Resolution Foundation

Fairer by design: efficient tax reform for those on low to middle incomes

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Executive summary

Redistribution through the tax and welfare system is economically costly, affecting incentives to work, save and invest. The current system, though, is inefficient and imposes greater costs than are necessary. In the long run if we want a redistributive system—and especially if there is any desire for a system that is more redistributive—we will need to tackle some of the system's quite fundamental flaws. In this report, which draws on findings from the Mirrlees review and the Commission on Living Standards, we set out some of the reforms which could allow the state to do more to support low to middle income households at a lower economic cost.

A first possible set of reforms would alter elements of the benefit system to increase work incentives. This may make sense for three groups: mothers of school age children, second earners and older workers.

For mothers of school age children, work incentives could be boosted by increasing the generosity of child tax credits for younger children and reducing them for older children. Because mothers of older children are more responsive to work incentives this would lead to higher levels of employment and, over a child's lifetime, leave redistribution the same on average.

For second earners, one could look at the way in which the benefit system, and particularly the proposed Universal Credit system, affects work incentives. Having two earners in work has proven to be an important route for lower income families to increase their incomes. But whilst Universal Credit will in many ways be a welcome improvement to the welfare system, it will leave second earners—mostly women—with limited incentives to move into work. Though it could be costly, there is a case for considering a second earner disregard in the universal credit system, so as to improve work incentives for women in low income families.

For those over 55, responsiveness to work incentives seems to be particularly high. Having a tax and benefit system which will keep modest earners in this age group in work is also likely to be a priority going forward. Reforms which, for example, bring forward the age at which National Insurance Contributions (NICs) cease to be paid—or reduce NICs payment for low earning older workers—but which also delay the age at which pension credit is available, could help achieve to achieve this. There are ways that such reforms could be paid for within the older group.

A second major area of the tax system worthy of consideration is Value Added Tax (VAT). Extensive zero and reduced rating is an expensive and extremely inefficient way of effecting redistribution. It would be possible to make the overall system as redistributive, or more redistributive, on average by ending this zero and reduced rating whilst increasing benefits and reducing other taxes. Such a reform would of course be politically difficult, to say the least. But dispassionate analysis shows clearly that if we do want a tax system which is more efficient and at least as redistributive, we will need to grasp certain nettles.

A third area is Council Tax, which is currently designed deliberately to be regressive as well as being economically inefficient. Council tax payments are based on property values which are more than two decades out of date and bills rise less than proportionally to the value of the property. The result is that typically poorer people living in low value properties pay a higher proportion of their property value than the typically richer inhabitants of more expensive homes. Again, we know well how difficult politicians find it to reform Council Tax, and even to allow property values to be revalued. But again if we are serious about having a tax system which is either fair or efficient this is the sort of issue that needs to be dealt with.

Finally, the report considers whether there are structural changes to the tax system which could both enhance its efficiency and raise money. Obviously raising any additional tax has economic costs. And of course for substantial sums one should look at raising the main taxes – income tax, VAT and NI. But there are also elements of the tax system which function poorly in part precisely *because* they offer generous treatment to some people or forms of income.

One example is capital gains tax which is currently entirely forgiven at death. This creates a perverse incentive for people to hold on to assets until death whilst also costing the exchequer several hundred million pounds a year in lost revenue. A second example is Inheritance Tax which also contains exemptions which both reduce its effectiveness and reduce revenues. Both could be reformed in ways that raise money and increase efficiency.

Most significantly, though, the taxation of pensions is generous in at least two respects. The first is the availability of a tax free lump sum of up to £435,000. Whilst there may be a case for some form of additional incentive to increase pension saving, one could certainly look at reducing the maximum available. More substantively, contributions made by employers are currently extremely highly tax advantaged in that no NI is payable at any point (in contrast, for example, with contributions made by employees). In the long run there may be a case for undoing this generous treatment, perhaps by phasing in some limited payment of NI on private pensions in payment.

Introduction

As the squeeze on living standards continues, discussions inevitably arise as to whether government could do more to support household incomes. For those on lower incomes in particular, that often means turning to the tax and benefit system to do the work of redistribution. Indeed the current system is progressive. It takes proportionately more money from the richest and, through the benefit and tax credit system, redistributes towards those on the lowest incomes. We could decide to make it more redistributive by changing various tax and benefit rates and allowances, for example by increasing benefit rates, tax credits or personal income tax allowances. These are essentially debates about taking money from one group to give to another.

Such arguments about winners and losers are of course important. But decisions about redistribution also carry costs beyond the losses felt by those from whom money is being redistributed. These are the costs to the economy of redistribution through effects on incentives to work, save or invest. Some such costs are unavoidable. But others vary significantly depending on the particular policy decisions we make. The fact is that the while the current tax and benefit system carries out a great deal of redistribution it does not do so as efficiently as it could. We could achieve a similar amount of redistribution at lower economic cost, or more redistribution at a similar cost, by restructuring the system to take account of what we know about efficient structures and what we know about how people respond to taxes.

This paper draws together lessons from these two debates about redistribution and efficiency. Rather than looking simply at how one might adjust tax and benefit rates to effect more redistribution, we look at how the system could be restructured to increase efficiency and thus allow more redistribution to occur without increasing economic costs. Could the system achieve the same amount of redistribution, or more, *and* be more efficient? In the long run, if one were to want to increase redistribution towards low to middle income households, that would likely require a more efficient and effective system. Failure to achieve that would impose unnecessary costs. In the same spirit the paper also looks at possible structural reforms to the tax system which could improve efficiency and raise revenue which could, if desired, be used to support particular groups of households The reforms we look at draw on the recommendations of the Mirrlees Review[1], which examined ways in which the UK tax system could be made more economically efficient, and on the findings of the Commission on Living Standards, which has examined the long-term financial pressures facing low to middle income Britain.

Now is a particularly important moment to consider the efficiency with which the tax system achieves redistribution. On the one hand we have experienced an unprecedented squeeze on living standards.

[1] Mirrlees, J. et al *Tax by Design* (2011) http://www.ifs.org.uk/mirrleesReview/design

Household incomes were rising only very slowly even in the run up to the crisis of 2008, certainly at the median, and real incomes have fallen by around 7 percent since 2010. On the other hand, we are facing a very tight fiscal environment both over the short-term in the pursuit of deficit reduction but also over the longer term as other demographic pressures bite, making any additional spend on redistributive measures extremely difficult and dependent upon tax increases or spending cuts elsewhere.

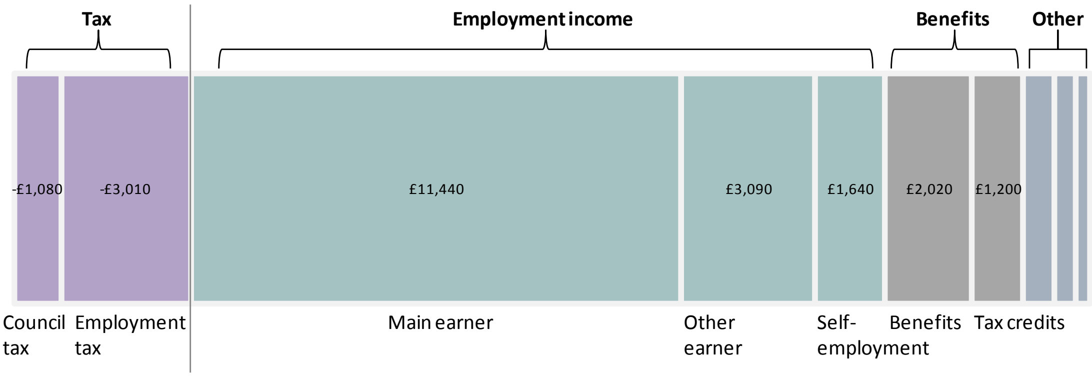
In this context we focus then on three big possible structural reforms to the current system which look desirable from the point of view of the overall efficiency of the system and could, facilitate support for households on low to middle incomes in more efficient ways. The first involves changing elements of the direct tax and benefit system to reflect more closely what we know about labour supply responses. Second we look at reforming the VAT system to create a more uniform rate of VAT, whilst compensating those on lower incomes. The recent Budget of course reminds us of the political difficulties of VAT reform. But it also reminds us of the absurdity of protecting low income households by picking hairs between biscuits and cakes and hot and cold pasties when other mechanisms would be far more efficient. Third, we look at possible reforms to council tax. Council Tax has long been ripe for reform. But for those on low to middle incomes, in general above the cut off for the compensatory mechanism of Council Tax Benefit, the flaws of the current system are particularly egregious.

Our focus in all three discussions is on reforms that could be broadly cost neutral and efficiency-enhancing whilst offering opportunities to create long-term benefits for the low to middle income group. The final section of the paper then relaxes this condition to ask a slightly different question: are there other elements of the tax system which look ripe for reform *and* where reform might raise more money from the better off, providing revenue that could be used to directly support low to middle income households?

Section 1 – The tax-benefit system and low to middle income households

Before discussing the principles behind certain elements of the tax-benefit system, as well as options for reform, we start with a discussion of the impact the tax-benefit system has on low to middle income households.[2] How important is the tax-benefit system to households in this group? And how has this changed over time?

Figure 1: The impact of the tax benefit system on low to middle income households



Notes: Average income from each source, £ per year, 2008

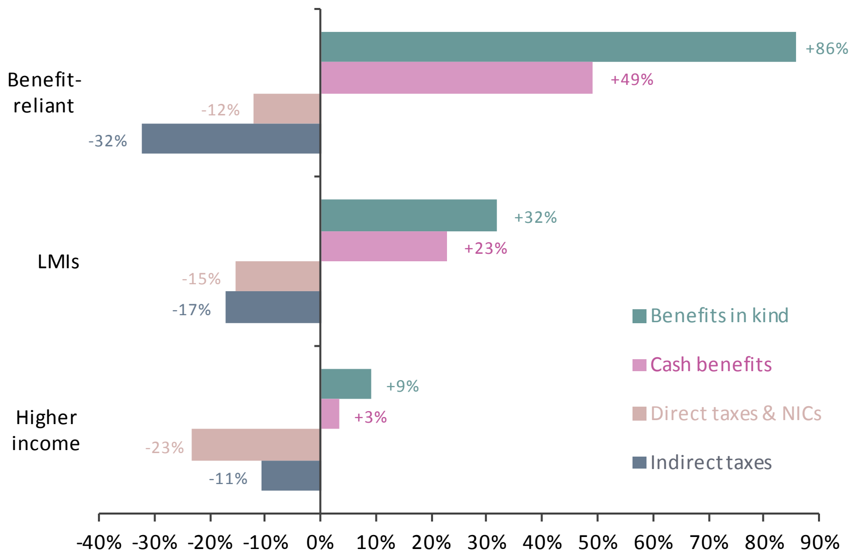
Source: RF analysis from figures provided by Brewer, Mike et. al. Why did Britain's households get richer? *(2011, Institute for Fiscal Studies for Resolution Foundation)*

Looking just at direct taxes and benefits, Figure 1 shows how the income of low to middle income households as a group is made up, indicating that they receive about 15 percent of their gross income (before tax) from benefits and tax credits but lose about 20 percent of their gross income through direct and indirect taxes. One could of course increase their incomes quite directly by increasing these tax credits and benefits or reducing the taxes. Someone, though, would have to pay.

Figure 2 shows the effects of the various elements of the tax and benefit system, and transfers in kind, on three groups – those largely dependent on benefits, those on low to middle incomes and those on higher incomes. The importance of benefits in kind (here meaning public services) and cash transfers to both low to middle income households and benefit dependent households is clear. The importance of the former is especially important to bear in mind. A proportionate increase in tax if used to finance public services which are used equally heavily by rich and poor will be significantly redistributive. The role of direct taxes in introducing progression into the system is also clear.

Figure 2: Household taxes and benefits as a proportion of gross income by income group, UK 2009/10

[2] This paper uses the Resolution Foundation definition of low to middle income households as working-age households in deciles 2 to 5 of the household income distribution, excluding those who receive more than 20 percent of their income from means-tested benefits.



Notes: Tax credits included as cash benefits

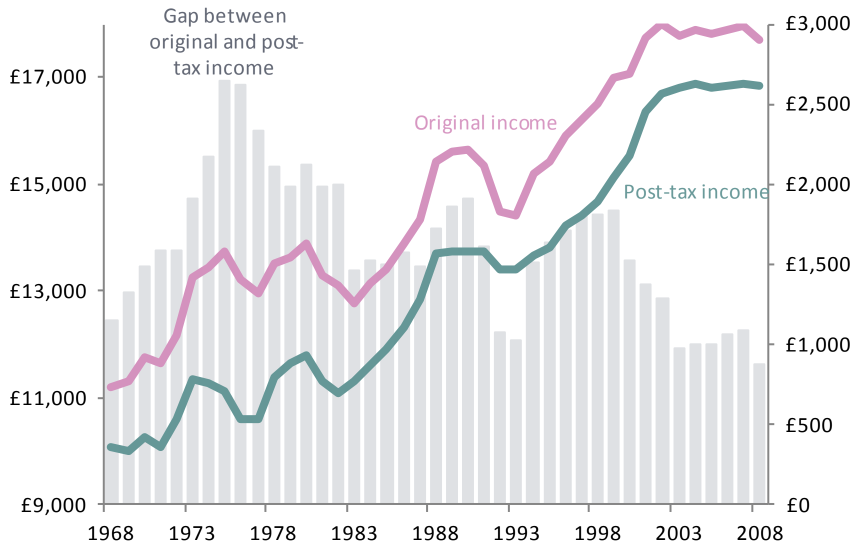
Source: RF analysis of ONS, *The effects of taxes and benefits on household incomes 2009/10*

Figure 3 illustrates how the impact of the tax and benefit system (though not other public spending) on low to middle income households has changed over a long period. The gap between their tax payments and benefit and tax credit receipts has fallen over time, with notable falls in recent years when tax credits became more generous. Indeed the introduction and expansion of tax credits, which saw spending of £20 billion on those in work by 2009-10, has been probably the biggest structural shift in the personal tax and benefit system in recent decades. And it is a shift which has particularly benefited low earners with children. This shift was itself in large part a response to concerns about the extent to which the relative living standards of this group were suffering. In these terms the policy was successful. Over the first decade of this century incomes of those in the lower to middle part of the income distribution did increase somewhat faster than incomes in the upper middle segment. This pattern is essentially explained by the growth in tax credits. Even this level of spending though was not enough for the living standards of these groups to keep up with those of the very richest few percentiles.

This pattern is illustrated in Figure 4 which shows how, in the period from 1996/97 to 2009/10, incomes increased rather more quickly in the third and fourth deciles of the overall income distribution than they did in the eighth and ninth deciles.

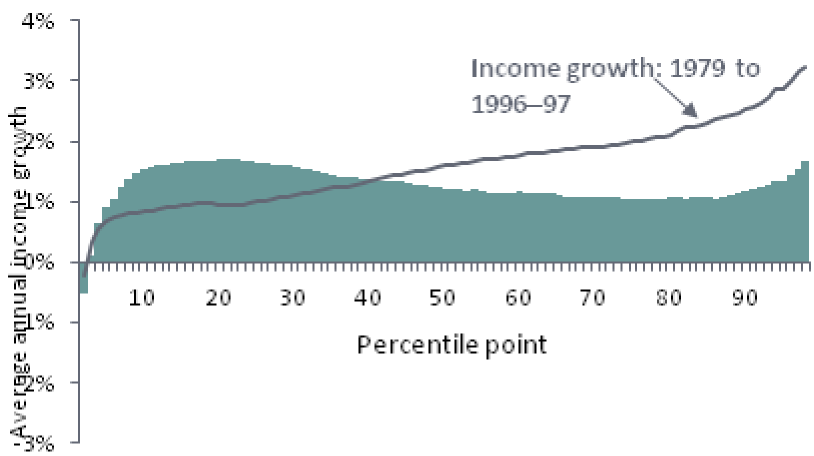
Figure 3: The impact of the tax-benefit system on low to middle income households

£ per year, original income and post-tax income (LHS) and net impact (RHS)



Source: Resolution Foundation analysis from figures provided by Brewer, Mike et. al. Why did Britain's households get richer? *(2011, Institute for Fiscal Studies for Resolution Foundation)*

Figure 4: Real household income growth across the distribution, 1996–97 to 2010–11 (GB)



Notes: The changes in income at the 1st and 99th percentiles are not shown on this graph. Incomes have been measured before housing costs have been deducted. The differently-shaded bars refer to decile groups.

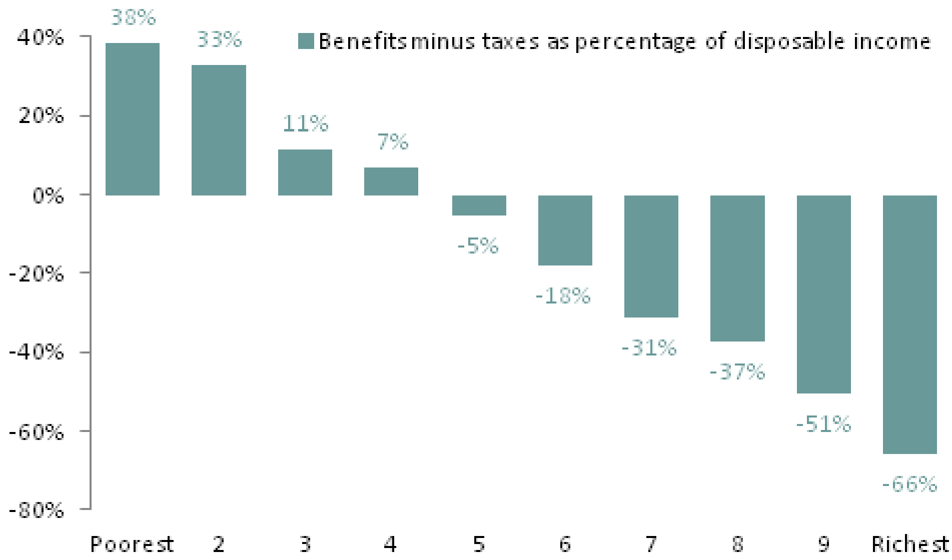
Source: Cribb, J., R. Joyce and D. Phillips based on (2012) *Living standards, poverty and inequality in the UK 2012* *http://www.ifs.org.uk/comms/comm124.pdf* based on Family Expenditure Survey and Family Resources Survey, various years

More recently, however, in the face of the need for significant fiscal tightening, the government has been reducing the generosity of benefits and tax credits. Given the overall scale of the consolidation some such cuts were always likely; and spending on benefits and tax credits has not been disproportionately hard hit relative to spending on public services. That said the burden has fallen very much on those of working age and some low to middle income households particularly families with children have seen significant cuts due to the reduced reach of tax credits –. To put this in perspective though it is important to recognise that the in work credit system remains substantial, and much more extensive and more generous than the old Family Credit system which tax credits replaced at the end of the 1990s. It is important to recognise also that one reason given for focussing on these sorts of cuts was the sense that the tax credit system had come to reach a long way up the income distribution along with concerns about the possible long term effects that dependence on tax credits might create.

The role of the tax and benefit system

We now consider more directly the different components of the tax and benefit systems. A broader sense of the role of the tax and benefit system in effecting redistribution is illustrated in Figure 5. It shows how the system as a whole redistributes significantly from high income to low income households. Benefits net of taxes (including indirect taxes) make up nearly 40 percent of the disposable incomes of households in the bottom tenth of the income distribution. It is only in the fifth decile that tax payments begin to outweigh benefit receipt on average. What the richest tenth of households pay in taxes, net of benefits, amounts to more than 60 percent of their disposable incomes.

Figure 5: Distributional impact of the UK tax and benefit system in April 2012



Notes: Income decile groups are derived by dividing households into ten equal-sized groups based on their disposable income adjusted for family size using the McClements equivalence scale. Assumes full take-up of means-tested benefits and tax credits. Excludes most 'business taxes' (notably corporation tax and business rates, though not employer National Insurance contributions) and capital taxes (notably inheritance tax, stamp duties, and capital gains tax).

Source: Author's calculations using the IFS tax and benefit microsimulation model, TAXBEN[3].

This overall pattern is of course not surprising. Benefits are largely designed to be paid to those with low incomes from other sources. The income tax system at least is significantly progressive: getting on for a third of households pay none while the average rate paid rises with income above the personal allowance. It is worth stressing two things though. First these figures take no account either of parts of the tax system like corporation tax and business rates which are very hard to attribute to individual households, nor to other forms of public spending such as health and education which broadly do favour lower income households. This paper does not tackle these important issues. Second, the chart and this discussion are based on a snapshot of incomes – what the tax and benefit system does to household incomes as they are today. It does not take account of redistribution that may go on across people's lifecycles – those receiving benefits today may have been paying significant amounts of tax in the past, and vice versa. This is an important issue for thinking about how taxes and benefits redistribute to people at with different levels of lifetime income, and is the subject of some discussion below.

Figure 6 breaks out the elements that make up the pattern seen in Figure 5, showing how important benefits are at the bottom of the income distribution and how direct taxes – income tax, NICs and council tax – rise

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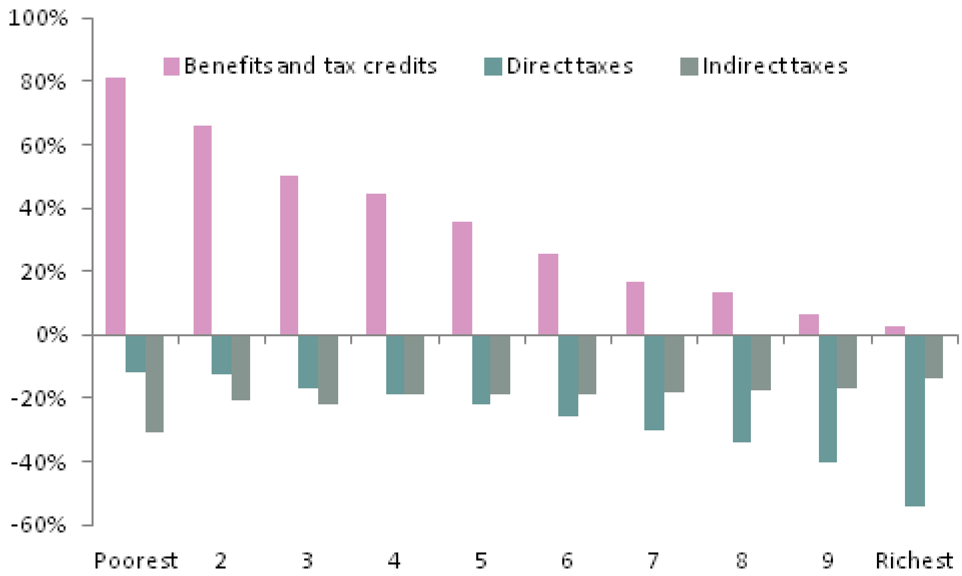
[3] Thanks to Stuart Adam for producing these figures

with incomes. Indirect taxes (VAT and excise duties) on the other hand are regressive on this measure[4]. This reflects the fact that low income households spend a lot relative to their income at any point in time, and the pattern exists despite zero rating of food, for example, which makes up a larger part of the budget share of poorer households than richer ones. Over a lifetime most households will spend their incomes (inheritances apart) so it is likely that the lifetime effects of indirect taxes will be rather different from the pattern seen here.

Figure 6: Distributional impact of different components of the UK tax and benefit system in April 2012



Notes: Income decile groups are derived by dividing households into ten equal-sized groups based on their disposable income adjusted for family size using the McClements equivalence scale. Assumes full take-up of means-tested benefits and tax credits. Excludes most 'business taxes' (notably corporation tax and business rates, though not employer National Insurance contributions) and capital taxes (notably inheritance tax, stamp duties, and capital gains tax). 'Direct taxes' includes income tax, employer and employee NICs, and council tax. 'Indirect taxes' are VAT and excise duties.

Source: Author's calculations using the IFS tax and benefit microsimulation model, TAXBEN[5].

What one sees quite clearly from this chart is that redistribution occurs through the progressivity inherent in our direct tax and benefit systems. That is not only how it is, but how it should be. Direct taxes and benefits are designed to achieve redistribution directly. Trying to achieve redistribution through other means – the structure of indirect taxes and capital taxes – has the potential to lead to unnecessary and costly inefficiencies. And this is a crucial insight when it comes to thinking about how the tax and benefit system should redistribute. It needs to be seen as a system and it is the amount of redistribution the system as a

[4] Though note that measured against current spending or lifetime income VAT will not appear regressive.
[5] Thanks to Stuart Adam for producing these figures

whole does that is important. Not every element of it needs to redistribute (any more than every element needs to promote lower carbon emissions). Tobacco taxation is highly regressive because smoking is more common among those on lower incomes. That is not in itself a reason for lowering or getting rid of duties on tobacco. As we will discuss in more detail later, viewing the system as a whole in this way has particularly important implications for the way we think about direct and indirect taxes.

Section 2 – Efficient reform to support living standards

As we have seen, then, the current direct tax and benefit system redistributes from higher income households to those on low to middle incomes and below. But it also creates substantial complexities and disincentives. Some disincentives are just inevitable but others depend heavily on the means by which we achieve redistribution. Of these inefficiencies, we focus on three that are particularly relevant to households in the low to middle portions of the income distribution. The first, the way that work incentives play out across the life-course, has long been identified as a key area for reform, but has been given renewed urgency by the rise of tax credits. While significantly lifting the incomes of large number of low to middle income households, the tax credit system has also brought more households into higher withdrawal rates, a trend that has had particularly important effects on some groups, most notably women with older children.[6]

The second area we look at is VAT. We currently attempt to inject progressivity into the system by charging no, or lower, VAT on certain 'essential' goods like food and fuel. As the recent budget has reminded us, these rules are as politically sensitive as they are complex. But the fact remains that they are an inefficient way of protecting lower income households. We look at how reforms towards a flatter structure of VAT, with compensation for lower income households, might work. Third, we consider Council Tax (CT), the regressive impact of which is particularly troublesome for households whose incomes are too high to qualify for compensatory Council Tax Benefit but low enough to make CT a significant portion of income. Reform of CT, or at least revaluation of properties to update the tax base, have long been the holy grail of CT reformers but the poison chalice of politicians. We look at whether there are incremental steps in this direction that might meet the needs of both.

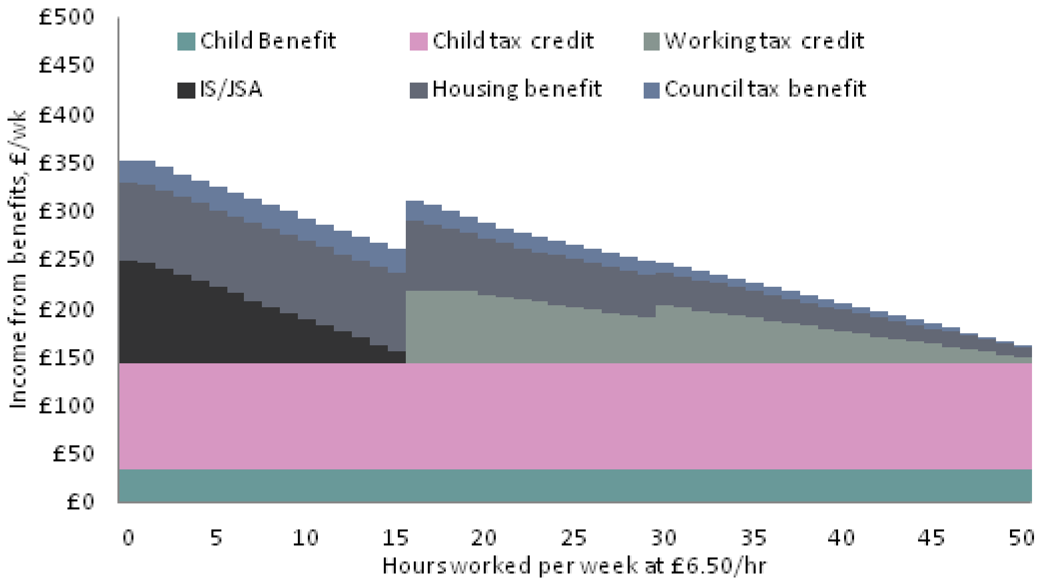
Work incentives across the life course

If we are going to pay benefits to people when they are out of work and take them back as they move into work and increase their earnings some disincentives on work are inevitable. In discussing the design of social security systems one is often simply talking about how to make trade-offs over where the disincentives occur. One can have benefits which are withdrawn quickly as incomes rise thereby creating very significant marginal tax rates and work disincentives for the affected population, or where benefits are withdrawn more gradually thereby ameliorating effects for this part of the population but drawing many more people into the taper area and therefore many more facing these more subdued, but nevertheless substantial, disincentive effects.

[6] See Paul Gregg, Matthew Whittaker and Alex Hurrell (2012) Creditworthy: Assessing the impact of tax credits in the last decade and considering what this means for Universal Credit, Resolution Foundation

The particular effects and complexities of the current system can be illustrated in a host of different ways but perhaps most strikingly in Figure 7 which shows for a particular family type how their benefit income changes as their income increases. Both the number of different benefits and the speed with which they are withdrawn create inefficiencies and make redistribution economically costly. For many households on low to middle incomes high withdrawal rates are a fact of life. Around 15 percent of workers, that's 3.5 million individuals, face effective marginal tax rates above 75 percent so that earning a little more buys them less than a quarter of what it costs their employer.[7]

Figure 7: Current system of welfare entitlements for an example family



Notes: The entitlements are based on an assumed couple with two children. Only one person in the couple is in work, and they can choose how many hours to work at a given wage rate, £6.50 per hour. The family has no disabled members and no unearned income. Their Local Housing Allowance (LHA) or eligible rent is £80/wk, and their council tax liability is £24 a week.

Source: Institute for Fiscal Studies

It is the complexity created by the sheer number of benefits which the government's proposed introduction of Universal Credit (UC) is designed to overcome. By integrating the benefits it should achieve an overall system which involves fewer families facing withdrawal rates of more than 80 percent and, perhaps more importantly, reduces the number of different processes and systems people have to go through in order to access benefits. It will also reduce *participation tax rates* - the cost in lost benefits and increased taxes of moving into work – for people looking to work relatively small numbers of hours.[8] One trade-off made as part of these simplifications is that UC will increase the basic withdrawal rate faced by households currently only in receipt of tax credits from 73 to 76 percent. This is potentially a good example of a change to the

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[7] Mirrlees p.84

[8] See Brewer, Browne and Jin (2012) "Univeral Credit: a preliminary analysis of its impact on incomes and work incentives" *Fiscal Studies* vol. 33, no. 1, pp. 39-71.

structure of benefits which should result in improvements in labour force participation rates and benefit take up rates without substantially increasing the overall generosity of the system. But the trade-offs remain. Withdrawal rates for some will increase. The move to UC will also remove the current system's approach of providing a very salient point at 16 or 24 hours of work per week at which in-work incomes are, for most, clearly higher than incomes out of work.

In addition to simplifying the system, there is another way of ensuring the efficiency of the system of redistribution, and that is by varying tax and benefit rates in line with what we know about how people respond to them. In brief we would generally be more worried about creating high marginal rates where we know that people are more likely to respond to them by reducing their labour supply. Put simply, some groups are unlikely to work even with much bigger incentives while others are relatively cheap to entice into work. The system can be designed with this information in mind yet there are elements of the current system which do not reflect this knowledge. In particular we know that two demographic groups are highly sensitive to the tax and benefit system in making work choices – mothers with school age children and people around retirement age, say between 55 and 70. We should be particularly concerned about the work incentives that face these groups. Conversely there are other groups, men between 30 and 50 for example, that appear to be extremely unresponsive, changing their behaviour less in response to changes in the design of the tax and benefit system.

Getting the system right for mothers matters and has become increasingly important as the tax credit system has expanded. Women's work has played a central role in boosting low to middle income household income: from 1968 to 2008, 27 percent of household income growth in low to middle income households came from women's work.[9] But female employment growth has stalled in recent years and the UK now ranks 15th in the OECD for female employment rates and looks to have particularly low rates of employment for women in the 35-39 year old age group, the group most likely to have children.[10]

In this context one concern with the Universal Credit proposals is that they will, as they stand, create greater disincentives for second earners to move into work than is the case under the current system.[11] One way of reducing this disincentive for second earners to move into work would be to introduce a second earner disregard. This would have the benefit of making it much more worthwhile for second earners, usually women, to work at all.

The cost of a second earner disregard would depend on its level. In response to questioning in 2011, the Minister of State for the Department for Work and Pensions has put the cost of a small disregard of £500 at

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[9] Brewer and Wren-Lewis, Why did Britain's households get richer? Decomposing UK household income growth between 1968 and 2008-09 (IFS analysis for the Resolution Foundation), 2011.
[10] Plunkett, J, Missiong Million, Resolution Foundation, 2011
[11] See Brewer, Browne and Jin (2012) for detailed analysis.

£130 million.[12] If it rose to £1,000, the same figures report a cost of £280 million, while a disregard of £1500 is estimated to cost £430 million, and to £2,500 around £780 million.

Introducing a second earner disregard would also increase the earnings required to escape the means tested system altogether – the usual trade-off. However, given how important incentives to move into work in the first place seem to be, and given how important second earners are to living standards, this may be a trade-off worth exploring.

An important observation made in the Mirrlees review is that mothers' decisions over whether and how much to work are more responsive to incentives once their youngest child reaches school age than when they have a child under five.[13] Because the tax and benefit system should provide stronger work incentives for people who are more responsive to them, we can afford to redistribute more from rich to poor among less responsive groups, where the damage that redistribution does to work incentives is less than for more responsive groups. As one might expect, financial incentives play a more limited role in the work decisions of mothers with very young children.

So one could tilt the system to reflect the differential responsiveness of parents with children of different ages by making Child Tax Credit more generous (and so means-testing more extensive) for families with any children under the age of 5, and less generous (with less means-testing) for families whose youngest child is aged 5 or older. The Mirrlees Review illustrates one such reform, raising the child element of CTC to £3,100 when the youngest child in a family is under five and reducing it to half that, £1,550, where the youngest child is five or over. It estimates that this would increase overall employment by about 50,000 and total earnings by around £0.8 billion. In total the amount of benefits going to families with children would stay the same and their earnings would rise. Of course there would be some redistribution from the group with older children to the group with younger children, though even this would largely be a redistribution across the lifecycle with gains when children are young offset by receiving less as they get older. This reform could be phased in slowly so that families would not lose out significantly overnight and would have to be done in the knowledge that it would make some low income families with children worse off in the short term. Cost neutral reforms always leave someone worse off.

A third set of reforms to increase work incentives in the tax-benefit system could focus on those in the 55 to 70 age bracket. The evidence that this group is particularly sensitive to financial incentives is very powerful[14]. And the growing need for people to stay in work longer in order to be able to afford a reasonable standard

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[12] Timms, S. Public Bill Committee Welfare Reform Bill debate, *28 April 2011*, Hansard, Column No.543, in debate with Chris Grayling, Minister of State for the Department for Work and Pension

[13] Blundell and Shephard (2011) find that the elasticity of employment for single mothers in the UK is 0.85 when their youngest child is aged 5 or older, compared with around 0.5 for those with younger children

[14] Gruber and Wise, 1999 and 2004

of living in retirement means that work incentives for this group are likely to be important over the long term. More than a quarter of low to middle income households are headed by someone over the age of 55 and workers in this age group provide a growing share of employment income in low to middle income households.[15] For those on low earnings, maintaining employment into later years can make a substantial difference to subsequent income in retirement.

Again the Mirrlees Review identifies a reform which would increase work incentives for this group. The specific illustrative reform considered would end employee and self employed NICs at 55 rather than at state pension age, would apply the higher personal allowance from age 55 rather than 65 and raise the age requirement for receiving Pension Credit to 70. The authors note that the net cost of these changes could be offset by some modest increases in NICs and cuts in the value of the personal allowance for those under 55. They estimate that the effect of a set of changes like this would be to raise overall employment levels by about 150,000. Obviously there would be immediate winners and losers from a set of changes like this, including some older people currently receiving pension credit and those in the younger groups affected by the tax and NI changes. It is also important to note that, since publication of this analysis, the current government has pledged to phase out the higher personal allowance for those over 65 and is also pledged to increase rather than cut the working-age personal allowance.

Instead of simply bringing forwards the point at which NICs payments end, it might be possible to focus the incentive on low earning older people by raising the point at which National Insurance begins to be paid and increasing the rate of NI. This would as ever have offsetting effects and may not be as effective in raising participation overall but could be particularly helpful to those with low earning potential. This would also avoid hitting younger workers. In this world, in which those aged 55-65 continue to pay NICs, it is worth noting debates about the relationship between National Insurance and the State Pension Age. As noted above, NICs payments currently end at State Pension Age and it has been suggested that this cut-off could be abolished, extending the NICs payments to those working past the SPA.[16] Certainly as it becomes more common to work past the State Pension Age, the cost of this cut-off point in terms of foregone revenue will grow. Abolishing this cut-off is already a difficult choice. On the one hand, applying NICs after the SPA would indeed end a somewhat arbitrary cliff-edge in the NICs system which currently means that workers enjoy a big increase in their post-tax income once they reach state pension age. On the other hand, an increase in employment tax of this kind runs counter to the evidence on incentive effects presented above. One possibility would be to combine lowering NICs rates from age 55 with an abolition of this cut-off point for those over the SPA.

[15] Cory, G (forthcoming), Unfinished business: barriers and opportunities for older workers, Resolution Foundation
16 Policy Bites, The Free Enterprise Group, June 2012

What these sorts of policy ideas illustrate is that there is some scope to escape, at least to a small extent, from the inevitable constraints on redistribution created by behavioural responses to the incentives created by redistributive policies. By, hopefully, simplifying and unifying the delivery of benefits the Universal Credit should improve the efficiency with which redistribution is effected. It should also increase incentives for those looking to work small numbers of hours. By taking account of what we know about the differential responses that people have to work incentives reforms of this type, affecting mothers of older children and those around retirement age, we could allow as much redistribution as we achieve now – at least when considered over the life cycle – at lower economic cost. Policies of this sort need thinking about *if* any further redistribution towards the low to middle income group is desired.

Moving towards a more uniform VAT system

As we saw in Figure 6 indirect taxes as a whole appear regressive when looking at a snapshot and when ranking people by their income rather than their expenditure. People with lower levels of income pay a higher proportion of that income in indirect taxes than do those with higher incomes. This is true despite the fact that there is extensive zero rating within the UK VAT system such that there is no VAT on food and a reduced rate of just 5 percent on domestic fuel both of which make up a significantly higher proportion of the spending of the poor than they do of the rich. A moment's reflection, though, will serve to show that such a system cannot actually be regressive. Compare people's VAT payments with either their current spending or their lifetime income and the system looks progressive.

It is well known that the existence of extensive zero rating creates considerable complexity – the legal dispute over whether a Jaffa Cake is a cake or a biscuit (the former being zero rated the latter being subject to VAT) being just the best known of the manifestations of this complexity. Similar issues have been raised in the 2012 budget by the, later rescinded, decision to impose VAT on certain types of hot take away food and the dispute over what counts as hot, and indeed what counts as bread, which has ensued. Box 1 illustrates just a tiny number of the fine lines that are already drawn in the current system.

Box 1: Oddities of the current VAT regime

The Chancellor's recent difficulties over the 'pasty tax' remind us of the political dangers of VAT reform. It was said of the original decision to impose VAT on hot pasties (but not on pasties that had cooled to room temperature) that it would have absurd implications, create new complexities and be hard to police. Yet the current system already contains many such absurdities, forcing HMRC enforcement officials and guidelines to distinguish between very similar products. In many such cases it is far from clear why we might want to protect the consumption of one type of product from VAT while charging VAT on another.

Products currently facing 20% VAT	**Products facing 0% VAT**
Cereal, muesli and similar sweet-tasting bars	Flapjacks
Potato crisps	Other roasted vegetable chips, tortilla chips
Marshmallow snowballs with no biscuit base	Marshmallow teacakes with a biscuit base
Chocolate bars that are 'eaten with fingers'	Chocolate body paint
Sweet tasting dried fruit for snacking	Sweet tasting dried fruit for home baking
Chocolate buttons not for use in baking	Chocolate mini-buttons for use in baking
Frozen yoghurt and ice cream	Baked Alaska
Gingerbread men decorated with chocolate	Gingerbread men on which the chocolate amounts to no more than two dots for eyes

Source: HMRC VAT guidance, http://bit.ly/M7pW2X

This differentiation also creates inefficiency and loss of welfare as people make their consumption choices on the basis of relative tax rates rather than to reflect their underlying preferences. But the same Budget also reminded us of the political difficulties associated with reforming the current VAT regime – difficulties which eventually scuppered the attempt in 1993 to impose VAT at the full rate on domestic energy. If we put political difficulties to one side for a moment, what can we say about the design of the present system?

In isolation any reform to end or limit the zero and reduced rating of things like food and energy would of course hit those on lower incomes relatively hard. But getting rid of zero rating would also raise a great deal of money – up to £40 billion annually if you include the costs of all zero rated and reduced rated goods and services recorded by HMRC.[17] Numerous studies have shown for zero and reduced rated goods in general, or for specific subsets like food and domestic fuel, it is possible to impose the full rate of VAT and then

[17] http://www.hmrc.gov.uk/stats/tax_expenditures/table1-5.pdf

redistribute such that lower income households are better off on average than they were before the change.[18]

One problem with this approach is always that some households will lose. Because of the diversity of consumption patterns some with particularly high consumption of food or fuel are almost bound to lose whatever the design of the compensation scheme. It was this fact which stymied the proposed increase in the rate of VAT on domestic fuel in 1993 and which has prevented further reform.

While these are real issues there is here a risk of the tail wagging the dog. By protecting a minority of households with atypical consumption patterns we may be preventing a policy which could both increase efficiency and be broadly redistributive. It is hard to imagine moving from a world in which VAT was charged on everything back to the current status quo because it would be very obvious that the biggest cash giveaway from such a change would be to those with the highest levels of spending.

There is, however, a more serious concern with policies of this sort which is that whilst fixing one problem – the inefficient nature of VAT – they create another by directly increasing the incomes of the poor while not protecting incomes higher up, thereby reducing work incentives.

Figures 8 and 9 set out the consequences of one possible revenue neutral reform which maintains work incentives and broadly protects those on lower incomes. The reform involves imposing VAT at the full rate on most consumption whilst increasing a range of benefits and reducing a range of taxes so as to keep work incentives unaffected. The interest here is less in the details of the proposed reform but rather in the issues it raises in terms of understanding its distributional effect.

Consider first Figure 8 in which the population is ranked by income and placed into deciles in the normal way. At first glance this does not look like a promising reform. The poorest two deciles are losing in cash terms (shown by the solid line) whilst the richest deciles are gaining. But then look at the bars. For the poorest group the percentage rise in income as a result of benefit increases and direct tax cuts is greater than the percentage rise in spending as a result of the VAT increase. Thinking of the VAT increase as having the same effect as inflation, this means that incomes have risen faster than prices for this group. How can this square with their observed cash losses? It arises because this group has expenditure greater than its income. Of course this can't persist over a life time. At the top end there are cash gains despite income and spending rising by similar proportional amounts because income for this group is greater than spending. All of this information seems relevant in determining the effect of the policy.

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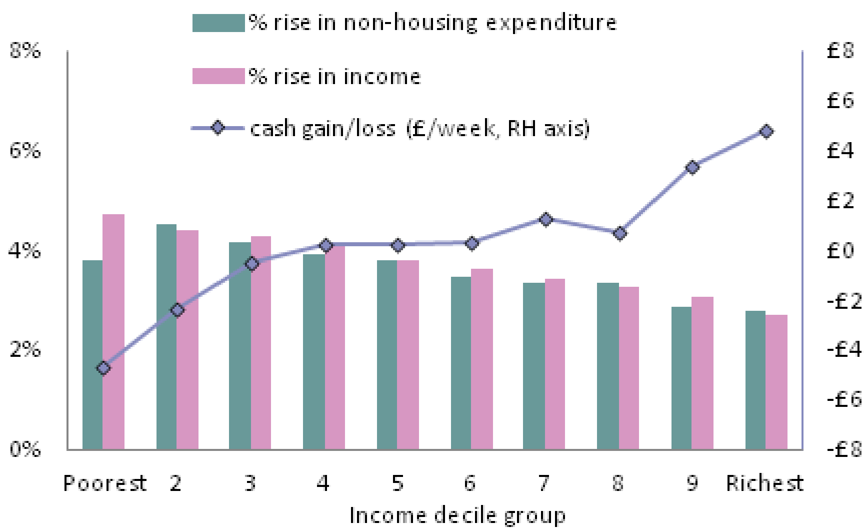
[18] See for example Crawford, I., M. Keen and S. Smith "Value added tax and excises" in Mirrlees, J. et al. *Dimensions of tax design* http://www.ifs.org.uk/mirrleesreview/dimensions/ch4.pdf *year*

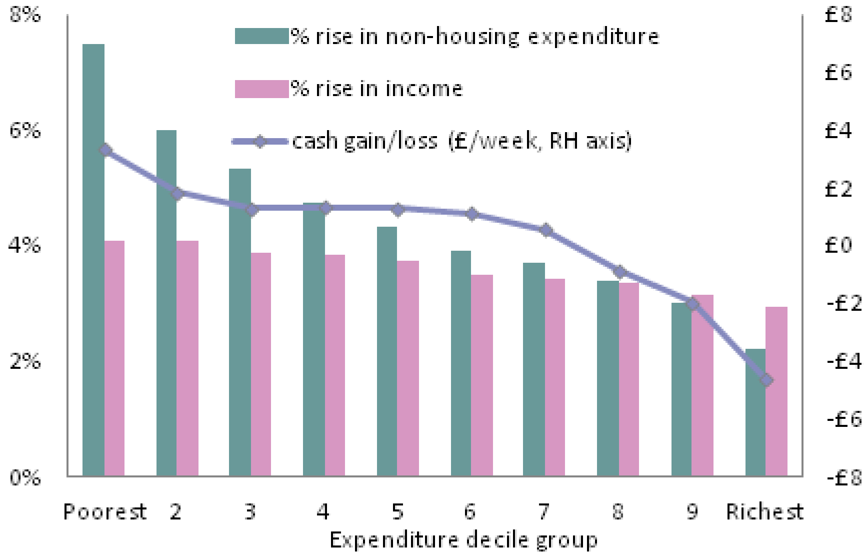
Figure 8: Effect of VAT reform by income decile



Source: Mirrlees et al. (p. 222)

Look now at Figure 10. This is the same as Figure 9 except this time the population is ordered according to spending levels – they are expenditure deciles across the bottom axis. We often think of spending as a better indication of long term welfare than is income. Think of students. Their incomes tend to be much lower than their expenditures because they, rightly, anticipate having higher incomes later on. They are not lifetime poor on the whole. In Figure 10 the poorest group, as defined by their spending, are making cash gains, whilst the highest spending group is making cash losses. The reform looks a great deal more progressive on this basis.

Figure 9: Effect of VAT reform by expenditure decile



Source: Mirrlees et al. (p. 223)

Of course, any transition overnight to a flatter VAT regime would be politically challenging (to put it at its mildest) though cuts in direct taxes as part of the compensation package might help. A more gradual transition to a flatter rate, either through intermediate rates or by transitioning categories gradually might also make change more palatable.

Most straightforwardly, instead of moving from zero rating to a 20 percent rate, one could extend the 5 percent rate to some or all of those goods currently zero rated. Any further increases, and concomitant changes to the direct tax and benefit system, could be phased in over a relatively long period. We do have examples in the UK tax system where apparently unpalatable changes have been made over long periods. The phasing out of tax relief for mortgage interest payments and the phasing out of the married couples' allowance are particularly good examples. These now unlamented elements of the tax system once looked untouchable.

An alternative strategy would extend coverage a pasty at a time, gradually bringing very specific categories of zero rated goods within the VAT net. Though this idea will strike fear into the heart of politicians, there may be ways to make specific changes more saleable by using specific policies to alleviate effects in particular areas. For example Paul Ekins has advocated a major additional investment in improving household energy efficiency to go alongside a rise in the rate of VAT on domestic energy.[19]

The nature of the compensation will also matter. Simply increasing out of work benefits would do the most for immediate redistribution but it would have undesirable effects on work incentives. Such a policy would also not really help low to middle income households. Both these problems can be addressed by raising tax allowances and reducing the basic rate of tax as part of a compensation package which would see rather salient increases in (at least nominal) disposable incomes for many households. These are indeed key elements of the reforms illustrated in Figures 9 and 10 above.

The main point of this discussion is to elucidate the point that what looks progressive, indeed what looks helpful to low to middle income households, may depend upon the extent to which one considers lifetime as opposed to short term income and exactly how one measures the effects of a policy. More generally there is clearly scope to impose VAT on a range of goods on which it is not currently charged and to (more than) compensate poorer and/or LMI households on average. There is no escaping the fact that some would lose from any such change. But that is more a reflection of the oddities of the current system in the way it favours people who happen to prefer to spend a great deal on food, heating or books relative to others with a similar income. Overall the tax and benefit system could be made more efficient and more redistributive by moving in this direction.

Dresner S and Ekins P (2006) 'Economic instruments to improve UK home energy efficiency without negative social impacts', *Fiscal Studies* 27 (1) 47-74

The taxation of housing

Council Tax is the main tax on housing in the UK and while it is nothing like so big a tax as either income tax or VAT it still raises in excess of £26 billion a year with average annual payments being about £1,200 in 2011-12. Stamp Duty Land Tax on residential property transactions raised another £4 billion or so in 2010-11[20].

Council tax is particularly interesting when looking at the effect of the tax system on low to middle income households because it is one of the few elements of the system which is deliberately regressive relative to its base. That is, council tax rises less than proportionately with the value of the property. This is illustrated in Table 1. Properties in band H were (in 1991) at least eight times as valuable as those in band A, but the tax levied on them was only three times as much. Today this ratio of house values would likely be significantly higher. As is also indicated by the table some two thirds of properties are in the three lowest bands, A, B and C.

Table 1: Council tax bands and tax rates[21]

Band	Value of dwelling (estimated at April 1991)	Proportion of the tax due for a Band D dwelling	% of total dwellings in England as at 13 September 2010
A	£40,000 and under	6 / 9	25
B	£40,001 - £52,000	7 / 9	20
C	£52,001 - £68,000	8 / 9	22
D	£68,001 - £88,000	9 / 9	15
E	£88,001 - £120,000	11 / 9	9
F	£120,001 - £160,000	13 / 9	5
G	£160,001 - £320,000	15 / 9	4
H	Over £320,000	18 / 9	1

This structure looks particularly odd if council tax is seen as a tax on the consumption value of housing. After all there is no VAT on new build housing so it is perhaps appropriate to think of Council Tax as standing in place of a VAT. We wouldn't charge a lower rate of VAT on a Ferrari than on a Nissan. It is not much more evident why we should charge a lower rate of council tax on a £2 million mansion than on a £50,000 flat.

Of course there is not a direct correspondence between property value and income but those in more expensive properties are in general more likely to have relatively high incomes. Analysis at IFS for the Mirrlees Review is contained in table 2. Of nearly three million working age households in the top four bands well over two million are in the top half of the income distribution. The vast majority of those in the bottom half of the income distribution, including low to middle income households, occupy properties in bands A to

[20] http://www.hmrc.gov.uk/stats/stamp_duty/table15-2.pdf
[21] Source: http://www.communities.gov.uk/publications/corporate/statistics/counciltax201112

D. Of course it is also the case that even those with low incomes in high council tax bands do have high levels of housing consumption and, if they are owner occupiers, high levels of wealth.

An obvious policy possibility would be to reform council tax so as to make payments proportional to (current) property value, and uncapped. That would broadly speaking make those in bands A to C a little better off whilst imposing significant costs on those in higher bands. On average this would benefit low to middle income households – with rather little effect on the poorest households because they would be entitled to Council Tax Benefit. These effects are illustrated in table 3, which shows clearly that the biggest gainers from such a reform would be working age households in the second and third quintiles – the majority of whom will be in the low to middle income group. But as with the modelled VAT changes there would also be some significant losers with 4 percent of those in the second quintile and 8 percent of those in the third quintile of working age households losing £5 a week or more (because they occupy expensive properties).

Table 2: Characteristics of households in England by council tax band 2009-10[22]

	Bands A–D	Band E	Band F	Band G	Band H
Number of all-pensioner households *Of which:*	4,195,000	499,000	315,000	215,000	33,000
In bottom half of overall income distribution	2,967,000	284,000	152,000	68,000	[a]
In bottom fifth of overall income distribution	1,163,000	134,000	80,000	40,000	[a]
Number of working-age households *Of which:*	13,200,000	1,514,000	811,000	558,000	82,000
In bottom half of overall income distribution	6,459,000	400,000	228,000	95,000	[a]
In bottom fifth of overall income distribution	2,553,000	148,000	97,000	46,000	[a]

a. Sample size too small to yield reliable estimate.

Note: Official figures for the total number of households in each band (shown in Table 16.1) differ slightly from those shown here, but they do not allow disaggregation by income or demographic group.

[22] Source: Mirrlees p. 390

Table 3: Average gains/losses and numbers gaining/losing from modelled change to council tax[23]

	Average weekly gain/loss	% gaining > £5 per week	% losing > £5 per week
All-pensioner households *Of which:*	–£1.41	9%	13%
Lowest income quintile	–£0.35	4%	5%
2nd income quintile	+£0.63	9%	3%
3rd income quintile	+£0.31	11%	6%
4th income quintile	–£0.52	11%	12%
Highest income quintile	–£7.10	9%	38%
Working-age households *Of which:*	+£0.49	25%	12%
Lowest income quintile	+£0.88	14%	4%
2nd income quintile	+£2.72	34%	4%
3rd income quintile	+£2.45	36%	8%
4th income quintile	+£0.88	28%	13%
Highest income quintile	–£4.47	14%	28%

Note: Income quintile groups are derived by dividing all all-pensioner households in England, or all working-age households in England, into five equal-sized groups according to net income adjusted for household size using the McClements equivalence scale.

Again any overnight change to CT in this way would clearly be politically difficult.The problems faced by those with low incomes living in high value properties would be very real. These can be overcome for many by, for example, rolling up any additional tax due (with interest) until either death or until sale of the property. The former option might for example be made available to those over state pension age living in properties in band F and above. More generally interim steps are available. One could carry out a revaluation exercise alongside the introduction of a couple of new bands at the top, for example. Wales

[23] Source: Mirrlees p. 389. Modelled reforms use existing price relativities, don't get rid of the band structure and do abolish the single person discount.

conduced such a revaluation in 2005 and has already introduced a new higher band. One could then gradually adjust band relativities over a period of years. In each case, a revenue neutral approach would make it possible to offer real terms cuts in CT to households in lower bands. Each step towards the desired outcome can look a lot easier than taking one giant leap into the unknown.

There is a general need to review the taxation of housing. The increasing reliance on Stamp Duty is damaging to the operation of the market. The continued reliance on relative valuations that are already more than 20 years out of date is increasingly absurd. But the reform that would do most to benefit low to middle income households would simply involve making council tax a flat tax on housing such that liabilities would be proportional to the value of the property rather than regressive in property value.

Section 3 – Sensible ways to raise revenue

This paper has focused on how the tax system could be structured to achieve Government's redistributive goals as efficiently as possible. It has not got into the general question of whether more support, for example through higher benefits, might be appropriate. There are obvious trade-offs and costs associated with such a decision. But as the squeeze on living standards continues, we may see increased pressure for additional support for low to middle income households, whether through reduced taxes, increased support through cash transfers or, increased investment in other services like childcare. In a constrained fiscal environment, that is likely to mean either reducing spending in other areas, or raising additional revenues. This section briefly discusses the pros and cons of a number of options for raising additional revenues.

Clearly it is for governments and electorates to choose where they want to be on the trade off that exists here between redistribution and lower inequality on the one hand and economic costs and reduced rewards for effort and success on the other. Nonetheless, some ways of raising revenue will be better – in the sense of being more efficient or less distorting – than others. This section talks very briefly through how we might think about these trade-offs when considering potential sources of revenue for new priorities, and how they will run alongside other key concerns of progressivity and political palatability.

When it comes to efficiency, a central contention of the Mirlees review is that we need to think about the tax-benefit system as a whole. It is important to remember this when considering new sources of revenue. Not all taxes need to redistribute and, in achieving overall progressivity, simplicity of design is also key. Simple reforms, such as increasing the basic rate of income tax, can raise substantial sums and should not be discounted.

But there are two reasons for looking elsewhere. The first is a simple political one – raising income tax and VAT rates is not popular. The second is more principled. There are parts of the tax system which need to be reformed for efficiency reasons and where more money could be raised. That said, a tax rise is a tax rise. There are always losers from a tax increase. And of course the tax system can be made more efficient without raising additional revenue.

This section then considers briefly the pros and cons of a number of different revenue raising options which, rather like the revenue neutral reforms considered above, could make the tax system more coherent. Given the obviously large number of reforms which could be made to the tax system, the discussion is necessarily selective, and we have sought to highlight options which are 'live' in current policy debates. In selecting and evaluating the different options we take into account whether reforms (1) make the tax system more efficient or coherent, and (2) whether they increase the overall progressivity of the system (in the sense of proportionally taking more from the better off).

We consider three changes in the discussion below: reforms to pensions taxation, to Capital Gains Tax, and to Inheritance Tax. In closing, we touch briefly on three other proposals that are commonly discussed: increasing corporation tax, imposing a "tobin tax" on financial transactions and restricting income tax relief on pension contributions.

Pensions' taxation

A "neutral" basis for taxing pensions would likely involve a system not too dissimilar from that affecting pensions at the moment – contributions are made free of tax, investment returns are broadly free of tax, but there is then tax on withdrawal. This provides an "expenditure tax" treatment of pension saving. But there are two significant ways in which pension taxation is more generous than that benchmark.

In the first place it is possible to withdraw up to £435,000, or a quarter of the value of the accumulated pension, as a lump sum entirely free of tax. Abolishing this altogether could raise up to £2.5 billion a year in the longer term. Limiting that right to a lump sum equal to the threshold for higher rate tax – just over £40,000 – could raise £500 million a year.

Secondly, employer contributions to pensions are very generously treated from the point of view of National Insurance Contributions. NICs are not paid at any stage meaning both that employer contributions are favoured relative to contributions from individuals and that pensions accumulated in that way are subject to a tax regime which is significantly more generous than a "neutral" expenditure tax. The cash value of this treatment is obviously much greater for those with the highest levels of employer provision – overwhelmingly those with high incomes.

At the same time there are significant concerns about the level of pension savings among low to middle income households, especially as those employed in the private sector are now most unlikely to have access to any kind of defined benefit scheme. Of those earning between £15,000 and £25,000 around three quarters do not have a pension which would qualify for the (limited) minimum criteria under the new auto enrolment scheme.[24] Reforming the NI treatment of pensions could be done in a way which simply raises money and is redistributed through the tax and transfer system, or the additional resource made available could be targeted on improving pension savings incentives for this group.

Changes such as these could improve the coherence of the system for taxing pensions. In fact many reformers look for additional revenue elsewhere in the system of pension taxation. The most often mooted proposal for raising more revenue from pensions is to reduce the generosity of tax relief on contributions, and in particular to restrict relief to the basic rate of tax. This looks superficially attractive when looking for progressive ways of raising additional revenue. Those with higher incomes pay higher taxes and are

[24] Author's calculations based in table 2.1 of http://www.dwp.gov.uk/docs/cp-oct10-chap02.pdf

therefore eligible for more tax relief. But this is not a reform that would enhance the coherence of the tax system. Pension taxation is designed to promote neutrality specifically by exempting contributions from tax while taxing receipts. Restricting tax relief for higher rate taxpayers would be administratively complex for Defined Benefit schemes. If relief were restricted to the basic rate, this would result in some people receiving relief only at the basic rate but then paying higher rate tax on their eventual pension income. Under the current system it is true that the majority who receive relief at the higher rate pay the basic rate on their pension income. But even that looks coherent if you think that the income tax system should be progressive when measured against lifetime, as opposed to annual, income.

Others have suggested restricting the annual or lifetime limits on pension tax relief. Annual limits are currently set at £50,000 of contributions while the current lifetime limit for pension tax relief is £1.8m, falling to £1.5m from 2012/13 onwards.. One could choose to restrict limits further. If one were to do so it would make more sense to focus on lifetime limits rather than arbitrarily on those with the highest contributions in any one year. This is not a reform that would in any sense improve the structure of the system.

Capital Gains Tax

Since in this paper we are eschewing a detailed consideration of the taxation of savings[25] this is not the place for a detailed discussion of CGT design. Nevertheless, and despite being a very small tax in terms of revenue, it is pivotal in the design and effectiveness of the tax system. This is because pressures to reduce rates of CGT come from concerns that high rates impede savings and entrepreneurship while pressures to increase rates reflect concerns that CGT rates lower than income tax rates present an open goal for those looking to avoid income tax. The direction suggested in the Mirrlees Review is to try to square this circle by charging CGT at the full labour income tax rate on just returns above the normal return.

Even within the current structure there remain numerous reliefs and exemptions which have the potential to create inefficiencies while generally advantaging the well off relative to those of modest means. Examples include “entrepreneurs’ relief” and, particularly, the exemption from CGT of gains realised at death. This creates a serious “lock in” effect whilst depriving the exchequer of revenues. Whilst it is hard to put firm numbers on the costs of these things HMRC estimates that Entrepreneurs Relief costs £1.2 billion annually while relief at death costs £600 million.

Inheritance Tax

Rather like CGT, inheritance tax (IHT) contains a number of reliefs and allowances which make it less effective than it might be in raising revenue – though unlike CGT it arguably plays a less central role in the

[25] See Mirrlees chapters 13 and 14 for detailed discussion

tax system. In general, being paid by only a very small fraction of all estates, IHT will not impinge upon low to middle income households at all – though there is evidence that they fear that it will.

The relevant question then is whether IHT can be reformed to raise more revenue and to make the overall system more coherent, and indeed more acceptable. The main problem with the system as it currently works is that it is easier for those of very substantial means to avoid paying than it is for those of more modest means, not least because it is only payable on transfers made at or near death. If I need to live in my house and keep control of my savings then I can't transfer them during life. If I have more than enough to live on then I can. The most radical reform would be to transform IHT into a tax on lifetime receipts of gifts and inheritances. More minimal and incremental changes would at least reduce the scope of reliefs which allow agricultural land, many businesses and some share holdings to be passed on free of tax.[26]

This discussion has not touched on a number of proposals which are commonly raised, including increasing corporation tax and imposing a "tobin tax" on financial transactions. There is often a sense that these sorts of taxes are either victimless or, self evidently, hit rich companies and rich fund managers. But no tax is victimless – some individual ends up paying it. There is good reason to believe that at least some of the effect of the former would, in the long run, lead to lower wages whilst the latter seems as likely to reduce returns to savers as it is to lead to a fall in pay or profits in the financial services sector. More fundamentally such changes would not improve the coherence in the system; rather the reverse. If one is to look to the financial sector for more revenue however there is scope to clear up one of the nastier messes in the current tax system – the exemption of financial services from VAT. This exemption causes considerable complexity and results in mis-pricing of financial services. While it is not possible to levy VAT on this sector in the traditional way alternatives do exist, including the Financial Activities Tax set out by the IMF.

The key thing about any tax reform is to be clear about what one is trying to achieve, the overall structure of the system we are aiming at, and what the trade-offs are being made in any choices.

Spending it

Were one to raise additional revenue in these or any other ways then many options for spending it in ways which would benefit low to middle income households obviously exist. It is well beyond the scope of this paper to consider such options but several issues and principles are worth bearing in mind:

- Additional direct support through the tax credit system is likely to have the biggest and most immediate effect on incomes, but work incentive and dependency problems which may be substantial in the medium term;

[26] There is also evidence to suggest that current inheritance tax reliefs hinder better management in UK family firms – see Nicholas Bloom, Christos Genakos, Rafaella Sadun and John Van Reenen, Management Practices Across Firms and Countries, CEP Discussion Paper No 1109, December 2011

- Increasing the income tax personal allowance is not well targeted on low to middle income households as it benefits those somewhat further up the income distribution, but it does avoid disincentive effects. Better than increasing the personal allowance would be an increase in the point at which NICs start to be paid. Having been aligned briefly the gap between the starting point for NI and the personal allowance has grown substantially as the current government has raised the allowance but ignored NICs. This is yet one more manifestation of the absurdity of having two separate systems of personal taxation. It is extremely hard to think of any justification for a policy which focuses on the one and ignores the other.
- Any additional money could be used to improve work incentives for the over 55s, as discussed above, or to reduce council tax rates for those in the lowest value properties.
- Crucially, spending on public services should not be ignored when considering issues of distribution. Increased spending on childcare could have quick pay-offs in terms of welfare and labour market participation. Spending on health and education focussed on those with lower incomes will improve their welfare and potentially also have long term economic pay-offs. The fact that these are hard to measure means that they are often neglected in thinking about distributional issues. They should not be.

Conclusion

The tax and benefit system already does a great deal of work in reducing inequality. Through tax credits, other benefits, and the progressive nature of the income tax system it supports low to middle income households. We are willing to accept a considerable economic cost to reduce inequality and support the living standards of those with lower private incomes. One could choose to do more of that, and there are plenty of options open including increasing the generosity of Universal Credit or increasing personal tax allowances. The current government has chosen the latter route – one which is less effective at redistributing to low to middle income households but which avoids bringing more people into high withdrawal rates.

In the long run it is likely to be possible to increase, or even maintain, this level of redistribution only if we do much more to ensure coherence and efficiency in the design of the system.

There are ways of making the system more efficient and this is likely to be a prerequisite for making it more redistributive towards the low to middle income population, should that be our aim. Redistribution is costly but it can be made less so by intelligent design.

The key principles of such intelligent design are:

- The direct tax and benefit systems should be the main vehicle for redistribution. Using other parts of the system is costly in terms of the inefficiencies created and tends to be less well targeted;
- Within the direct tax and benefit systems we should make better use of what we know about responsiveness to tax rates. We know that there are some groups whose behaviour is more affected than others. Taking this into account in design can allow greater efficiency and/or more redistribution;
- It is crucial in thinking about redistribution to any group, including the low to middle income group, to think about their incomes and welfare not just in a particular year but over a longer period. Conclusions about the extent to which the system redistributes towards or away from them can be fundamentally affected by the time period under consideration.

We have looked at three areas where there is scope to improve the efficiency of the system in ways which could allow more redistribution, or the current level of redistribution at lower cost. Changes which improve work incentives for mothers with older children, for second earners, and for older workers could have an important impact on the long term welfare of low to middle income households,though even these are not costless and could result in short term losses for some currently dependent on benefits. The current VAT system is complex, inefficient and achieves some redistribution at high cost. Reforms look politically difficult, but if we are serious about finding ways to redistribute more efficiently then some sacred cows will need to be gradually put to sleep if not immediately slaughtered – rather as mortgage interest relief and the married couple's allowance were gradually allowed to die. In similar vein it is in many ways extraordinary that we accept a regressive and very out of date tax on housing as an important part of our tax system. A strategy for its reform is needed.

No one lever – be it tax credits or tax allowances – can keep on being pulled without creating difficulties. Many aspects of the tax and welfare system matter for how effectively and efficiently it redistributes to poor and low to middle income households. They all involve understanding and making careful judgements over trade-offs, careful judgements that are all too often over simplified in political debate. Too many of the levers are currently ignored because they are deemed too politically sensitive to touch. That can't remain the case if we are truly to get the best from our tax and welfare system.

Of course, all of this is tough, and there are trade offs to be made. But the potential gains are big both economically and in terms of the welfare of many low to middle income households. Given that we know that to be the case there is some urgency to finding politically achievable reforms.

The Resolution Foundation

The Resolution Foundation is an independent research and policy organisation. Our goal is to improve the lives of people with low to middle incomes by delivering change in areas where they are currently disadvantaged. We do this by:

- Undertaking research and economic analysis to understand the challenges facing people on a low to middle income;
- Developing practical and effective policy proposals; and
- Engaging with policy makers and stakeholders to influence decision-making and bring about change.

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