco-are-less-efficient-than-they-look

Although the self-employed remain a minority (comprising 14.8% of the workforce at the end of 2018), Figure 15 shows that growth in self-employment has outpaced that in employment over the past two decades. Increases in self-employment have accounted for nearly a third of total growth in the UK workforce over the past 10 years.*

Figure 15: Numbers of people in employment and self-employment in the UK (Jan to Mar 2001 = 100)

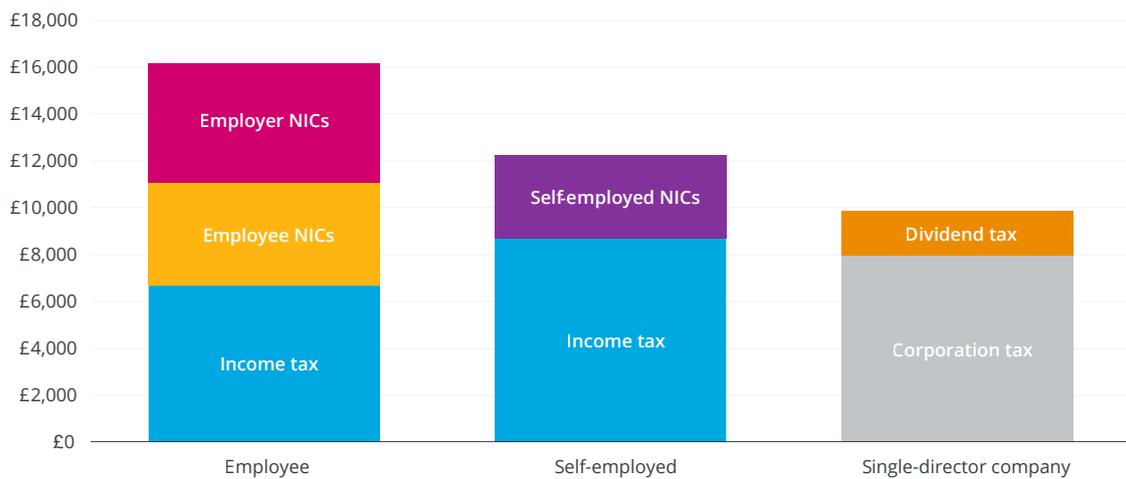


Source: Institute for Government analysis of ONS, *Quarterly Labour Force Statistics*.

If someone is employed, they pay income tax and employee's NICs, based on their salary, and their employer also pays employer's NICs on their behalf. Self-employed people pay income tax at the same rates as employees but are only liable to pay Class 2 and Class 4 NICs, which are levied at a much lower rate than the combined total of employee and employer NICs. Company owner-managers face considerably greater flexibility and more generous tax treatment than either employees or the self-employed, meaning the share of income they hand over in tax is typically even lower.¹⁸ The current difference in tax treatment of different forms of work is illustrated by Figure 16.

* ONS Labour Market Statistics. The ONS figures include single-director companies in their definition of self-employed. ONS, *A01: Summary of labour market statistics*, (updated monthly), www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/datasets/summaryoflabourmarketstatistics

Figure 16: Tax due on £50,000 of income (2017/18)*



Source: OBR, *Fiscal Risks Report 2017*, Chart 5.12.

There is no clear economic rationale for this different tax treatment. In theory the lower NICs paid by the self-employed could be justified by lower entitlement to contributory state benefits, but in practice the difference between the rights that employees and the self-employed accrue are far too small to justify the different tax treatment.¹⁹ From an economic perspective, the lower tax burden is also not justified by the more limited employment rights of self-employed people²⁰ – although these are an important part of the public debate and something politicians are likely to want to think about if considering changes to how public policy treats the self-employed.

Regardless of the merits of the differential tax treatment,** the fact that it exists means the Government raises less revenue than it would if these groups were taxed identically – or, conversely, that employees pay more tax than they could do. The growing prevalence of these alternative forms of work – which are more common among older workers and may also be facilitated by new technologies – therefore risks undermining the Government’s tax-raising capacity. The OBR estimated that faster than expected growth in incorporations between 2015/16 and 2021/22 would cost the Exchequer £4.5bn a year by 2021/22; equivalent to 0.6% of total expected revenues in that year.²¹

In its response to the OBR’s latest Fiscal Risks Report, the Government said it had no plans to try to reduce the gap between the level of NICs paid by the employed and self-employed, following Chancellor Philip Hammond’s unsuccessful attempt to do this in March 2017.²² This incident demonstrates the political risks associated with attempts to reform the tax system, even when there is a clear economic rationale for doing so.

* The figures shown assume that company directors withdraw profits in the most tax-efficient way, paying themselves a salary up to the primary threshold for NICs, and taking the rest as dividends, all in the same year.

** For example, in his government-commissioned review of modern working practices, Matthew Taylor concluded that “the different rates of National Insurance in particular mean that the UK system of taxing labour is not neutral – a self-employed person doing the same work as an employed person can pay a different amount of tax or National Insurance despite receiving similar contributory benefit entitlements in return... this situation is not justified, or sustainable, nor is it conducive to the goal of a good work economy”. See: GOV.UK, *Good work: the Taylor review of modern working practices, July 2017*, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/627671/good-work-taylor-review-modern-working-practices-rg.pdf, page 68

Globalisation and digital services

The basic design of the UK's corporation tax has remained largely unchanged for decades. It is designed to tax UK-resident companies, and companies with a permanent establishment in the UK, on their profits. However, this model has been challenged by globalisation: it has become increasingly hard to identify where economic activity takes place, where value is created and thus what profits should be subject to tax in any country.

Multinational companies can and do arrange their business affairs to minimise their tax liabilities. As a result, headline corporate tax rates have been falling over the past two decades across advanced economies, including in the UK. Across all the advanced nations that are members of the OECD, the average corporate tax rate in 2000 was 32.2%, but this had fallen to 23.7% by 2018.*

Despite this, corporate taxes continue, as described in Chapter 2, to raise significant revenues. Across the OECD, the average revenue raised from corporate taxes was 2.9% of GDP in 2016, compared to 2.6% in 1996.

Digitalisation has exacerbated the existing difficulties and created new ones.²³ Digital companies have a different model to traditional businesses – making money from advertising and the data they gather, while offering customers 'free' services that can be delivered without the company having any physical presence in the country where the consumer lives. The difficulties posed by digitalisation are in part conceptual: for example, which government should have the right to tax the profits generated by companies supplying services across international borders? They are also partly practical: how can HMRC ensure it collects all the VAT due on goods bought by private consumers from foreign suppliers and shipped in small consignments directly to the consumer in the UK?

Globalisation and digitalisation make it more difficult for the Government to raise revenue from taxing companies. The risk of losing a significant chunk of government revenues increases pressure for a more radical overhaul of the UK's tax system. Effective reform in this area requires international co-ordination, adding to the domestic barriers that other types of tax reform face. The UK is working with other countries through the OECD/G20 project on base erosion and profit shifting (BEPS) to co-ordinate approaches to tackling tax avoidance by multinational companies.²⁴

The latest stage of this project (at the end of May 2019) was to agree a "programme of work to develop a consensus solution to the tax challenges arising from the digitalisation of the economy", with the aim of achieving consensus by the end of 2020.²⁵ However, as different countries disagree on the appropriate way forward and it is expected to take some time to reach an international consensus, Philip Hammond announced in October 2018 that the UK would adopt its own approach to taxing digital services, in an attempt to raise some additional revenues from these companies.²⁶

* These figures are calculated as the simple average of combined central government and sub-national government corporate tax rates across all OECD countries. Source: OECD, *Corporate tax statistics database* (no date), retrieved 10 April 2019, http://stats.oecd.org/index.aspx?DataSetCode=TABLE_I11

Economic and behavioural trends will increase the cost of failing to reform tax

Past governments have struggled to make significant reform to the tax system. Instead they have tended to stick with the status quo or make piecemeal reforms that have made the system more inefficient. There are so far only limited signs in the current political debate of an appetite for major reform.* Attempts to address some of these economic trends – such as the Taylor Review of Modern Working Practices – have been instructed to steer clear of recommending tax reform.²⁷ But economic and behavioural changes – some of which are being induced by the distortive incentives in the current tax system – are set to undermine some existing tax bases and shift the economy towards less heavily taxed activities.

The current Government has acknowledged many of these emerging risks to revenue and the need to take steps to address them, but policy change has so far been largely ad hoc and failed to substantially address the risks. These economic and behavioural trends will increase the cost to future governments of failing to reform the tax system.

* Several candidates in the 2019 Conservative leadership race proposed making tax cuts, but only two suggested major tax reform. Rory Stewart MP said that he would embark on “comprehensive tax reform” to help “secure the long-term sustainability of Britain’s public finances”. *Financial Times*, ‘Leadership rivals’ spending promises are unrealistic’, 12 June 2019, retrieved 13 June 2019, www.ft.com/content/5f72006c-8c68-11e9-b8cb-26a9caa9d67b. Michael Gove MP proposed abolishing VAT and replacing it with a retail sales tax. This would be a major reform, but it is not clear that it would address any serious inadequacies that have been identified with the current tax system; indeed value-added taxes have advantages over retail sales taxes. The trend over the past 40 years has been for countries to adopt value-added taxes, which are considered superior to sales taxes. The US is the only major advanced economy not to have a VAT or goods and services tax. OECD, *Consumption Tax Trends 2018*, retrieved 13 June 2019, https://read.oecd-ilibrary.org/taxation/consumption-tax-trends-2018_ctt-2018-en#page1 and *Financial Times*, ‘Conservative contenders pledge looser purse strings to woo party’, 11 June 2019, retrieved 13 June 2019, www.ft.com/content/cc4f720-8b94-11e9-a24d-b42f641eca37

5. Conclusion

Tax reform is, understandably, not something that most politicians relish tackling. It poses political risks. A mix of good fortune and sleight of hand has allowed UK politicians to largely avoid making big reforms and yet to maintain a fragile balance between the public's expectations of public services and welfare, with resistance to paying more or different taxes.

But tax reform is well overdue and a combination of pressure to spend more on the UK's ageing population and trends that are undermining the revenues raised by the current tax system mean politicians need to start thinking seriously – and speaking openly – about tax reform: not just about how much tax they raise but how they raise it.

A well-designed tax system will raise enough revenue and redistribute resources as desired, while creating the least economic distortion or discouragement to economic activity. The UK tax system currently falls a long way short of this ideal. Reforms are needed to deal with these issues, but also to ensure that the UK tax system keeps pace with future economic and behavioural changes.

The political and economic environment over the next decade or so is unlikely to make it easy for this or a future government to make such reforms. The current Government's lack of a parliamentary majority has made it difficult to pass any contentious legislation, and it is possible that future governments will find themselves in a similar position.¹

Even for governments with a majority, recent experiences – such as Philip Hammond's abortive attempt to increase the rate of NICs for the self-employed or the 2012 'omnishambles' Budget, which attempted to impose VAT on pasties and static caravans – show the difficulty of making the case for any changes, especially in the face of powerful special interests.

A variety of barriers appear to stand in the way of making reforms. Some of these are political – such as the difficulty of pushing through tax reform that may have long-term benefits but impose short-term costs on some groups – and so particularly difficult for minority governments. Tax is also a complex area, which most members of the public understand little about, meaning it is often easier for opponents to highlight those who lose out than it is for reform advocates to articulate why changes are needed. Traditional and social media are usually quick to highlight who is affected by proposed reforms. This problem can be confounded by a lack of evidence on the likely impact of reforms, which can make it harder still to build a compelling case for change.

Some aspects of the process for making tax policy in the UK also militate against structural improvements, as previous Institute for Government work has highlighted.²

For example, UK chancellors rarely set out a clear strategy for what they want the tax system to achieve, meaning it is difficult to challenge or scrutinise whether new or existing tax policies achieve the desired objectives. Even if such a strategy were laid out, parliamentarians lack the opportunity – and often also the expertise and capacity – to look thoroughly at new and existing tax policies. In the civil service, efforts have been made to increase the formal tax training provided to staff in HM Treasury, but high rates of turnover³ mean there is still concern that those working on tax lack necessary expertise in the subject and that insufficient use is made of external tax specialists and academics in tax policy making.

But previous governments in the UK and elsewhere have managed to make significant tax reforms at times in the past, despite these difficulties. The Conservative Government in the 1990s, for example, managed to phase out mortgage interest tax relief, even though doing so was costly for homeowners. A particularly striking international example of successful reform is the wholesale tax changes made in New Zealand in the 1980s.⁴

These examples suggest that, while there are real barriers to making tax reforms, there is scope to learn from past experience – both in the UK and abroad. Examining past examples of success and failure provides insight into what serves to entrench these barriers and how they can be overcome. Understanding these issues is the focus of the Institute for Government's ongoing work, which will culminate in a follow-up report. To do this, we are interviewing a wide range of people who have been involved with, or are observers of, tax policy, in the UK and abroad, over the past four decades and reviewing relevant existing literature. This includes interviewing current and former politicians, their advisers, current and former civil servants in HM Treasury and HMRC, academics and tax experts, think tanks, journalists, pollsters and special interest groups. We are focusing on understanding how tax changes do – and do not – get made and what past experiences teach us about what did and did not work well.

So far, these interviews suggest a range of factors could help to improve the quality of tax policy making and increase the likelihood of difficult reforms being made. Politicians in the past have managed to head off adverse public reaction by laying the foundations for change well in advance, packaging reforms together and building broad coalitions. Thinking carefully about implementation can also smooth the passage of change and help ensure there are no unexpected problems. Comprehensively scrutinising and evaluating tax measures – both before and after they are implemented – could also play an important role in challenging the status quo and ensuring policies continue to deliver the desired results.

Circumstances also appear to matter – from the state of the economy to the strength of the Government's support in Parliament, and the personalities and expertise at the helm of the Treasury. Brexit currently casts a long shadow over Whitehall, depleting the Government's political capital and distracting attention from other long-term policy questions, including tax reform.

Developing an effective tax system is an important objective for any modern government, regardless of the Brexit outcome. There is scope to start making changes now that will ensure the necessary groundwork has been done when the Government comes to focus on these issues. Our objective is to highlight the priorities for action.

References

Chapter 1: Introduction

- 1 Kelly G, 'The politics of UK tax rises are as complex as the system', *The Financial Times*, 2 January 2019, retrieved 10 April 2019, www.ft.com/content/a13a61f8-0e7b-11e9-b2f2-f4c566a4fc5f
- 2 Murray A, 'Budget 2017: How will increasing national insurance bills make things fairer?', *The Telegraph*, 10 March 2017, retrieved on 21 May 2019, www.telegraph.co.uk/work-salary/national-insurance/budget-2017-will-increasing-national-insurance-bills-make-things
- 3 The Office of Tax Simplification published a report identifying 1,042 tax reliefs and recommending the abolition of 47 of them. Office of Tax Simplification, *Review of tax reliefs: final report*, March 2011, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/198570/ots_review_tax_reliefs_final_report.pdf. Many of these recommendations were met with opposition from various special interest groups in a subsequent Treasury consultation. HM Treasury, *The abolition of 36 tax reliefs: response to consultation*, December 2011, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/190281/condoc_responses_tax_reliefs.pdf
- 4 Rutter J, Dodwell B, Johnson P, Crozier G, Cullinane J, Lilly A and McCarthy E, *Better Budgets: Making tax policy better*, Institute for Government, 2017, www.instituteforgovernment.org.uk/publications/better-budgets-making-tax-policy-better

Chapter 2: The UK tax system: a system in need of reform

- 1 Office for Budget Responsibility, *Public Finances Databank*, 25 March 2019, retrieved 10 April 2019, www.obr.uk/download/public-finances-databank
- 2 OECD, *Revenue Statistics 2018*, OECD Publishing, www.oecd.org/tax/tax-policy/revenue-statistics-highlights-brochure.pdf
- 3 YouGov, Question 1: 'Moral tax argument', 1–3 November 2014, http://cdn.yougov.com/cumulus_uploads/document/mg4auwxn3k/tabs_OPI_taxes_20141103.pdf
- 4 YouGov, Question 2: 'Which moral argument about tax do you think is stronger?', 30–31 October 2014 http://cdn.yougov.com/cumulus_uploads/document/foeoy17eab/Internal_Results_141031_Tax.pdf
- 5 Alt J, Preston I and Sibieta L, *The political economy of tax policy*, Institute for Fiscal Studies, 2010, retrieved 11 June 2019, www.ifs.org.uk/publications/5230
- 6 Rees-Mogg J, *BBC Question Time*, 23 September 2016.
- 7 Office for National Statistics. Series: MS6W, LISB, MF6X, JW20. www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/timeseries/ms6w/pusf?referrer=search&searchTerm=ms6w
- 8 Office for National Statistics. Series: CTRU, AHGO, *ibid*.
- 9 Office for National Statistics. Series: AIH, *ibid*.
- 10 HM Revenue and Customs, *Number of individual income taxpayers*, GOV.UK, 25 May 2018, retrieved 24 April 2019, www.gov.uk/government/statistics/number-of-individual-income-taxpayers-by-marginal-rate-gender-and-age
- 11 Office for National Statistics, *Table A1-1, Principal projection- UK summary*, 26 October 2017, www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationprojections/datasets/tablea11principalprojectionuksummary
- 12 YouGov, *A Majority Of Brits Now Support Increasing Income Tax To Fund The Nhs*, 24–25 June 2018, retrieved 5 June 2019, <https://yougov.co.uk/topics/politics/articles-reports/2018/07/03/majority-brits-now-support-increasing-income-tax-f>

-
- 13 Office for Budget Responsibility, 'Tax by tax, spend by spend: VAT', (no date), retrieved 15 April 2019, <https://obr.uk/forecasts-in-depth/tax-by-tax-spend-by-spend/vat>
 - 14 European Commission, *Vat Rates Applied In The Member States Of The European Union*, 1 January 2019, https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/vat/how_vat_works/rates/vat_rates_en.pdf
 - 15 *Ibid.*
 - 16 OECD, *Consumption Tax Trends 2018*, retrieved 30 May 2019, https://read.oecd-ilibrary.org/taxation/consumption-tax-trends-2018_ctt-2018-en#page57, Figure 2.3.
 - 17 HM Revenue and Customs, *Principal tax reliefs, 2019*, retrieved 10 April 2019, www.gov.uk/government/statistics/main-tax-expenditures-and-structural-reliefs
 - 18 OECD, *Consumption Tax Trends 2012*, retrieved 30 May 2019, https://read.oecd-ilibrary.org/taxation/consumption-tax-trends-2012_ctt-2012-en#page86, Table 3.10.
 - 19 HM Revenue and Customs, *Corporation tax to 17% in 2020, Policy Paper*, 16 March 2016, retrieved 10 April 2019, www.gov.uk/government/publications/corporation-tax-to-17-in-2020/corporation-tax-to-17-in-2020
 - 20 Worstall T, 'Corporations do not pay taxes: they can't, they're not people', *Forbes*, 22 September 2011, retrieved 30 May 2019, www.forbes.com/sites/timworstall/2011/09/22/corporations-do-not-pay-taxes-they-cant-theyre-not-people/#12579a6a6222
 - 21 HM Revenue and Customs, *Shares of total income tax liability*, 25 May 2018, retrieved 10 April 2019, www.gov.uk/government/statistics/shares-of-total-income-before-and-after-tax-and-income-tax-for-percentile-groups
 - 22 Resolution Foundation, *How to spend it: Autumn Budget 2018 response*, October 2018, retrieved 10 April 2019, www.resolutionfoundation.org/publications/how-to-spend-it-autumn-2018-budget-response; Institute for Fiscal Studies, *Personal tax and benefit measures*, 30 October 2018, retrieved 10 April 2019, www.ifs.org.uk/publications/13655
 - 23 Bourquin P and Waters T, *The effect of taxes and benefits on UK inequality*, Institute for Fiscal Studies, May 2019, retrieved 30 May 2019, www.ifs.org.uk/publications/14127
 - 24 John Kay, 'Tax reforms happen better by stealth', 4 September 2017, retrieved 10 April 2019, www.johnkay.com/2017/09/04/tax-reforms-happen-better-stealth
 - 25 Mirrlees J, Adam S, Belsey T and others, *Tax by Design*, Institute for Fiscal Studies, 2011, Oxford University Press. Chapter 9, page 460
 - 26 Griffith R and Miller H, *Taxable Corporate Profits*, Institute for Fiscal Studies, 2014, vol.35 no.4, www.ifs.org.uk/publications/7605
 - 27 Eslake S, 'Why small business tax cuts aren't likely to boost jobs and growth', *The Conversation*, 19 February 2017, retrieved 19 February 2019, <https://theconversation.com/why-small-business-tax-cuts-arent-likely-to-boost-jobs-and-growth-72658>; Harrison JD, 'Who actually creates jobs: Start-ups, small businesses or big corporations?', *The Washington Post*, 25 April 2013, retrieved May 2019, www.washingtonpost.com/business/on-small-business/who-actually-creates-jobs-start-ups-small-businesses-or-big-corporations/2013/04/24/d373ef08-ac2b-11e2-a8b9-2a63d75b5459_story.html?utm_term=.b2c3c84c554b
 - 28 Mirrlees J, Adam S, Belsey T, Blundell R, Bond S, Chote R, Gammie M, Johnson P, Myles G and Poterba JM, *Tax by design*, Institute for Fiscal Studies, 2011, Oxford University Press, Chapter 9, page 460, www.ifs.org.uk/publications/5353
 - 29 Kay J and King M, *The British Tax System, 5th edition*, 1990, Oxford University Press.
 - 30 Kay J, *IFS at 50: The Future of Tax*, Institute for Fiscal Studies, April 2019, www.ifs.org.uk/future-of-tax
 - 31 The IFS-led *Mirrlees Review* of the tax system (Mirrlees J, Adam S, Belsey T, Blundell R, Bond S, Chote R, Gammie M, Johnson P, Myles G and Poterba JM, *Tax by design*, Institute for Fiscal Studies, 2011, Oxford University Press, Chapter 2, www.ifs.org.uk/publications/5353), the OECD, (OECD, *Addressing the Tax Challenges of the Digital Economy*, September 2014, retrieved 23 May 2019, www.oecd.org/tax/addressing-the-tax-challenges-of-the-digital-economy-9789264218789-en.htm), the IMF, (Du Mooj R and Keen M, *Taxing Principles: Making the best of a necessary evil*, December 2014, www.imf.org/external/pubs/ft/fandd/2014/12/pdf/basics.pdf), The Chartered Institute of Taxation, (CIOT, Written evidence to the Treasury Select Committee January 2011, <https://publications.parliament.uk/pa/cm201011/cmselect/cmtreasy/memo/taxpolicy/m25.htm>), the Law Society of England and Wales (The Law Society, *Tax and the Rule of Law*, April 2015, retrieved 23 May 2019, www.lawsociety.org.uk/policy-campaigns/consultation-responses/documents/tax-and-the-rule-of-law-law-society-response/), The Institute of Chartered Accountants of England and Wales (ICAEW, *Towards a Better Tax System*, October 1999, retrieved 23 May 2019, www.icaew.com/-/media/corporate/files/technical/tax/tax-news/taxguides/taxguide-0499.ashx, section 2) and the Treasury Select Committee (House of Commons Treasury Committee, *Principles of tax policy, Eight Report of the Session 2010-11*, 9 March 2011, publications. parliament.uk/pa/cm201011/cmselect/cmtreasy/753/753.pdf).

-
- 32 Mirrlees J, Adam S, Belsey T, Blundell R, Bond S, Chote R, Gammie M, Johnson P, Myles G and Poterba JM, *Tax by design*, Institute for Fiscal Studies, 2011, Oxford University Press, www.ifs.org.uk/publications/5353
 - 33 HM Revenue and Customs, *Estimated costs of principal tax reliefs*, January 2019, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/805191/Jan19_Principal_Reliefs_Final__Revised_for_Marriage_allowance_.pdf
 - 34 Wallop H, 'M&S wins 13-year dispute with tax man over tea cakes', *The Telegraph*, 5 February 2009, www.telegraph.co.uk/finance/newsbysector/retailandconsumer/4514338/MandS-wins-13-year-dispute-with-tax-man-over-tea-cakes.html
 - 35 Adam S, Miller H and Pope T, *Tax, legal form and the gig economy*, Institute for Fiscal Studies, February 2017, retrieved 30 May 2019, www.ifs.org.uk/publications/8872
 - 36 'Pasty tax: hundreds of bakers in Downing Street protest', *The Telegraph*, 26 April 2012, retrieved 20 May 2019, www.telegraph.co.uk/foodanddrink/foodanddrinknews/9227995/Pasty-tax-hundreds-of-bakers-in-Downing-Street-protest.html
 - 37 Richard M Bird's commentary on Crawford, Keen and Smith in Adam S, Besley T, Blundell R, Bond S, Chote R, Gammie M, Johnson P, Myles G and Poberta J.M., *Dimensions of Tax Design*, September 2010, Oxford University Press, page 363.
 - 38 HM Treasury, *Corporation Tax Road Map*, 29 November 2010, retrieved 10 April 2019, www.gov.uk/government/publications/the-corporation-tax-road-map; praised in Rutter J, Dodwell B, Johnson P and others, *Better Budgets: Making tax policy better*, Institute for Government, January 2017, www.instituteforgovernment.org.uk/publications/better-budgets-making-tax-policy-better
 - 39 Adams S and Waters T, *Options for raising taxes*, Institute for Fiscal Studies, October 2018, www.ifs.org.uk/publications/13495
 - 40 Institute for Fiscal Studies, *Tax and benefit reform*, IFS post-Autumn Statement Budget, November 2016, www.ifs.org.uk/uploads/publications/budgets/as2016/as2016_sa.pdf
 - 41 Coney J, 'Patients feel pain as doctors cut clinics over tax', *The Times*, 5 May 2019, retrieved 30 May 2019, www.thetimes.co.uk/edition/news/patients-feel-pain-as-doctors-cut-clinics-over-tax-m07wvjff5

Chapter 3: Pressure to raise revenues

- 1 Office for Budget Responsibility, *Public Finances Databank*, 4 June 2019, retrieved 13 June 2019, <https://obr.uk/data>
- 2 Office for Budget Responsibility, *Fiscal Sustainability Report 2018*, Table 3.10. *Total spending excludes interest and dividend payments*. Figures for defence spending from HM Treasury, Public Expenditure Statistical Analysis 2018, July 2018, Table 4.2.
- 3 International Monetary Fund, *United Kingdom: Selected Issues*, 2018, retrieved 10 April 2019, www.imf.org/~media/Files/Publications/CR/2018/cr18317.ashx
- 4 *Ibid.*
- 5 Office for Budget Responsibility, *Fiscal Sustainability Report*, July 2018, <https://cdn.obr.uk/FSR-July-2018-1.pdf>, page 7
- 6 Department of Health and Social Care and HM Treasury, 'Prime Minister sets out 5-year NHS funding plan', 18 June 2018, retrieved 20 May 2019, www.gov.uk/government/news/prime-minister-sets-out-5-year-nhs-funding-plan
- 7 HM Treasury, *Summer Budget 2015*, HC 264, The Stationary Office, 2015, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/443232/50325_Summer_Budget_15_Web_Accessible.pdf
- 8 Atkins G, 'The Government must not keep delaying the social care Green Paper', blog, Institute for Government, 1 April 2019, retrieved 10 April 2019, www.instituteforgovernment.org.uk/blog/government-must-not-continue-delaying-social-care-green-paper
- 9 Office for Budget Responsibility, *Fiscal Sustainability Report 2018*, July 2018, <https://cdn.obr.uk/FSR-July-2018-1.pdf>, page 145
- 10 *Forward Together, Our Plan for a Stronger Britain and a Prosperous Future*, The Conservative and Unionist Party Manifesto 2017, The Conservative Party.
- 11 Proposed in Lightfoot W, Heaven W and Henson Gric J, '21st Century Social Care: What's wrong with social care and how we can fix it', *Policy Exchange*, 21 May 2019, <https://policyexchange.org.uk/wp-content/uploads/2019/05/21st-Century-Social-Care.pdf>

-
- 12 Andrews E, Atkins G, Campbell L, Tetlow G and Lilly A, *Performance Tracker: 2018*, Institute for Government, October 2018, www.instituteforgovernment.org.uk/publications/performance-tracker-2018
 - 13 HM Treasury, *Spending Review and Autumn Statement 2015*, The Stationery Office, 2015, p. 33
 - 14 Andrews E, Atkins G, Campbell L, Tetlow G and Lilly A, *Performance Tracker: 2018*, Institute for Government, October 2018, www.instituteforgovernment.org.uk/publication/performance-tracker-2018/adult-social-care
 - 15 Ministry of Housing, Communities and Local Government, 'Core spending power: final local government finance settlement 2018 to 2019', The Stationary Office, 2018, retrieved 14 September 2018, www.gov.uk/government/publications/core-spending-power-final-local-government-finance-settlement-2018-to-2019
 - 16 *Forward Together, Our Plan for a Stronger Britain and a Prosperous Future*, The Conservative and Unionist Party Manifesto 2017, The Conservative Party.
 - 17 Office for Budget Responsibility, *Fiscal Sustainability Report 2018*, July 2018, <https://cdn.obr.uk/FSR-July-2018-1.pdf> p.82.
 - 18 OECD, General Government Debt (no date), accessed 23 April 2019, <https://data.oecd.org/gga/general-government-debt.htm>
 - 19 Crawford R and Emmerson C, *Inevitable Trade-Offs Ahead: Long-run public spending pressures*, Institute for Fiscal Studies, 2017, retrieved 10 April 2018, www.ifs.org.uk/publications/9219
 - 20 Andrews E, Atkins G, Campbell L, Tetlow G and Lilly A, *Performance Tracker: 2018*, Institute for Government, October 2018, www.instituteforgovernment.org.uk/publications/performance-tracker-2018
 - 21 European Commission, *The 2018 Ageing Report: Economic and Budgetary Projections for the EU Member States (2016-2017)*, 25 May 2018, retrieved 30 April 2019, https://ec.europa.eu/info/publications/economy-finance/2018-ageing-report-economic-and-budgetary-projections-eu-member-states-2016-2070_en, Table III.1.136
 - 22 The Commission on Funding of Care and Support, *Fairer Care Funding*, July 2011, <https://webarchive.nationalarchives.gov.uk/20130221121529/https://www.wp.dh.gov.uk/carecommission/files/2011/07/Fairer-Care-Funding-Report.pdf>
 - 23 Asthana A and Elgot J, 'Theresa May ditches manifesto plan with "dementia tax" U-turn', *The Guardian*, 22 May 2017, retrieved 22 May 2019. www.theguardian.com/society/2017/may/22/theresa-may-u-turn-on-dementia-tax-cap-social-care-conservative-manifesto

Chapter 4: Economic change is undermining the tax system

- 1 Office for Budget Responsibility, *Fiscal Risks Report: 2017*, July 2017, https://cdn.obr.uk/July_2017_Fiscal_risks.pdf
- 2 HM Treasury, *Managing fiscal risks: government response to the 2017 fiscal risks report*, 17 July 2018, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/725908/managing_fiscal_risks_final_print.pdf
- 3 Office for Budget Responsibility, *Public Finances Databank*, 25 March 2019, retrieved 10 April 2019, www.obr.uk/data/
- 4 Department for Environment, Food and Rural Affairs and Department for Transport, *UK plan for tackling roadside nitrogen dioxide concentrations*, July 2017, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/633269/air-quality-plan-overview.pdf
- 5 House of Commons Business Energy and Industrial Strategy Committee, *Electric Vehicles: driving the transition*, 14th Report of the Session 2017–19, 19 October 2018, <https://publications.parliament.uk/pa/cm201719/cmselect/cmbeis/383/383.pdf>
- 6 SMMT, February- electric vehicle registrations, 7 May 2019, retrieved 10 May 2019, www.smmt.co.uk/2019/03/february-ev-registrations-2
- 7 Office for Budget Responsibility, *Fiscal Sustainability Report 2014*, 10 July 2014, <https://cdn.obr.uk/41298-OBRR-accessible.pdf>
- 8 Tetlow G and Campbell P, 'Dwindling fuel duty sparks interest in road pricing', *Financial Times*, 18 August 2017, retrieved 10 April 2019, www.ft.com/content/9891f282-7ead-11e7-ab01-a13271d1ee9c
- 9 Johnson P, Leicester A and Stoye G, *Fuel for thought: the what, why and how of motoring taxation*, Institute for Fiscal Studies, 15 May 2012, retrieved 10 April 2019, www.ifs.org.uk/publications/6175
- 10 Summers D, 'Road pricing is not a stealth tax, says Blair', *The Guardian*, 21 February 2017, retrieved 10 April 2019, www.theguardian.com/politics/2007/feb/21/immigrationpolicy.transport

-
- 11 HM Treasury, *Tobacco Levy: The response to consultation*, September 2015, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/464795/PU1814_Tobacco_Levy_final_v3.pdf, p199.
 - 12 Office for Budget Responsibility, *Public Finances Databank*, 25 March 2019, retrieved 10 April 2019, www.obr.uk/data
 - 13 Office for Budget Responsibility, *Fiscal Risks Report*, July 2017, cdn.obr.uk/July_2017_Fiscal_risks.pdf, Chart 5.6.
 - 14 OBR, *Fiscal Sustainability Report*, June 2015, obr.uk/docs/dlm_uploads/49753_OBR-Fiscal-Report-Web-Accessible.pdf, Table 4.3
 - 15 Office for Budget Responsibility, *Public Finances Databank*, 25 March 2019, retrieved 10 April 2019, www.obr.uk/data
 - 16 Office for Budget Responsibility, *Fiscal Sustainability Report*, June 2015, obr.uk/docs/dlm_uploads/49753_OBR-Fiscal-Report-Web-Accessible.pdf
 - 17 *Ibid*, Figure 4.4.
 - 18 Adam S, Miller H and Pope T, *Tax, legal form and the gig economy*, Institute for Fiscal Studies, February 2017, retrieved 10 April 2019, www.ifs.org.uk/publications/8872, Figure 7.3.
 - 19 Adam S, Miller H and Pope T, *Tax, legal form and the gig economy*, Institute for Fiscal Studies, February 2017, retrieved 10 April 2019, www.ifs.org.uk/publications/8872
 - 20 Miller H, *Lack Of Employment Rights Doesn't Justify Lower Taxes For The Self-Employed*, June 2018, retrieved 11 April 2019, www.ifs.org.uk/publications/13079
 - 21 Office for Budget Responsibility, *The Effect Of Incorporations On Tax Receipts*, November 2016, retrieved 10 April 2019, <https://obr.uk/box/the-effect-of-incorporations-on-tax-receipts/>. Paragraph 4.49 of Office for Budget Responsibility, *Economics and Fiscal Outlook: March 2017*, retrieved 7 May 2019, <https://obr.uk/efo/economic-fiscal-outlook-march-2017>
 - 22 HM Treasury, *Managing Fiscal Risks: Government response to the 2017 Fiscal risks report*, July 2018, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/725913/Managing_Fiscal_Risks_web.pdf, page 79.
 - 23 OECD, *Tax Challenges Arising from Digitalisation – Interim Report 2018*, March 2018, retrieved 10 April, www.oecd.org/ctp/tax-challenges-arising-from-digitalisation-interim-report-9789264293083-en.htm
 - 24 OECD, *Base Erosion and Profits Shifting*, www.oecd.org/tax/beps
 - 25 OECD, OECD/G20 Inclusive Framework on BEPS: *Progress report July 2018–May 2019*, www.oecd.org/tax/beps/inclusive-framework-on-beps-progress-report-july-2018-may-2019.pdf, page 2.
 - 26 HM Treasury and HM Revenue and Customs, *Digital Services Tax Consultation*, *The Stationary Office*, 8 November 2018, retrieved 10 April 2019, www.gov.uk/government/consultations/digital-services-tax-consultation
 - 27 Gov. UK, *Good Work: The Taylor Review of Modern Working Practices*, July 2017, www.gov.uk/government/uploads/system/uploads/attachment_data/file/627671/good-work-taylor-review-modern-working-practices-rg.pdf

Chapter 5: Conclusion

- 1 Curtice J, 'A return to normality? How the electoral system operated', *Parliamentary Affairs*, Volume 68, Issue supplement 1, 3 September 2015, Pages 25-40.
- 2 Rutter J, Dodwell B, Johnson P, Crozier G, Cullinane J, Lilly A and McCarthy E, *Better Budgets: Making tax policy better*, Institute for Government, 2017, www.instituteforgovernment.org.uk/publications/better-budgets-making-tax-policy-better
- 3 Sasse T and Norris E, *Moving on: The costs of high staff turnover in the civil service*, Institute for Government, January 2019, www.instituteforgovernment.org.uk/publications/moving-on-staff-turnover-civil-service
- 4 Stephens R, 'Radical tax reform in New Zealand', *Fiscal Studies*, 1993, vol. 14, no. 3, pp45-63.

About the authors

Gemma Tetlow

Gemma is Chief Economist at the Institute for Government, working across the Institute's programme areas. She joined the organisation in April 2018 from the *Financial Times*, where she was Economics Correspondent. Previously, Gemma worked as an economist at the Institute for Fiscal Studies.

Gemma has a PhD in economics from University College London, and an MSc and BSc in Economics from the University of Warwick.

Joe Marshall

Joe is a Researcher at the Institute for Government, working on tax and Parliament. He joined the organisation in October 2018 from HM Treasury, where he worked on EU exit legislation as policy lead on the EU (Withdrawal Agreement) Bill and the 'meaningful vote'.

Joe has a MA(Cantab) in Law from the University of Cambridge, and a Bachelor of Civil Law from the University of Oxford.

Acknowledgements

We would like to thank all those we spoke to during the course of our research, with special mention to those who attended our private roundtables in January and May. We are also grateful to Judith Freedman, Helen Miller, Thomas Pope, Heather Self and Sir Edward Troup for their comments on earlier drafts of the report.

Thanks also to colleagues at the Institute for Government, in particular Bronwen Maddox, Hannah White and Jill Rutter for their comments, and Matthew Batchelor, Will Driscoll, Melissa Ittoo, Sam Macrory and Nicole Valentinuzzi for their support with publication.

Any remaining errors are the authors' alone.

The Institute for Government is the leading think tank working to make government more effective.

We provide rigorous research and analysis, topical commentary and public events to explore the key challenges facing government.

We offer a space for discussion and fresh thinking, to help senior politicians and civil servants think differently and bring about change.



 instituteforgovernment.org.uk

 enquiries@instituteforgovernment.org.uk

 +44 (0) 20 7747 0400  +44 (0) 20 7766 0700

 [@instituteforgov](https://twitter.com/instituteforgov)

**Institute for Government, 2 Carlton Gardens
London SW1Y 5AA, United Kingdom**

© Institute for Government 2019

The Institute for Government is a registered charity in England and Wales (No.1123926) with cross-party governance. Our main funder is the Gatsby Charitable Foundation, one of the Sainsbury Family Charitable Trusts.