Long-term challenges for the tax system

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TaxPayers' Alliance

POLICY RESEARCH SERIES

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Executive summary

Society and the economy are always changing. Laws and regulations need to evolve, too, to avoid becoming redundant and out of date. That applies to tax just as much as other areas of life. This note considers how ten tax groups are particularly at risk of failing to keep up with a changing world: alcohol duties, driving taxes, stamp duty, the television licence fee, tobacco taxes, national insurance, business rates, high street retail tax, corporation tax and digital presence taxes.

The rapid growth of online shopping, working from home and video conferencing, the decline in smoking and the emergence of heated tobacco products, vaping, online streaming, electric vehicles and the gig economy are all affecting a tax system designed for another era.

For each tax area we consider its long-standing problems, its emerging problems, a range of proposals for reform and which reforms best resolve the problems. Many of the decisions policy makers must make rest in part on what the objective of the tax system ought to be, such as its optimal tax burden and the trade-offs between efficiency, simplicity and various other potential objectives.

We do not address those objectives or levels of government spending but do offer proposals which provide taxpayers as a whole with a lower burden. The literature on optimal tax-to-GDP ratios is extensive and not repeated here.[1]

Alcohol duty is complicated and arbitrarily punitive towards wines and spirits, especially as consumer tastes diversify beyond traditional patterns. Alcohol harms are mostly borne by individual consumers rather than wider society. The government's proposed simplification is welcome but it should go further and reduce the number of rates to three instead of six.

Driving taxes very poorly target external costs of driving, which means frequently congested roads, polluted neighbourhoods and – for the most part – over-taxed driving. Rising populations and car ownership levels will continue to exacerbate these problems while growing electric car sales mean government will have to look elsewhere for revenues. Road pricing could replace all five taxes (fuel duty, vehicle excise duty, low emission zones, congestion charges and workplace parking levies), enabling people to access more jobs in places without good public transport options by reducing congestion and speeding up trips.

Stamp duty places a barrier between people who want to make mutually beneficial exchanges of homes, making it harder for home owners to take advantage of new jobs or adjust to new circumstances. The growing role of agglomeration economics and reassessments of working patterns following the pandemic only exacerbate this problem. Full abolition should be the aim but a transitional step could be raising the threshold to £1 million or halving all the rates.

The **television licence fee** was created to fund the BBC when it was the only television available. It became out of date with the arrival of ITV but the advent of online video and streaming services have left it unquestionably archaic. Reforming it into a BBC subscription fee would be the simplest answer but a full or partial privatisation could offer greater benefits to taxpayers.

Tobacco taxes are paternalistic and confused. They are arbitrarily punitive to smokers and the harms of smoking are mostly borne by individual consumers rather than wider society, especially with the ban on smoking indoors. Either the higher rates of tobacco duty should be lowered to simplify the system or – if the paternalism principle is maintained – the rates on less harmful heated tobacco products should be reduced to reflect relative harm.

[1] See Booth, P. et al., *Taxation, Government Spending and Economic* Growth, Institute of Economic Affairs, 2016, and Heath, A. et al, *The Single Income Tax*, TaxPayers' Alliance and Institute of Directors, May 2012.

National insurance is a needless duplicate of income tax on earned income, with fiddly differences in the rules. As technology enables more piecework and self-employment in the gig economy, its pointless distinctions and different rates for the self-employed demonstrate its outdated nature ever more starkly. Aligning its rules and thresholds with income tax could help simplify the system but a full merger should be the final objective.

Business rates discourage commercial use and development of land and weigh heaviest on businesses which are more land-intensive, such as traditional retail. The particularly harmful aspects of business rates could be addressed by eliminating empty property relief and removing the value of structures and improvements from the 'rateable value', leaving a tax on land value.

High street retail tax, most notably an online sales tax, largely attempts to solve problems arising from consumer preferences shifting online which ought not to be the role of the tax system. However, business rates do impose genuine distortions against high street retailing and the commercial use of property more broadly. They should be reformed to make them less distortionary and more efficient.

Corporation tax is an inevitably complex tax on income that also taxes corporate investment with inexorable downward pressures on rates as more economies become competitive with the west. In the short term, permanently excluding investment from the tax base could soften the edges of the tax but a longer-term, sustainable solution requires switching the base from profits to distributions.

Digital presence taxes attempt to claw revenue from foreign (predominantly American) companies but risk leaving the British exchequer worse off while adding further complexity to an already labyrinthine corporate tax system. Substantial simplification through moving to a single tax on corporate distributions would provide a more efficient system.

Alcohol duties

What are the long-standing problems?

Alcohol duties are needlessly complicated, economically distortionary and morally oppressive. There is also much evidence that they fail to achieve the public health aims of many advocates, despite their negative impact on the lifestyles of the majority of drinkers without dependency problems.[2] By contrast, evidence suggests that high taxes encourage illicit alcohol markets. HMRC estimated the illicit market share in 2019-20 at 12 per cent for beer, 3 per cent for spirits and 3 per cent for wine (in 2016-17, the last available year with data).[3,4]

Because most drinkers – in other words most adults – do not create additional health spending or crime and disorder problems, the case for charging all drinkers with the public spending costs of those problems is weak. There is no good reason why a law-abiding moderate drinker should pay a greater share of the costs for irresponsible drinkers than a non-drinker. Similarly, there is no good reason why taxes should seek to discourage drinking among people whose drinking is not problematic, especially when taxes have been shown to have very little effect on problem drinkers but nonetheless significantly interfere in the lifestyle choices of moderate drinkers.

Finally, alcohol duties distort patterns of economic activity with negative implications for the night-time economy and UK supermarket sales which are diverted to lower-tax alternatives such as northern France for shopping trips and much of Europe in terms of 'city break' weekends.

What are the emerging problems?

Spirits and wine, which are taxed far more punitively than beer and cider, are increasingly consumed by drinkers who do not have an alcohol problem, particularly within pre-mixed products. It is not clear why a gin and tonic, for example, with an alcohol content of, say, 8 per cent attracts a higher rate of duty than a beer with the same alcohol content.

Beyond this change in consumption patterns, only a steady decline in alcohol consumption (with consequences for alcohol duty revenues) affects the situation more broadly. Instead, the UK's withdrawal from the European Union means that the structures of the duties are no longer constrained by EU regulation. This means that parliament is now able to simplify the duties directly, rather than hoping for change at EU level. The government is consulting on a partial but substantial simplification of alcohol duties (see next section).

What proposals for reform have been made?

The then chancellor announced a substantial simplification of alcohol duties in the October 2021 budget.[5] The proposal would switch all products to a fixed rate of duty per unit of alcohol (within one of four bands), whereas currently cider and wine are levied per litre of product, within a much larger number of bands. A band would apply (regardless of the product) to alcohol within the bands of 1.3 to 3.4 per cent, 3.5 to 8.4 per cent, 8.5 to 22 per cent and above 22 per cent. Within the range of 3.5 to 8.4 per cent one rate would apply to wine and spirits with a lower rate for beer and a still lower rate for cider. The consultation cited "simplifying the tax system, reducing burdens, improving public

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[2] Duffy, J.C., and Snowdon, C., *Punishing the majority. The flawed theory behind alcohol control policies*, IEA, June 2014 iea.org.uk/wp-content/uploads/2016/07/IEA%20Punishing%20the%20majority%20EMBARGOED.pdf, (accessed 6 February 2022).

[3] HM Revenue & Customs, *Measuring tax gaps 2021 edition – tax gap estimates for 2019 to 2020*, 8 February 2022, www.gov.uk/government/statistics/measuring-tax-gaps/measuring-tax-gaps-2021-edition-tax-gap-estimates-for-2019-to-2020, (accessed 20 February 2022).

[4] HM Revenue & Customs, *Measuring tax gaps 2018 edition,* 14 June 2018.

[5] HM Treasury & HM Revenue & Customs, *The new alcohol duty system: Consultation*, October 2021.

health, spurring innovation, and being fair to producers – while at the same time also being fiscally responsible" as its objectives.

Alcohol Health Alliance propose five principles for reform: that duty should be proportionate, consistent, scaled, uprated and targeted. These principles are all ultimately based on harm reduction, which appears to determine which prevails when they conflict, and underlies the objective of making alcohol less affordable.[6]

The Wine and Spirits APPG proposed a system that recognises that treasury revenue maximisation is the objective. Accordingly, it suggests rate reductions overall and a reform package that taxes alcohol itself, regardless of the product the alcohol is in. Specifically it calls for the surcharge on sparkling wines to be scrapped but also a breach of the neutrality principle to allow for reduced rates for alcohol purchased at vineyards, breweries and distilleries to promote tourism and rural economic development.[7]

Mirrlees et al say that alcohol is an "obvious example" of "clear cut situations where there should be a deviation from uniformity" in consumption tax but "assume no changes to the structure of the excise duties applied".[8] They suggest that taxing fatty foods more heavily is "much more complex than taxing alcohol and tobacco, in part because, of course, moderate consumption of most foods is beneficial". Moderate consumption of alcohol has also been shown to be beneficial in some studies,[9] but it is not clear whether they dismissed these results or simply did not take them into account.

In a recent briefing note, Kate Smith of the Institute for Fiscal Studies argued that the government should "stop trying to favour certain parts of the industry, instead focusing on removing distortions and creating a simpler system of alcohol taxes targeted at socially costly drinking" rather than favouring, for example, cider or having a single rate of tax on a unit of alcohol. Citing the external costs of alcohol consumption such as disease, drink driving and antisocial behaviour together with "evidence that a large fraction of the social costs of drinking are generated by "heavy" or "problem" drinkers", the system can "better target these social costs by levying higher rates on drinks preferred by heavy drinkers". [10]

Booth et al called the case for "Pigovian taxes weak with socialised healthcare provision but almost non-existent in its absence"[11] because "physiological and behavioural responses to substances varies greatly, so does the extent to which a uniform tax adheres to Pigovian principles rather than being an arbitrary, distortionary tax. In other words, taxes can encourage people who can cope well with gambling, alcohol or tobacco consumption to consume less than optimal quantities" while "evidence that price mechanisms can affect problematic behaviour is weak" due to price inelasticity of demand among the heaviest drinkers. To achieve an economically efficient tax on the external element alone would require a discount to reflect this, plus another to reflect that "further distortions are caused by a tax system that does not cover all external costs (and external benefits)." Abolition of surtaxes on alcohol would be the best way to deliver a transparent and efficient tax system, in the context of designing a system from first principles without reference to political constraints.

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[6] Alcohol Health Alliance, *Alcohol Duty* Reform, 2022, ahauk.org/what-we-do/our-priorities/alcohol-duty-reform/, (accessed 18 February 2022).

[7] WSTA, *SMEs hit back over Government's proposals to overhaul alcohol taxation*, 22 March 2022, wsta.co.uk/press-release/smes-hit-back-over-governments-proposals-to-overhaul-alcohol-taxation/

[8] Mirrlees, J. et al., *The Mirlees Review: Chapter 6: Taxing Good and Services*, Oxford University Press, 2011 p. 163,.

[9] Adams, S., & Stanbridge, J., & Zylstra, R., *Alcohol consumption: an overview of benefits and risks*, Southern Medical Journal, July 2004.

[10] Smith, S., *The Chancellor should reform alcohol taxes in the Budget*, Institute for Fiscal Studies, 19 October 2021, ifs.org.uk/publications/15761, (accessed 12 February 2022).

[11] Booth, P. et al., *Taxation, Government Spending and Economic* Growth, Institute of Economic Affairs, 2016.

For the Social Market Foundation,[12] Scott Corfe proposed a 'duty strength escalator' and an inflation or earnings index annual rate increase with reviews every five or ten years, reflecting an objective of covering external costs of alcohol consumption. In addition, "regrettable lifestyle choices (such as those that undermine their job prospects) could justify a higher tax take". To simplify the system, "products of the same strength should face the same rate of duty". However, duty relief should be available to on-premises licensees to reflect the lower likelihood of sales to problem drinkers there.

What reforms resolve the problems best?

To the extent that the objective of reform is a neutral, simple and efficient tax system, outright abolition of alcohol duty is the best policy option. Once external costs are discounted to reflect heterogeneous responses to alcohol consumption, the case for taxes to reflect external costs becomes very weak, even with socialised healthcare and police. The remaining justification from first principles is paternalism. The justification is that at least some people drink more than they ought to and it is the job of policy makers to control their consumption through tax policy.

Few people would agree that all drinkers ought to have their consumption affected by policy for their own good, but the principle that the heaviest drinkers ought to be controlled is more widely held. The problem is that attempts to penalise those drinks which are most favoured by the heaviest drinkers, such as drinks with high alcohol content – especially when sold for consumption off premises – are circumvented because the target consumers are the least responsive to price signals. Duties are more likely to distort ordinary drinkers' choices rather than affect problem drinkers' consumption. They are also highly regressive.

This leaves a flat-rate tax on a unit of alcohol as the best available option to affect consumption while minimising the welfare losses arising from distorting consumers' choices towards products that they deem ideal towards inferior, but less heavily taxed, alternatives. Governments might also wish to retain a flat-rate duty on alcohol as the least distortionary form of an arbitrary tax which raises revenue. They might find it politically more difficult to raise such revenue in a more neutral way, such as through raising the standard rate of VAT.

If the government chooses to retain the preferential rate for alcohol within beer and cider compared to wine and spirits within the alcohol content range of 3.5 to 8.4 per cent, it should minimise the number of bands in the schedule. Instead, this would be a single rate above 3.5 per cent and aligning the rate on all alcohol between 1.3 and 3.4 per cent with the cider rate between 3.5 and 8.4 per cent. This would leave just three rates instead of the proposed six.

[12] Corfe, S., *Pour decisions? The case for reforming alcohol duty*, Social Market Foundation, May 2019.

Driving taxes

What are the long-standing problems?

Fuel duty is the largest driving tax. It's too high and it's economically damaging. There is a justification for some level of fuel duty in principle. The degradation of local air quality and the contribution to climate change are both reasonable arguments for a particular tax on motoring fuel and all fuel, respectively. The problem is that these arguments only support a level of fuel duty much lower than the current rate.

Using Department for Business, Energy and Industrial Strategy assumptions for short-term traded carbon values in the emissions trading scheme to reflect the cost of reducing carbon emissions and applying them to the emissions factor for petrol, Booth et al found that those carbon costs plus local and national roads expenditure implied a maximum justifiable fuel duty of 37p a litre.[13] Adjusted for inflation, that would be approximately 41p in 2021-22 prices (it currently stands at 57.95p). Road pricing (including congestion charges) deals with congestion while local emissions regulations (such as low emissions zones) are much less blunt tools than a national (or even local) fuel duty.

In addition to the economic damage all taxes inflict on the economy, fuel duty above the 41p a litre level indicated above has two specific problems. First, it distorts economic patterns of consumption and production. Secondly, it prevents workers from accessing potential jobs. This restricts economies of scale, reduces competitiveness and hinders industrial specialisation, resulting in lower income levels.

Meanwhile, vehicle excise duty (VED) is a tax on vehicle ownership that is arbitrary and the current system is needlessly complex. The revenue raised would be less economically damaging if taken from overall consumption through VAT, or from income through income tax. Concerns about emissions, meanwhile, are already addressed through fuel duty. Congestion has almost no link with vehicle ownership because it is highly specific to certain times and locations. Congestion charges and other road-pricing mechanisms are much better designed to address congestion.

VED discourages vehicle ownership, which affects low income households more, with worrying implications for employment, particularly in areas which cannot sustain frequent and dense public transport networks.

Congestion charges also operate in central London and Durham and successfully reduced traffic volumes and increased speeds.[14] However, they are crude and small, applying a fixed daily charge only to drive within their areas, and charge drivers the same amount whether they spend ten minutes or ten hours within the zones. Additionally, they are obviously administered completely separately, with an additional system for government to operate and drivers to navigate. Yet further systems in the form of 'workplace parking levies' and 'low emissions zones' are operated in cities including Nottingham, Oxford and Glasgow.

Workplace parking levies aim to reduce congestion and associated external costs while low emission zones specifically target air quality and usually apply to vehicles over certain emissions levels. Workplace parking levies are particularly problematic because they tax private land use when the owner of the land already pays the cost of the foregone alternative use of the land, typically by authorities which simultaneously operate their own parking businesses.[15]

[13] Booth, P. et al., *Taxation, Government Spending and Economic* Growth, Institute of Economic Affairs, 2016.
[14] Transport for London, *Congestion Charging 6 months on*, October 2003.
[15] TaxPayers' Alliance, *Workplace parking levies*, July 2019.

What are the emerging problems?

The replacement of internal combustion engine cars with electric vehicles, especially if the government does implement its plan to ban the sale of new petrol and diesel powered cars in 2030, changes the way motor vehicle use affects third parties via traffic noise, local air quality and public finances.

Electric motors are substantially quieter than internal combustion engines. Despite a requirement since last year for electric vehicles to be fitted with a noise-emitting device, some charities for the blind have said that it is not enough and their relative quiet poses a danger to blind people, who cannot hear them.[16] The artificial noise required to overcome this problem will weaken the arguments against fuel duty to cover the noise pollution imposed by drivers on those who can hear their vehicles. Fuel consumption is already an incredibly poor proxy for noise externalities, though, due to the fact that vehicle noise is poorly correlated with fuel consumption and the external cost of vehicle noise is poorly correlated with noise emissions. In other words, a poorly tuned motorbike driving in a busy urban centre can make much more noise, heard by far more people, than a car driving on a sparsely populated road.

A literature review into brake, tyre, clutch, road surface wear emissions by the European Commission found that "exhaust and non-exhaust sources contribute almost equally to total traffic-related PM10 emissions".[17] The implication is that the greater the share of electric vehicles, the weaker the link between total PM10 emissions and fuel duty. As with noise emissions, where these occur matters too. The same quantity of pollution causes more harm in a heavily populated area and less harm in a sparsely populated area.

The number of licensed diesel and petrol cars fell for the first time in 2020.[18] That was probably primarily caused by a collapse in new car registrations from 2.2 million in 2019 to 1.5 million in 2020.[19] But if the rapid increase in electric car sales continues then it is likely to happen again very soon. Battery electric vehicles comprised 0.1 per cent of total licensed cars in 2017 but had risen to 0.6 per cent in 2020. The replacement of petrol and diesel cars with electric cars combined with enhanced fuel efficiency of new internal combustion engine cars replacing old ones is likely to start shrinking receipts from fuel duty. Despite being required to assume that fuel duty will rise with its escalator rather than be frozen as it has every year since 2011, the OBR expects fuel duty receipts to start falling in real terms from 2025-26.[20] As fuel duty becomes increasingly outdated the government will have to look either to savings or alternative taxes or charges to replace the lost revenues.

With a growing number of local authority schemes intended to manage congestion or improve air quality, both drivers and government face a widening array of systems to administer or navigate.

[16] Wilkins, R., *Electric cars a danger to the blind, say charities*, BBC, 16 September 2021, www.bbc.co.uk/news/uk-wales-58585312, (accessed 12 March 2022).
[17] Grigoratos, T., & Martini, G., *Non-exhaust traffic related emissions. Brake and tyre wear PM*, European Commission, 2014.
[18] Department for Transport, *Cars (VEH02): Table VEH0205a: Licensed cars at the end of the year by engine capacity, Great Britain from 1994; also United Kingdom from 2014*, 13 May 2021, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/985935/veh0205.ods, (accessed 12 March 2022).
[19] Department for Transport, *Cars (VEH02): Table VEH0211a: Licensed cars at the end of the year by year of first registration, Great Britain from 1994; also United Kingdom from 2014*, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/985940/veh0211.ods, (accessed 12 March 2022).
[20] Office for Budget Responsibility, *Economic and fiscal outlook – October 2021*, October 2021.

What proposals for reform have been made?

Mirrlees et al said that "fuel duty is a poor substitute for road pricing"[21] and "over time, fuel duty will do a less and less good job of capturing the externalities associated with driving". Despite this, they thought "current levels of fuel duty are somewhat below their optimal level on average", principally referring to congestion. Nonetheless, the ideal answer was that "it should be reduced if a coherent congestion charge policy is introduced. Linking reductions in fuel duty to the introduction of congestion charging would also increase the chances of gaining political acceptance".[22]

In 2012, the RAC Foundation said that a fuel duty of 14p a litre was appropriate to cover carbon emissions but that "no single, universal rate of fuel duty can be regarded as appropriate for all" because of the flaws in fuel duty in dealing with other externalities.[23]

Booth et al recommended cutting fuel duty (and abolishing vehicle excise duty except for HGVs) to "an average of around half its current rate" (with local variation) and introducing "market-based mechanisms for allocating road space (such as road pricing and better parking charges) would eliminate most of the negative local externalities associated with driving".

The Institute for Global Change recommended introducing road pricing but cautioned against it being presented as an 'attack on motorists', without saying what would need to be done to avoid that possibility.[24] However, they did warn that "we can expect the political opposition to be high enough to prevent such a move" in the event that it was seen as such.

The Social Market Foundation commissioned polling which found net opposition to road pricing as a standalone policy but when it was presented as a replacement for existing motoring taxes, it achieved net support.[25]

Most recently, the house of commons select committee on transport noted "failure to failure to replace existing motoring taxes with an alternative road charging mechanism will lead to either decreased investment in public services, including road maintenance, or increased Government borrowing" and recommended abolishing both fuel duty and VED to be replaced with road pricing, which they said must be revenue neutral and "factoring in vehicle type and congestion".[26]

Policy Exchange proposed road pricing as part of a "new deal for drivers" which "must work for this lion's share of the British public", partly by replacing VED and fuel duty and be "capped at the size of the current set of motoring taxes" while also ensuring most drivers pay less or no more than under the present system. It also recommended raising the motorway speed limit to 80mph and spending more on new roads and maintenance.[27] Doing this could bring "millions of Britons within range of better jobs by saving them millions of hours they otherwise would have spent in traffic".

What reforms resolve the problems best?

Fuel duty should be cut back to reflect only the cost of carbon emissions, because they are the only external cost involved with driving which is well-matched to fuel consumption. Driving imposes other costs on third parties but these are either entirely unrelated or very weakly correlated to fuel

[21] Mirrlees, J. et al., *The Mirrlees Review: Chapter 20: Conclusions and Recommendations for Reform*, Oxford University Press, 2011.
[22] Mirrlees, J. et al., *The Mirrlees Review: Chapter 12: Taxes on Motoring*, Oxford University Press, 2011.
[23] Johnson, P., & Leicester, A., & Stoye, G., *Fuel for Thought: The what, why and how of motoring taxation*, RAC Foundation, May 2012.
[24] Lord, T., & Palmou, C., *Avoiding Gridlock Britain*, Tony Blair Institute for Global Change, 31 August 2021.
[25] Corfe, S., *Road to ruin? Public attitudes towards road pricing as an alternative to the current fuel duty regime*, Social Market Foundation, October 2021.
[26] House of Commons transport committee, *Road pricing: Act now to avoid £35 billion fiscal black hole, urge MPs, 4 February 2022,* committees.parliament.uk/committee/153/transport-committee/news/160791/road-pricing-act-now-to-avoid-35-billion-fiscal-black-hole-urge-mps/, (accessed 9 March 2022).
[27] Southwood, B., *A New Deal for Drivers*, Policy Exchange, 4 February 2022.

consumption and so should be addressed more directly. Externalities including noise pollution, local air quality, congestion and safety are highly dependent on the location and time. Road maintenance costs, meanwhile, are primarily dependent on vehicle weight, not fuel use or time.

A road pricing system dependent on location and time could much more effectively match the price of driving to where and when it actually does impose costs on others. It could also make driving less infuriating by eliminating congestion for those who need to drive at busy times and places and cheaper for those who need to drive at quiet times and places by substantially reducing fuel duty. It is crucial that this is the objective of a road pricing system, not raising revenue. Charging at levels above these external costs would be arbitrary, highly unpopular and that could, with justification, jeopardise the potential wider benefits by leading to plans being scrapped.

To be successful it would have to gain broad support, including from the 78 per cent of households which have a car or van.[28] Credible guarantees that most drivers would pay either the same or less than they do now in tax are an important foundation of that support. Any scheme which transfers driving charges from all drivers to those who drive where congestion is worst would mean those in London paying more and those elsewhere paying less. A few other notoriously congested cities like Edinburgh, Bournemouth, Bristol and Manchester may pay more, too, but drivers in small cities, towns and rural Britain would be the ones who would pay less.

Another important consideration is privacy and surveillance. There is a trade-off between the level of sophistication a scheme can offer and its potential for surveillance and misuse of data. If policy makers wish to maximise the efficiency benefits that come with more sophisticated tracking, they should design out surveillance to ensure that privacy concerns do not lead to its abandonment. Doing so would mean resisting pressure from police and security services, which are likely to want to take advantage of the technology.

A road pricing scheme that targets congestion and accounts for local air quality in urban areas would render existing low emission zones, congestion charges and workplace parking levies redundant. They should all be scrapped, along with vehicle excise duty. Incorporating a carbon emissions component to the charge would mean fuel duty should be scrapped, too.

[28] Office for National Statistics, *Percentage of households with cars by income group, tenue and household composition: Tables A47*, 24 January 2019, www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/expenditure/datasets/percentageofhouseholdswithcarsbyincomegrouptenureandhouseholdcompositionuktablea47, (accessed 9 March 2022).

Stamp duty

What are the long-standing problems?

The 'incidence' (who is economically worse off, as distinct from who is required to pay the money) of stamp duty land tax (abbreviated as stamp duty or SDLT[29]) depends on whether we are thinking about who 'pays' the tax after it has already been put in place, or who 'pays' when it is introduced (or withdrawn, or the rates are altered).

Because buyers factor in their stamp duty bill when deciding how much to pay for a property, the buyer 'pays' when considering transactions on their own. Buyers start off with cash worth the value of the property and the value of the stamp duty and then end up with just the value of the property. A seller, by contrast, swaps a property for cash of the same value. But when SDLT is introduced or raised, property owners immediately 'pay'. Instead of increasing their overall budget, buyers allocate some of their overall budget for stamp duty, leaving less left over for the purchase. This means that prices fall to account for the reduced demand from buyers, reducing the value of property. So the cost falls on both buyers and sellers and adds up to much more than the tax receipts HMRC receives.

The big problem with stamp duty is that its incidence on buyers means that it reduces people's willingness to buy property, which in turn means that people fail to move homes when it suits their requirements, such as for a new job or to reduce their housing costs when adult children have left home after education. This gets in the way of the housing market reallocating homes when circumstances change. Growing companies find it harder to recruit the right employees, older home-owners stay in family homes which could be better suited to younger, growing families, and workers who do take new jobs sometimes accept longer, less pleasant commutes because stamp duty means it's just not worth moving.[30]

The previous chancellor's growth plan in September 2022 increased the threshold from £125,000 to £250,000 (and the threshold for first time buyers from £300,000 to £425,000), thereby abolishing the 2 per cent rate in that band. This has reduced the problems by removing buyers within the band from tax as well as reducing the liability by £2,500 for buyers of homes bought for over £250,000. The current chancellor announced in the autumn statement that this change would be reversed in 2025, however.

What are the emerging problems?

It is still too early to tell exactly how and to what degree patterns of working, commuting and living have been affected by the pandemic. Few doubt, however, that there has been some shift in a wide range of preferences relating to property use, even if there is much debate regarding what these shifts may be and their size.

Many of the changes like the perceived usefulness of remote working and online shopping brought about by necessity of the pandemic are likely to permanently change how often at least some people shop online or work remotely. That in turn raises questions about how much commuting patterns will change. Will preferences for a longer commute increase if we continue to do it less often? Will firms demand less office space if it's being used less intensively? Or perhaps more, because more spacious working environments with better air quality and ventilation are more highly valued? Will central pubs, restaurants and shops continue to struggle to remain as viable and will suburban counterparts flourish in their place? Will these effects be small or large?

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[29] Stamp duty can refer to a range of duties on property, including shares in public companies. But for the purposes of this note it refers to stamp duty land tax.
[30] Hilber, C., *Written evidence to the treasury select committee*, 2 May 2016, personal.lse.ac.uk/hilber/evidence/Hilber_Evidence_HMTreasuryCommittee_2016_05.pdf, (accessed 3 March 2022).

Answers to these questions are beginning to appear to emerge, but regardless of what they end up looking like, they are almost certain to involve at least somewhat different use patterns to what would have happened had there not have been a pandemic. The extent of this change is one measure of how the frictions and barriers to liquidity in property markets have increased as a result of stamp duty. If location preferences in the economy continue to change faster than before the pandemic then that could mean stamp duty's 'grit in the engine' effect could worsen permanently rather than being a change in the level of the scale of the problem.

The growing role of 'agglomeration economics' – the phenomenon of faster and more sophisticated knowledge transfer in larger, denser cities fostering more productive economies – is substantially constrained in the UK, largely by regulatory restrictiveness against property development. Stamp duty, however, compounds this problem, and increasingly so, through its disincentive effect on owners moving property when their circumstances change.

If agglomeration economics favours increased levels of 'clustering' of types of workers or sectors then stamp duty will impede the ability of the housing market to distribute people most effectively, reducing the potential to gain from the phenomenon. In other words, some workers who might move to a city more specialised to their own industry could be put off moving by the financial penalty of stamp duty. Another worker employed in an industry that is clustered in the first city in but who lives and works in the second city might similarly find stamp duty tips the balance away from making an equivalent move in the opposite direction. Both industries, both cities and both workers suffer immediately because the workers are obstructed from making the move. But after their moves they might have been more likely to have made business connections and generated new ideas due to the specialisation and effective size of the cities, increasing the cost of stamp duty over time.

What proposals for reform have been made?

Stamp duty is such a bad tax that its outright abolition has been advocated by a wide range of organisations and individuals, including the Adam Smith Institute, the Centre Forum, the Institute for Economic Affairs, the Institute for Fiscal Studies, the Institute for Public Policy Research, the National Institute of Economic and Social Research and the OECD as well as the TaxPayers' Alliance.[31]

Reform proposals often assume fiscal neutrality as a condition of reform and link abolition of stamp duty to an imposition of another tax.

Heath et al recommended abolishing stamp duty immediately with no replacement tax, as part of a tax-cutting programme. They argued against replacement taxes because "any tax on property people have already bought – which is expensive for people to sell – in part thanks to the tax system, will be disruptive". They also argued that council tax should retain its function as a "charge connected to the services people consume" rather than a tax on their own housing, criticising taxes levied other than "when people have the cash to pay them" as "disruptive and unfair". They argued that taxing imputed rent would be "unfair and inefficient" partly because it would tax non-market transactions, unlike in other cases such as childcare, gardening and cleaning.

Clougherty et al concurred with a straightforward abolition of transaction taxes for the Centre for Policy Studies and the Tax Foundation, saying that by their "very nature, these taxes distort economic decision-making" and "discouraging mutually beneficial trade at the margin".[32] They recommended broadening the VAT base to recoup lost revenue.

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[31] TaxPayers' Alliance, *The 25 prominent voices who support abolishing stamp duty*, 14 December 2017, www.taxpayersalliance.com/the_25_prominent_voices_who_support_abolishing_stamp_duty, (accessed 4 March 2022).
[32] Centre for Policy Studies & Tax Foundation, *A framework for the future: reforming the UK tax system*, 2020.

Mirrlees et al recommended a 'housing services tax' based on the rental value of a residential property (whether rented or owner-occupied), to function as an equivalent of VAT on housing, along with a land value tax, with no cap and no single person discount.[33] These would replace council tax and stamp duty (and on business property, business rates, too). They said that "ideally" the housing services tax would be set at the same rate as VAT "but a more pragmatic medium-term goal might be to replace the revenue currently provided by council tax and stamp duty on residential properties."

Similarly, Booth et al recommended a 'location value tax' which "should be considered alongside the array of related taxes which ought to be abolished: business rates; stamp duty land tax; council tax (which in any case should be replaced by a previously discussed simulated extension of VAT to housing); and fiddly local quasi-taxes (the community infrastructure levy and so-called 'affordable housing requirements' and other obligations under 'section 106' of the Town and Country Planning Act 1990)". The rationale is that "little economic damage, because land cannot be hidden or taken overseas to avoid the tax and owners cannot respond to the tax by producing less value in its location – for the reason that they are not responsible for it in the first place".[34] Tax should "seek neutrality in property use by taxing the consumption of residential property (whether rented or imputed from owner occupancy)" which would be "much more conducive to growth". The proposed rate was 12.5 per cent, the same as proposed for VAT, again as part of a substantial overall tax cut.

In late 2019 the TaxPayers' Alliance recommended raising the SDLT threshold to £1 million, for which it was calculated receipts would be reduced by approximately £4.4 billion in 2020-21. We calculated that doing so would have resulted in an extra 220,000 transactions in the first year, of which 135,000 would have been a permanent increase (in the annual number of transactions).

What reforms resolve the problems best?

Any serious approach to property tax reform has to include the abolition of stamp duty. The question is whether to introduce or raise another tax at the same time to recoup foregone revenues for the exchequer. If another tax ought to be raised, should it be something unconnected like VAT or another property tax?

The answers to these questions depend on whether revenues as a whole ought to be maintained and whether property tax revenues should be. The principle of restricting tax to market transactions is worth considering. But if this principle were to be breached then a 'land value tax' (LVT) would be an efficient way of doing it, although still ultimately unfair for those who have already bought properties.

Nonetheless, revenue from an LVT could enable cuts to other, more damaging taxes. Similarly, re-introducing domestic rates at the same rate as VAT would reduce the distortion between housing and other types of household spending. Nonetheless, given the small size of residential stamp duty relative to council tax, introducing either or both of domestic rates/housing services tax and an LVT would realistically require the abolition of council tax at the same time. Without such a wholesale reform of property tax, the case for a standalone cut or abolition is strongest.

The government should therefore abolish stamp duty entirely when possible but in the meantime either raise its threshold to £1 million or extend the first time buyers' threshold of £300,000 to all, eliminating the 2 per cent rate, while halving the remaining rates of 5, 10 and 12 per cent to 2.5, 5 and 6 per cent.

[33] Mirrlees, J. et al., *The Mirlees Review: Chapter 16: The Taxation of Land and Property*, Oxford University Press, 2011.
[34] Booth, P. et al., *Taxation, Government Spending and Economic* Growth, Institute of Economic Affairs, 2016.

Television licence fee

What are the long-standing problems?

The licence fee means that those television viewers who do not care for or who object to BBC output are compelled to fund the BBC to gain legal permission to watch non-BBC output. In addition to questions about whether this is a proper role for the tax system, it also diverts funding away from television output that viewers would have chosen in favour of BBC output. The system where the BBC methods to collect the licence fee of sending menacing letters to households without licences under a separate brand ('TV Licensing') and prosecuting those who opt not to pay is also ethically dubious.

There is a lack of democratic oversight on how cash is spent as a result of the desire to keep the corporation independent of government. The fee is regressive, being flat rather than proportionate to the income of the payer.

What are the emerging problems?

The licence fee became out of date in 1955 when ITV was launched. ITV, and then subsequently Channel 4, Channel 5 and Sky have progressively made the licence fee more anachronistic as the likelihood that someone with a television might not wish to consume BBC content grew with the growing range of alternatives. With the advent and growth of internet streaming the licence fee is becoming ever more absurd and, with it, support for its abolition high. Among 16-34 year olds in 2018, YouTube alone accounted for almost as much viewing as all live TV broadcasting combined.[35] Various recent opinion polls have found support for abolishing the licence fee at 61,[36] 68,[37] and 74 per cent.[38]

Increasingly, other providers offer public service content such as documentaries beyond the provision that has always been made by terrestrial broadcasters.

What proposals for reform have been made?

Proposals for reform tend to fall into four categories. Replacing the licence fee with a subscription charge, either keeping the current institutional framework or replacing it with a subscriber-owned mutual organization. Or privatising, either fully or by keeping some public service broadcasting within the BBC, funded by a direct grant.

The BBC itself has suggested a 'poll tax' replacement for the licence fee, that even households who don't watch any broadcasting would be forced to pay.[39] It has termed this charge a 'levy on all households'. They suggested that it might exempt those on certain benefits and students.

David Graham recommended "voluntary subscription as an alternative funding model" to the licence fee with public service content (current affairs, public health, education, heritage and overseas promotion of the UK) remaining free-to-air and subsidised, without specifying how.[40]

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[35] Ofcom, *Media nations: UK 2019*, 7 August 2019.
[36] Maddox, D & Williamson, D., BBC crisis as poll finds 60 percent want to scrap licence fee, *Daily Express,* 23 February 2020.
[37] TaxPayers' Alliance, *New polling from the TaxPayers' Alliance shows tax cuts are key to winning working class votes*, 5 November 2019, www.taxpayersalliance.com/new_polling_from_the_taxpayers_alliance_shows_tax_cuts_are_key_to_winning_working_class_votes, (accessed 26 February 2022).
[38] Bodkin, H., Three-quarters want BBC licence fee abolished, poll finds, *The Daily Telegraph,* 28 December 2019.
[39] Sweney, M., BBC backs replacing licence fee with universal levy, *The Guardian*, 7 September 2015.
[40] Adam Smith Institute, *Scrap the TV Licence fee and reform the BBC*, 2 August 2010, www.adamsmith.org/blog/media-culture/scrap-the-tv-licence-fee-and-reform-the-bbc, (accessed 26 February 2022).

Booth et al recommended ‘privatising’ the BBC, with a range of options including a subscriber-owned mutual, full privatisation or a ‘slimmed down’ BBC to reduce the scope of the problems involved in the licence fee.[41]

Darwin Friend considered a similar suite of options including floating the BBC with a public offering on the stock exchange, leaving it to choose its own (subscription or advertising) model and concluded that a part privatisation of the BBC, with popular channels sold and a public service core retained, funded by direct grant.[42]

What reforms resolve the problems best?

The principal problem with the licence fee is its compulsory nature, which means it is effectively a tax on owning television receiving equipment. The simplest way of solving this problem would be to make it payable only for receiving BBC broadcasts. In practice, this would mean scrambling the signals and requiring licence fee payers to use a descrambling device on terrestrial televisions signals, or an account linked to the fee on the BBC’s online media player, iPlayer. A more immediate measure could be to decriminalise non-payment.

Whether or not the organization was then floated on the stock exchange, retained its current arrangements or became a subscriber-owned and controlled trust, and whether it was done so in its current form or reduced in size or split up with public service broadcasting possibly retaining subsidy through a direct grant funded by general taxation are secondary questions about the role of public service broadcasting, subsidy and, perhaps, general tax. They are all important questions but they are not questions upon which abolition of the licence fee in its current, compulsory form depends.

The public service broadcasting of ITV and Channel 5 and the quality of commercially-produced television available on services such as Netflix and Amazon Prime call into question the need for any state involvement. The BBC is likely to continue to have an especially strong commercial incentive to continue offering high quality programming given the nature of its brand. Nonetheless, if it were not the case, hard questions would need to be asked about whether there was a genuine collective action problem to justify forcing taxpayers to subsidise programming that is not valued by viewers and could not attract voluntary donors to fund, even with a less problematic tax than the licence fee.

[41] Booth, P. et al., *In Focus: The case for privatising the BBC*, 2016.
[42] Friend, D., *Switching off: BBC and Channel 4*, TaxPayers’ Alliance, October 2021.

Tobacco taxes

What are the long-standing problems?

Tobacco duty is needlessly complicated, economically distortionary and morally oppressive. It is also associated with large 'grey' and 'black' markets caused by attempts to avoid or evade high rates in the UK. Illicit sales are estimated to have comprised 17 per cent of the UK tobacco market in 2019-20, according to HMRC.[43] The two main aspects of the case for duties is that they charge users for the full cost of an activity by reflecting the 'external' costs (those which third parties suffer) and that they discourage use of harmful products and are as a consequence beneficial to taxpayers by saving them from their own poor decisions.

The 'sin tax' argument can be discarded as paternalistic but the external costs arguments are also incredibly weak. The relationship between public expenditure and tobacco consumption is weak for two reasons. First, many smokers do not acquire lung cancer or other major health problems due to smoking, so the case for charging all smokers with the public spending costs of those problems is weak. Secondly, smokers who do suffer major health problems due to smoking are more likely to die prematurely, reducing expenditure on state pensions and other age-related benefits. A premature death is obviously a cost to smoking, but it is a cost borne by the individual smoker, not other taxpayers. Snowdon and Tovey found that smoking saves the exchequer £5.2 billion in reduced "pension, healthcare and other benefit payments (less taxes forgone)" due to premature mortality, even before tobacco duty was accounted for.[44] With the then £9.5 billion of duty revenues, the net benefit was £14.7 billion.

What are the emerging problems?

As a source of revenue tobacco duty is declining with falling popularity of smoking across advanced economies due to cultural changes (arguably in part attributable to regulatory and fiscal policy). In addition, e-cigarettes ('vaping') are contributing to the decline of smoking as consumers switch to take advantage of their substantially lower health risks.

Heated tobacco products ('heat not burn') are subject to duty but at a lower rate (currently £270.22 per kg rather than £302.34 for hand rolling tobacco). To the extent that consumers switch from traditional smoking products to tobacco for heating, duty receipts will fall due to the lower rate. This may represent a policy objective achieved or a fiscal problem, depending on whether the function of tobacco duty is an arbitrary tax for raising revenue or a sin tax designed to reduce smoking.

In addition, VAT is applied at the standard rate on e-cigarettes (and tobacco products) but not on 'smoking cessation products', such as patches, gums and inhalators.[45] If discouraging smoking remains the objective of tax policy,[46] charging VAT on e-cigarettes would be inconsistent. However, if maintaining revenues is the objective, then the zero rate for other smoking cessation products would be inconsistent. A similar dilemma applies to the level of tobacco duty on tobacco for heating.

[43] HMRC, *Outputs for April 2020 to March 2021*, 10 May 2022, www.gov.uk/government/publications/tackling-tobacco-smuggling-2013-to-2014-outputs/outputs-for-april-2020-to-march-2021 (accessed 9 October 2022).
[44] Snowdon, C., & Tovey, M., *Smoking and the Public Purse*, Institute of Economics Affairs, August 2017.
[45] HM Revenue & Customs, *Health professionals and pharmaceutical products*, 9 December 2021, www.gov.uk/guidance/health-professionals-pharmaceutical-products-and-vat-notice-70157, (accessed 15 February 2022).
[46] Department of Health & Social Care, *The Government Response to the Science and Technology Committee's Seventh Report of the Session 2017-19 on E-cigarettes*, December 2018, assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/762847/government-response-to-science-and-technology-committee_s-report-on-e-cig.pdf, (accessed 17 February 2022).

The government agrees that heated tobacco is safer than smoked tobacco and that tax should reflect relative harm[47] but the level of duty is only 11 per cent lower.

What proposals for reform have been made?

The Tobacco Manufacturers Association proposes scrapping the 'escalator', which increases duty annually by 2 per cent above inflation, citing Laffer effects due to evasion and avoidance.

Action on Smoking and Health (ASH) argues that smokers ought to be coerced into quitting for their own good, partly due to the fact that smokers are disproportionately comprised of people in lower income groups and in manual occupations. They recommend measures such as increasing the escalator for hand rolling tobacco (HRT) to 15 per cent above inflation to remove the distortion between cigarettes and HRT, although their concern is not ensuring a neutral tax environment but a worry that too few people are being priced out of smoking by tax policy. They also propose a windfall tax and annual surcharge on tobacco profits, altering the tax treatment of marketing and 'corporate social responsibility' expenditure for tobacco companies and eliminating duty free status for tobacco products bought abroad under a threshold (currently 800 cigarettes).

Mirrlees et al largely evades the question of what to do on tobacco tax, merely noting the general principle that "a uniform rate avoids distorting the choices" and the "rather more contentious argument that the consumption of alcohol and, especially, tobacco harms the consumers themselves".[48]

Heath et al note "higher taxes lead to a larger black market and broadly increase tax evasion" and "tobacco duties have been justified on the basis of externalities that are mostly either dubious or actually private costs" and "tobacco duties are extremely regressive".[49] Nonetheless, the recommendations concerned direct taxes.

Booth et al recommended abolishing tobacco duty altogether due to 'weak' Pigovian arguments and the need to discount assessment of externalities by the extent of conceptual flaws.[50]

What reforms resolve the problems best?

If policy makers decide that taxes should function as a tool to alter smokers' decisions for their own good then the rate of duty on tobacco for heating is probably too high relative to traditional alternatives. The additional loss of revenue this would entail by encouraging people to switch away from smoking to heating would be considered a consequence of a policy objective met. Similarly, if e-cigarettes are more successful than alternative smoking cessation products such as patches and gums, applying the same zero rate of VAT would help meet the objective. By contrast, if the objective is to retain as much revenue as possible, minimising the gap between the duties would discourage switching and the consequent loss of revenues.

However, if the objective is an efficient, neutral tax system which only taxes external costs then the approach would be substantially different. Due to the lack of external harms in smoking replacement products, there is no opportunity to raise incidental revenue from measures to address externalities. Therefore the tobacco element of forecast reduction of tobacco and alcohol duty receipts by 0.2 per cent of GDP must be met by spending restraint.[51]

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[47] Department of health and social care, *The Government Response to the Science and Technology Committee's Seventh Report of the Session 2017-19 on E-cigarettes*, December 2018, p. 12, assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/762847/government-response-to-science-and-technology-committee_s-report-on-e-cig.pdf (accessed 10 October 2022).

[48] Mirrlees, J. et al., *The Mirlees Review: Chapter 6: Taxing Good and Services*, Oxford University Press, 2011.

[49] Heath, A. et al, *The Single Income Tax*, TaxPayers' Alliance and Institute of Directors, May 2012.

[50] Booth, P. et al., *Taxation, Government Spending and Economic* Growth, Institute of Economic Affairs, 2016.

[51] Office for Budget Responsibility, *Economic and fiscal outlook – October 2021*, October 2021.

Ideally, tobacco duty would be abolished due to the absence of external costs to justify it, but given the combination of low esteem of tobacco among policy makers and the large deficit that may be implausible. Instead, reform should focus on the needless complexity of having multiple rates of duty by reducing the most onerous rates to match the less onerous rate for tobacco for heating or hand rolling tobacco products.

Windfall taxes on tobacco companies, along with annual levies on tobacco company profits, are distortionary and should be ruled out. They add uncertainty to the tax system and open up questions about whether a wide range of industries or companies might be the next 'one off' target for a tax raid.

National insurance

What are the long-standing problems?

Like any income tax, national insurance weakens incentives to engage in productive economic activity. In some cases and for some people, it makes the difference between an activity being worthwhile or not. This means that some jobs and promotions are not sought by workers, and some are not created by employers because some investments are not made in the first place. This leads to lower employment, lower incomes and lower productivity. The difference between taxes on consumption and taxes on income is that the income taxes also hit investment, which makes them disproportionately damaging to the economy. More directly, they reduce the amount of money workers and investors have to spend on what they value for themselves and their families.

Since changes to the state pension removed its link to national insurance only a tiny fraction of its receipts can now be attributed to contribution-dependent welfare spending, Consequently, national insurance contributions are effectively a pair of duplicate income tax systems. This creates a bloated tax code which leads to inflated numbers of planning and avoidance agents and compliance officials to monitor and understand the system on behalf of taxpayers and HMRC. Economically, the employer charge operates as another income tax on workers because labour markets reflect the charge through adjusting wages. In the short term, however, before changes are passed through to wages, changes operate as a business tax on employers. This means that some tax (and wages) are hidden from employees, making it harder for employees to understand what their full compensation and tax liabilities are.

What are the emerging problems?

Technology is disrupting traditional working patterns and creating a growing 'gig economy' of workers who are self-employed or something like it. As it grows, the fiscal and economic impact of the disparity between the tax treatment of the self-employed and standard employees also grows. Taxing employment more heavily than self-employment means that some workers who would prefer an employment relationship if the tax liabilities were equal will opt to be self-employed to take advantage of the lighter tax burden. That distortion is harmful and is growing. In turn, that growth reduces tax receipts as work shifts from employment to self-employment, meaning either higher borrowing, spending reductions or rises in other taxes.

The recent creation of the health and social care levy, due to be implemented in April 2023 but scrapped in the September 2022 growth plan would have created yet another set of taxes on income. Rates of national insurance were raised by 1.25 percentage points and these were planned to be reversed at the same time as implementing the new levies in the new fiscal year. The fact that this major programme of tax complexification was built on national insurance shows how the existence of national insurance itself poses a risk to tax simplicity.

As the average incomes of people over the state pension age have risen relative to working-age taxpayers, the unfairness on working-age taxpayers of being subject to all income taxes while those above the state pension age enjoy exemptions from some of them has become harder to justify.[52]

What proposals for reform have been made?

The TaxPayers' Alliance has run a long campaign to abolish national insurance as a separate tax and merge it into income tax, beginning in 2011 with *Abolish National Insurance*.[53] Merger would make the

[52] Hood, A., *Pensioners are no longer worse off than the rest of the population – a triumph of decades of social policy*, Institute for Fiscal Studies, 24 February 2015, ifs.org.uk/articles/pensioners-are-no-longer-worse-rest-population-triumph-decades-social-policy (accessed 9 October 2022).

system simpler, cheaper to administrate with one set of rules instead of three, and more transparent than "the 'smokes and mirrors' accounting devices of National Insurance". Most recently, the TaxPayers' Alliance recommended replacing employer national insurance contributions with a temporary payroll tax on pay above £9,500,[54] while raising the threshold to match the income tax personal allowance (currently £12,570) at the same time as aligning rules with income tax on employee national insurance.[55]

Heath et al recommended the same as part of their wholesale reform of all taxes on income into a 'single income tax': "National Insurance should be abolished, with all the rates and schedules of Income Tax replaced by a single proportionate tax on labour income. Such a change would require careful implementation and a serious attempt to inform the public to avoid the obvious danger of it being perceived as a tax rise, but would be worthwhile."

Mirrlees et al were similarly clear: "National Insurance is not a true social insurance scheme; it is just another tax on earnings, and the current system invites politicians to play games with NICs without acknowledging that these are essentially part of the taxation of labour income. The two systems need to be merged. Given our proposal to apply the same rate schedule to income from all sources, integration would be a good opportunity to, in effect, broaden the NICs base to cover self-employment and capital income in full".

In a paper published by the Centre for Policy Studies, David Martin argued that pension reforms in 2011 "effectively remove the last justification for the continuation of NICs" which are "riddled with anomalies, complexity and a lack of cohesion".[56] He recommended merging employee national insurance with income tax "once the fiscal situation has improved as it will require a small overall tax cut", adding that a "simple payroll tax will also be needed to cover the cost of abolishing employers' NICs".

Alfie Sterling of IPPR called for income tax and employee national insurance to be "combined into a single tax schedule" and tax bands to be replaced with a "'formula-based' system such that every taxpayer's marginal rate would depend on their own precise level of income" because the current system "creates perverse economic incentives and helps to create political opposition to tax rises".[57] Employer national insurance was out of scope but a separate report by Grace Blakeley recommended reform to "increase the rate of corporation tax to 24 per cent and use the revenues to reduce the rate of employers' National Insurance contributions to 11.4 per cent. We believe this to be a practicable and politically feasible proposal which could be achieved over, say, a five-year period."[58]

What reforms resolve the problems best?

The emerging problem with national insurance is that its differences with income tax are increasing the scope of the distortions in the labour market between standard employment and self-employment. The most straightforward way to address this emerging problem would be to make the treatment of employees and the self-employed equal. That would entail equalising rates of national insurance and the treatment of expenses. That, however, involves one or other of a substantial tax increase for the self-employed or a substantial loss of revenues from a tax cut for the employed. If a

[53] Meakin, R., *Abolish National Insurance: A simpler and more transparent tax system*, TaxPayers' Alliance, 2012.
[54] TaxPayers' Alliance, *Tax reforms to secure a recovery from coronavirus*, June 2020.
[55] Meakin, R., *One big hit: fixing national insurance for good*, TaxPayers' Alliance, February 2020.
[56] Martin., D., *Abolish NICs: Towards a more honest, fairer and simpler system*, Centre for Policy Studies, November 2010.
[57] Stirling, A., *Tapering Over the Tax: Reforming taxation of income in the UK*, Institute for Public Policy Research, March 2018.
[58] Blakeley, G., *Fair dues: Rebalancing business taxation in the UK*, Institute for Public Policy Research, March 2018.

government were to address this most politically difficult aspect of reform, the additional benefits available from a full merger would have even smaller additional costs.

The problems of complexity (operating three separate taxes on the same income), administrative expense (accountancy and HMRC staff being required to navigate the rules relating to three functionally equivalent sets of taxes in place of one) and the transparency deficit (obscuring public understanding and debate around tax) remain. Critics argue that modern payroll software means that the benefits of a straightforward, simple tax system have shrunk. This is only partly true. The fewer rates of tax the better, and the fewer thresholds and bases the better, too. Replacing a basic rate band with a formula would make it even more difficult for a typical taxpayer or employer to understand a tax liability on earnings.

The best reform to solve these problems would therefore be fully merging national insurance into income tax. That this has not already happened despite the powerful case for it is testament to the political difficulty it entails. As well as the fiscal implications, edge cases involving 'losers' from reform require special transitory treatment and political skill would be required to present it as beneficial to most taxpayers, and indeed careful design of the details to ensure such a presentation would be honest. But that is certainly possible.

Those in self-employment or with multiple jobs who might lose out could be given a temporary transitional relief, for example. Existing pensioners (and those near to retirement) could be given an option to retain the existing tax rates on their pension incomes. Such measures would neutralise the political difficulties at the expense of retaining some transitional complexity for some groups (and some foregone revenue for the exchequer). But a much simpler, more honest and cheaper tax system would be achieved.

Business rates

What are the long-standing problems?

Business rates can be seen as fulfilling two tax functions. The first is to tax the value of the land on which business premises sit. The second is to tax the value of the buildings and any other improvements made to the land. The first leads to very little economic distortion and destruction. The second, by contrast, is highly destructive. The effect of the second dominates.

Taxing the unimproved value of business land is relatively unproblematic. Taxing the increase in the rental value of a premises caused by an improvement of nearby facilities or demand will do little to discourage such improvements. Introducing any tax harms incentives but, because owners are largely not responsible for demand or nearby facilities, taxing unimproved land value should not prompt much reduction in their provision.

By contrast, the tax on the value of improvements and buildings is highly problematic. It distorts property use away from commercial use in favour of residential use and other production inputs, because the consumption value of business property is taxed, like all other inputs, through VAT. Taxing its consumption through business rates prompts businesses to reduce their use of commercial property and prompts landowners to shift property away from double-taxed commercial use to relatively untaxed residential use.

To make tax neutral between commercial and non-commercial use, commercial use must be untaxed if the consumption goods and services it is used to produce are themselves taxed. The distortions caused by the arbitrary nature of business rates harm productivity and prosperity, leading to some combination of lower incomes and fewer jobs (depending on how labour markets respond to the imposition).

What are the emerging problems?

Advances in e-commerce have disrupted the business model of traditional high streets in areas with higher rents and business rates in favour of online deliveries handled from distribution centres in cheaper locations. To some extent, this phenomenon can be seen as a shift in consumer preferences to which traditional retailers must adapt. The problem is that business rates discourage commercial use of property in more expensive town centre locations. The standard business rates multiplier is 0.512 this year. In other words, business rates are roughly equivalent to half of commercial rents on a property. By contrast council tax, the equivalent tax on residential property, is typically far smaller than half the rent.[59,60]

The heavier tax burden on a commercial use of property relative to a residential use means that businesses are disadvantaged by the tax system relative to households. The shortage of residential property is commonly referred to as the 'housing crisis' but this shortage of property affects businesses, too. The consequences for businesses are less striking than they are for households but the high costs of property causes firms to lose their premises and locate in more disadvantageous locations, too. In turn, the lower productivity and job losses translate into lower incomes and fewer job opportunities.

These problems are made worse by the extent that business rates charges more for property of the same value than council tax. Some town centre retail properties would surely be made unviable by

[59] The average UK rent was £1,007 per calendar month in 2020, or £12,084 annually, according to Homelet. The average annual council tax was £1,818 in 2020-21. See www.propertyreporter.co.uk/landlords/uk-average-rent-breaks-the-1000-per-month-barrier-for-the-first-time-on-record.html

[60] Department for Levelling up, Housing and Communities, *Council tax levels set by local authorities: England 2022-23*, 30 March 2022.

the rise of online shopping and home delivery. Where they are converted to other commercial uses liable to business rates, that indicates that business rates are not likely to be a significant issue. But in many cases where owners convert properties to residential use the deciding factor is likely to be the relatively heavy burden of business rates.

What proposals for reform have been made?

The Confederation of British Industry (CBI) has a campaign for business rates reform with three policy recommendations: a permanent cap in the headline rate to prevent further rises and "deliver the certainty business needs", an (unspecified) mechanism to "enable businesses to recoup costs before rates rise in-line with the new value of the property" and aligning rates better "to the economic cycle".[61]

Similarly, Basey recommended allowing a fall in prevailing rental values exceeding a given percentage to be considered a material change in circumstances allowing a revaluation of a premises.[62]

The British Retail Consortium (BRC) has called for a 'sustainable' level "at least 20 per cent lower than the current level" with more frequent revaluations and a faster valuation appeals process.[63] Meanwhile, Marks and Spencer chief executive Steve Rowe called for the headline rate to be cut from 50p to its 1990 level of 35p. In addition, revaluations should be more frequent and where valuations fall that should affect charges without delay. The fiscal impact of this should be offset with "a modest increase" in corporation tax.[64]

Kevin Hollinrake MP recently tabled a ten-minute rule bill which would have abolished business rates entirely.[65] He advocated raising VAT to replace the foregone revenues and estimated that a rise from 20 to 23 per cent in the main rate would be enough. This would, he argued, level "the playing field between online and high street businesses" while allowing the system to "completely dispense with the convoluted business rates system including revaluations, check, challenge, appeal, annual bills and debt collection" meaning that it would "no longer need the myriad of reliefs available to small business, charities, empty properties".[66]

Mirrlees et al recommend "focusing on finding ways to replace the economically damaging business rates system with a land value tax" which "should be implemented gradually, with transitional protection for those most affected" and "agricultural land should be brought within the net".[67] The authors suggest a rate "somewhere in the region of 4% of land value levied once a year". Notably, they argue that it should also replace stamp duty land tax on business property as well as business rates.

Similarly, Booth et al recommended a 'location value tax' which "should be considered alongside the array of related taxes which ought to be abolished: business rates; stamp duty land tax; council tax (which in any case should be replaced by a previously discussed simulated extension of VAT to housing); and fiddly local quasi-taxes (the community infrastructure levy and so-called 'affordable housing requirements' and other obligations under 'section 106' of the Town and Country Planning Act 1990)". The rationale is that it causes "little economic damage, because land cannot be hidden or

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[61] Confederation of British Industry, *A fair business rates system that rewards investment*, 2022, www.cbi.org.uk/our-campaigns/a-fair-business-rates-system-that-rewards-investment/, (accessed 3 March 2022).
[62] Basey, P., TaxPayers' Alliance, *Business Rates Reform*, 1 December 2018, www.taxpayersalliance.com/business_rates_reform (accessed 6 October 2022).
[63] British Retail Consortium, *Business Taxation & Rates*, 2022, brc.org.uk/priorities/business-rates/, (accessed 3 March 2022).
[64] Rowe, S., If retail is to survive, the UK's archaic business rates must change, *Financial Times*, 19 February 2021.
[65] UK Parliament, *Abolition of Business Rates Bill*, 2021, bills.parliament.uk/bills/2818, (accessed 3 March 2022).
[66] Kevinhollinrake.org.uk, *It's time to abolish business rates,* January 2021, www.kevinhollinrake.org.uk/campaigns/its-time-abolish-business-rates, (accessed 3 March 2022).
[67] Mirrlees, J. et al., *The Mirlees Review: Chapter 16: The Taxation of Land and Property*, Oxford University Press, 2011.

taken overseas to avoid the tax and owners cannot respond to the tax by producing less value in its location – for the reason that they are not responsible for it in the first place".[68]

Clougherty et al concurred for the Centre for Policy Studies and the Tax Foundation saying it "should reflect the value of the underlying site given its permitted use, but should exclude buildings, plant and machinery, and any other improvements". [69] They recommended broadening the VAT base to recoup lost revenue.

What reforms resolve the problems best?

Business voices tend to advocate modest reform and reductions in the overall level of business rates while policy institutes are more likely to advocate the effective abolition of business rates as we know it by turning it into a tax on land value. Policy makers whose objective is the best reform without political considerations should look to the policy institutes' consensus and remove buildings, improvements and machinery value from business rates assessments while expanding its scope by removing exemptions. Empty property relief, for example, would no longer serve its function of avoiding demolitions because demolitions would not affect the charge under a reformed business rates which no longer taxed buildings.

Arguably the most interesting reform is complete abolition and replacement with VAT. For obvious reasons this would offer a substantial simplification of the tax system but has significant drawbacks, too. The 'incidence' (that is, who becomes economically worse off rather than who administratively 'pays') of VAT is likely to fall more on consumers than business rates, which is more likely to fall on commercial premises owners, at least after rents have had time to adjust.[70] There are efficiency gains available from eliminating the effort expended in administering and policing the business rates system. These are likely to outweigh any loss from greater avoidance and compliance effort in an equivalent rise in VAT. But to the extent to which business rates functions as a land value tax it functions as the least damaging tax available. VAT is more distortionary than that and to that extent the reform would weaken the supply side of the economy, by transferring the burden of taxation from commercial landowners to workers.

These problems mean that the best reform would be to deduct the value of structures and improvements from business rates while eliminating empty property relief, leaving it effectively as a land value tax. The administrative liability should be transferred to the owner from the occupier, to reflect the economic reality of the burden. Further research into business opinion at all levels would be useful, however, to identify technical challenges that may arise from such reforms.

[68] Booth, P. et al., *Taxation, Government Spending and Economic* Growth, Institute of Economic Affairs, 2016.
[69] Centre for Policy Studies & Tax Foundation, *A framework for the future: reforming the UK tax system*, 2020.
[70] Mehdi, N., *The capitalization of business rates: An empirical study of tax incidence in six London boroughs*, London School of Economics, 2003.

High street retail tax

What are the long-standing problems?

High street retailing has long been in decline as other forms of distribution have gained market share. In the late twentieth century, expanding ownership of cars, fridges and freezers made it increasingly viable for supermarkets to leave high streets and relocate to out-of-town sites, enabling shoppers to drive to do their shopping in less frequent but bigger transactions, saving time and expanding choice. Shopping malls and retail parks played a similar role.

More recently, internet shopping has won market share from physical shops including those on high streets but shopping malls and out-of-town supermarkets and retail parks, too. This was accelerated rapidly by the coronavirus pandemic as shoppers avoided physical proximity to other people and government mandated closures of many premises, anyway.

To some extent, the initial switch to supermarkets and then the switch to online shopping represent a spontaneous change in consumer preferences, enabled by new technology (affordable cars, fridges and freezers and then affordable personal computers). However, business rates means the tax system disproportionately taxes commercial property relative to residential, which provides a tax penalty to high street retailers relative to other physical forms of shops and to all physical retailing premises relative to online retailing.

What are the emerging problems?

High streets have suffered from a loss of custom as consumers have switched spending online to companies like Netflix, Amazon and Asos. While some argue that the high street has intrinsic value that should be preserved by government intervention, traditional retailers bear a disproportionate share of the tax burden due to business rates, which tax the higher value locations where traditional retailers operate from more heavily compared to the lower value distribution hubs used by online delivery companies.

Attempting to save high streets for intrinsic reasons would be economically distortionary and harmful to those who prefer shopping online, including staff employed to market and deliver goods and services online. But the objective of providing tax neutrality between online and traditional retail is stronger. The problem is that the distortion is a function of business rates and that, in turn, should be split into two parts to analyse what is happening.

Business rates can be seen as fulfilling two tax functions (see previous section on business rates for further details). The first is to tax the value of the land on which business premises sit. The second is to tax the value of the buildings and any other improvements made to the land. The second part should be abolished to avoid a distortionary intermediate tax on business value creation (that is anyway already captured by VAT). This applies to distribution equipment in online retailers' distribution centres as it does to décor and fittings in traditional high street shops. The more significant difference between an online retailer's costs and an equivalent high street shop's, however, is the land value under the respective premises.

The evidence suggests that the economic incidence, that is, who is made worse off, of business rates falls on the owners of the premises rather than the occupant, at least in the medium term, once rents have been negotiated again.[71] But, as discussed in the business rates section, a heavier tax burden on commercial property relative to residential property provides a distortionary incentive for landowners in favour of residential use. This means that commercial property is more expensive than

[71] Cambridge Econometrics, *The relationship between national non-domestic rates and rents on commercial property: empirical evidence from enterprise zones*, 2008.

it would otherwise be and that in turn disproportionately affects businesses which make a greater use of commercial property in their operation. In other words, high street retailers relative to online retailers.

What proposals for reform have been made?

As the treasury's '*Online sales tax: an option to help rebalance taxation of the retail sector*' consultation explained, online sales tax "proponents argue that in-store retailers pay a disproportionate share of business rates". Among others, it has been proposed by the major retailer Tesco in a letter to the treasury select committee in 2019.[72] The retailer argued that they "do not agree with the view that a reduction in business rates will lead to an increase in rents in the coming years. This view is based on economic theory, which we do not see borne out in practice."[73]

By contrast, the British Retail Consortium has opposed the measure.[74] Eloise Walker, head of corporate tax at Pinsent Mason said "once you start looking at the challenges of introducing the tax in practice it is far from a silver bullet" and that it was "disappointing that HM Treasury is thinking that imposing new taxes instead of fixing the problems with old taxes is the way forward". Similarly, professor Len Shackleton concluded that "taxing newer ways of conducting business cannot be the answer",[75] arguing that the problems high street retailers face is primarily one of changing consumer preferences and that high streets themselves ought to be allowed to reflect that through liberalising land use restrictions.

Kevin Hollinrake MP recently tabled a ten-minute rule bill which would have abolished business rates entirely.[76] He advocated raising VAT to replace the foregone revenues and estimated that a rise from 20 to 23 per cent in the main rate would be enough. This would, he argued, level "the playing field between online and high street businesses" while allowing the system to "completely dispense with the convoluted business rates system including revaluations, check, challenge, appeal, annual bills and debt collection" meaning that it would "no longer need the myriad of reliefs available to small business, charities, empty properties".[77]

What reforms resolve the problems best?

An online sales tax is a weak proposal. It seeks to offer redress for a problem that is not a legitimate concern of a neutral, efficient tax system: the shift in consumer preferences from incumbent practices to newer, disruptive ones. The extent to which this shift might be artificially accelerated by the tax system through business rates has to be small because the higher business rates bills which are payable by traditional retailers are predominantly a function of land values rather than structures and fittings, which means that their value is especially likely to be reflected in rents.

It would be a secondary consumption tax arbitrarily directed at and borne by online shopping consumers. This raises fairness questions about those groups who rely on online shopping services, notably those living in areas which lack good traditional shopping facilities (such as rural areas) and people with mobility impairments who find leaving the home, using transport or navigating shops difficult. The only reason to support an online sales tax would be to frustrate consumers' preferences out of a (mistaken) belief that society would be better off if more of us were made to

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[72] House of Commons treasury committee, *Impact of business rates on business*, 22 October 2019.
[73] HM Treasury, *Online sales tax: Assessing an option to help rebalance taxation of the retail sector*, February 2022.
[74] Partington, R., Online sales tax aims to 'shift balance' as UK high streets struggle, *The Guardian*, 7 February 2021.
[75] Shackleton, L., *Online sales taxes: wrong in theory, an administrative nightmare in practice*, Institute of Economics Affairs, 7 March 2022, iea.org.uk/online-sales-taxes-wrong-in-theory-an-administrative-nightmare-in-practice/, (accessed 19 March 2022).
[76] UK Parliament, *Abolition of Business Rates Bill*, 2021, https://bills.parliament.uk/bills/2818, (accessed 19 March 2022).
[77] Hollinrake, K., *It's time to abolish business rates,* January 2021, www.kevinhollinrake.org.uk/campaigns/its-time-abolish-business-rates, (accessed 19 March 2022).

shop in traditional retailers at the expense of our online shopping. The government announced in the autumn statement that it will not introduce an online sales tax and will respond to its consultation shortly.

For obvious reasons the abolition of business rates and their replacement of foregone revenue would offer a substantial simplification of the tax system but has significant drawbacks, too. The 'incidence' (that is, who becomes economically worse off rather than who administratively 'pays') of VAT is likely to fall more on consumers than business rates, which is more likely to fall on commercial premises owners, at least after rents have had time to adjust.[78]

There are efficiency gains available from eliminating the effort expended in administering and policing the business rates system. These are likely to outweigh any loss from greater avoidance and compliance effort in an equivalent rise in VAT. But to the extent to which business rates functions as a land value tax it functions as the least damaging tax available. VAT is more distortionary than that and to that extent the reform would weaken the supply side of the economy, by transferring the burden of taxation from commercial landowners to workers. Nonetheless, this proposal scores well in terms of apparent fairness between online and traditional retailing sectors while not being affected by the considerations regarding intangible exports.

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[78] Mehdi, N., *The capitalization of business rates: An empirical study of tax incidence in six London boroughs*, London School of Economics, 2003.

Corporation tax

What are the long-standing problems?

The explosion of tax complexity in recent decades owes much to the conceptual difficulties with trying to accurately attribute – and therefore tax – value creation in an increasingly globalised and information-driven economy. When corporate profits arose largely from the manufacture, distribution and retail of goods, usually in the same country, allocating those profits to tax jurisdictions was relatively simple. But the well-publicised tax affairs of Starbucks UK (with coffee grown in Africa, bought in Switzerland, roasted in the Netherlands and sold under a royalty to the US company) illustrates how ill-suited corporation tax is to a modern, globalised economy. Few of these stages have tradable prices, hence the need for complex 'transfer pricing' rules to determine the pricing to transfer value between linked companies. The system is riddled with rules designed to patch up fundamental flaws like this.

Profit is a measure of how efficiently a company operates. The value its operations provide to shareholders, measured in sales less the value consumed in costs, not only provides investors with income but also serves as a measure of efficiency and waste. Taxing profits weakens this measure and weakens the incentive for investors to manage companies well.

The difference between taxing profits and taxing distributions is, ultimately, investment. Profits held but not distributed will either be invested directly or indirectly via banks or other financial intermediaries. As the long-term source of growth, investment is the last thing the tax system should target.

What are the emerging problems?

Ever enhancing telecommunications capabilities and a greater number of advanced economies have made it easier for companies to relocate between tax jurisdictions. The experience of the pandemic in spreading remote working in particular has weakened the link to geography in many sectors, although it still remains to be seen how much of this can be sustained in 'normal times'. The earlier manifestation of the underlying trends have exerted a downward pressure on corporate tax rates since the 1980s and while that has markedly slowed since the great financial crash, the widespread adoption of remote working patterns may intensify the competitive pressure on tax authorities once again.

This pressure could become markedly more intense if a major, advanced economy were to switch its corporate tax base from profits to distributions. In recent years, Latvia and Georgia have copied the Estonian example of using distributions for the corporate tax base. The advantages to a firm of being able to retain earnings for reinvestment must be weighed against the downsides of locating to very small formerly Soviet markets. Tax is an important factor influencing incorporation decisions but it is not the only one. A large economy would be a much more competitive prospect and could cause a domino effect if others followed suit to retain their corporate appeal. It is worth noting that OECD governments have agreed, at least in theory, to avoid tax competition through 'base erosion and profit sharing' measures, including a 15 per cent minimum tax rate. A government wishing to abolish the profits tax base may have to revise such agreements, however, although Latvia and Estonia are signatories so this ought not to be insurmountable.

What proposals for reform have been made?

Auerbach et al in Mirrlees *Taxation by Design* consider source, residence and destination bases of taxes along with cash flow taxes versus an allowance for corporate equity (and an allowance for corporate capital) along with the traditional corporate income tax status quo.[79] A standard cash flow tax would tax 'real' income less expenses rather than profit, in other words allow full expensing of investments while disallowing interest as a cost. They concluded that a destination-based cash flow tax (that is, one that assesses cash flows where the sales take place rather than an 'origin-based' one which assesses the base where the business is located) is the best option albeit with border adjustments (disregarding export sales but taxing imports) citing elimination of the debt-equity bias, removal of tax on marginal investments and reductions in the scope for profit shifting. An allowance for corporate equity or capital was rejected due to concerns regarding transfer pricing and profit shifting.

Heath et al in *The Single Income Tax* proposed a unified tax on income incorporating a corporate income tax that is conceptually broadly equivalent to the Mirrlees proposal, except based on distributions.[80] Distributions to capital would be taxed with a system of transferrable credits for investment designed to eliminate incumbency bias. The proposal would eliminate tax on investment and the debt-equity bias. This system was also recommended by Booth et al.[81]

The Institute for Public Policy Research (IPPR) considered the changing economy in its report *A new plan for the economy* and recommended raising the headline rate from 19 per cent (and then scheduled to fall to 17 per cent) to 24 per cent "while simplifying the system of reliefs and allowances to increase the tax base".[82] Despite this, they also said "there is scope to raise the level of investment allowances to tilt corporate incentives towards investment". Nonetheless, they recommend adding an 'alternative minimum corporation tax' to the tax code intended for companies "which consistently reported low profits in the UK and were unable to show that these were genuine" on a formulary apportionment basis.

The Adam Smith Institute has advocated full expensing for investment on machinery and buildings as abolishing the 'factory tax',[83] which has been recommended by various groups such as the Centre for Policy Studies.[84] Budget 2021 introduced temporary full expensing for two years from April 2021 intended to salvage marginal investment due to the pandemic. The budget also raised the rate from 19 to 25 per cent from 2023, which will have a counteracting depressing effect on investment. This rise was cancelled in the previous chancellor's 'growth plan' in September 2022 but reinstated by the current chancellor shortly afterwards in October.

What reforms resolve the problems best?

Given the background of increasing mobility of capital and the UK's particularly global, open economy, the pressure to remain competitive in tax policy is strong, as are the advantages of attracting inward investment as well as enhancing incentives for domestic investment. Raising headline rates, as proposed by the IPPR and planned by the previous-but-one chancellor, were rightly rejected by the previous chancellor in September, especially if the effective average rate would be raised further still by a programme of removing reliefs and allowances. The tax code is far too complex, however, and simplification should be welcomed, which is why adding an alternative minimum tax should also be rejected. The prospect of a parallel system of corporate tax to factor into corporate decisions would disadvantage British competitiveness.

[79] Mirrlees, J. et al., *The Mirrlees Review: Chapter 9: Taxing Corporate Income*, Oxford University Press, 2011.
[80] Meade's 'S' base rather than the 'R + F' base favoured by Mirrlees.
[81] Booth, P. et al., *Taxation, Government Spending and Economic Growth*, Institute of Economic Affairs, 2016.
[82] Institute for Public Policy Research, *Prosperity and Justice: A Plan For A New Economy*, 2018.
[83] Dumitriu, S., & Serodio. P., *Abolishing The Factory Tax: How to Boost Investment and Level Up Britain*, 19 February 2020, Adam Smith Institute.
[84] Entin, S., *Boosting Growth as the UK Leaves the European Union*, 6 March 2020, Centre for Policy Studies.

An allowance for corporate equity or debt would address the debt-equity bias inherent within corporation tax to some extent, but would only have a small effect on investment,[85] and would add further complexity to the tax system and widen the gap between the headline rate and the average effective rate, which already causes confusion regarding existing reliefs and allowances. For this reason, full expensing of investment in equipment, buildings and skills is not ideal for the public understanding of how the tax system operates, either. But it does provide a quick and easy solution to the problem of tax getting in the way of investment and so the drawbacks are worth 'paying' to purchase the higher productivity, growth and incomes it enables.

Ultimately, however, a corporation tax with full expensing is much of the way towards a cash flow tax such as those proposed by Mirrlees or Heath in terms of exchequer impact yet without the benefits of radical simplification and removal of the worst economic distortions. The ambition of the single income tax proposed by Heath et al far exceeds the reforms recommended by Mirrlees. As well as removing distortions between debt and equity and removing tax on investment, the distribution base in their proposal also removes the need to calculate profits at all, even on a cash basis. Little beyond transfer pricing and disguised distributions would remain.

Another substantial advantage is that the conceptual tax base would correspond to what would actually be taxed. A cash flow tax on real profits would still diverge from accounting profits. But if a system unambiguously rejects tax on profits and instead taxes distributions, that divergence loses salience.

Like many firms which aim to expand their market share, Amazon operates with very low profit margins which means that their corporation tax liabilities as a share of their sales are especially low. Media reports sometimes compare Amazon's (profits-based) corporation tax liabilities to their sales. Such reports suggest that ill-considered comparisons are unlikely to disappear entirely if the corporate tax base switches from profits to distributions. But they lack the power of comparisons between accounting and tax profits because they are clearly not comparable and are easily refutable.

By contrast, comparing the accounting profits against the tax liabilities of a firm which operates normal profit margins but takes advantage of tax reliefs for investment (because it is in an industry that is capital-intensive) or carried forward losses (because it made losses in previous years) is less straight-forward. A tax on distributions would therefore be more robust to ill-founded criticism and consequently be more politically sustainable.

[85] Hebous, S., & Klemm, A., *A Destination-Based Allowance for Corporate Equity*, November 2018, CESifo.

Digital presence taxes

What are the long-standing problems?

Digital taxes are either very recent in the case of the digital services tax or proposals in other cases, such as an online sales tax. The desire to tax online activity more heavily has existed for many years, at least since the 1998 American Internet Tax Freedom Act which prohibited federal, state and local governments from levying internet-only taxes, such as on internet access, bandwidth or emails.

The Clinton administration passed that act primarily to encourage the development of nascent online commerce but it also serves to ensure sound principles of good taxation are upheld, preventing harmful impositions on the economy. One of the four principles of tax cited by Adam Smith was that it should be "so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state".[86]

An important way that tax can take value out of the pockets of the people is by distorting decisions arbitrarily, prompting people to make suboptimal choices in comparison to those we would make if taxes treated such decisions neutrally. Taxes on internet access, bandwidth or emails would be akin to taxes on entrances into physical shops, till technology or conversations with shop staff in that they would distort economic decision making. They would also offend Smith's proportionality principle which holds that tax should be levied "in proportion to the revenue which they respectively enjoy under the protection of the state".[87]

What are the emerging problems?

Until the last few years, such taxes have been relatively rare in the west although some emerging economies have implemented them. Pakistan introduced a broadband tax in 2015.[88] Perhaps the most eye-catching example of a proposal in the west was made in 2011 by the late general secretary of the RMT train workers' union to levy a penny of tax per email.[89] And in 2010, he suggested a penny tax on text messages would eliminate the deficit.[90] But the most substantial form of digital taxation proposals have been online sales taxes, digital services taxes and the 'base erosion and profit shifting' (BEPS) agreements relating to corporate income taxes, co-ordinated by the OECD.

In addition to the high street and physical retailing issues raised to justify an online sales tax (see section on high street retail tax), justifications for digital taxes tend to fall into one of two groups: fair international allocation of taxes on profits and taxing untaxed profits.

Fair international allocation of profits.

The expansion of the digital economy has been unequal and many suggest that the traditional way of measuring how much of a multinational enterprise's value is allocated between the jurisdictions in which it operates is no longer appropriate. This is due to the extent to which profits are dependent on intangible assets and services which can be inaccurately 'shifted' for tax avoidance purposes rather than substantive commercial reasons. At least some of the value created by a multinational enterprise occurs as a result of a consumer's location and therefore ought to be taxable by that jurisdiction rather than the one where, typically, the most useful processes in the production chain occur.

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86 Smith, A., *An Inquiry into the Nature and Causes of the Wealth of Nations*, 1776, MetaLibri Digital Library, p.640.
87 Smith, A., *An Inquiry into the Nature and Causes of the Wealth of Nations*, 1776, MetaLibri Digital Library, p.639.
88 BBC, *Broadband tax hits Pakistan internet users,* 23 September 2015, www.bbc.co.uk/news/av/business-34331699, (20 March 2020).
89 Prince, R., Bob Crow: email should be taxed to pay off deficit, *The Daily Telegraph*, 28 February 2011.
90 Ray, B.*, Txt tax would wipe out half UK deficit, claims union* baron, 14 December 2010, www.theregister.com/2010/12/14/text_tax/, (accessed 20 March 2020).

The long history of the rise of intangible value as a share of economic activity and the relatively recent interest in attributing value creation to consumers' locations rather than producers' locations raises questions about whether the interest genuinely arises from tax principles or whether it is just a function of the gap between American and European success in creating companies and value in the digital economy. The EU's agreement on digital services taxes in 2018, the commission said, were "intended as a temporary solution to help Member States claw back some revenues and to address the immediate risks to EU competitiveness".[91] Among the ten largest digital economy companies in the world, only the tenth largest, Booking.com, is European.[92] Two are Chinese, Alibaba and Tencent. The remaining seven, including the three largest, Amazon, Alphabet (Google) and Meta (Facebook), are all American.

Should a good tax system apportion the value created by a company according to where its customers are or where the valuable activity takes place? The ideal answer is neither. The creation of value should be shielded from the deleterious effects of taxation as far as possible. That principle underpins why there is broad agreement that investment should not be taxed even if the income from that investment is. The absurd effect of taxing economic activity by value creation is that beneficiaries of more productive companies who have a lower total income face a higher tax burden than beneficiaries of less productive companies who have a higher total income. It also has the damaging effect of transferring resources from more productive enterprises to less productive ones.

Setting aside whether value creation should be taxed in the first place, does it make sense to apportion value by the location of the consumer rather than where the producer carries out the functions that create it? It is hard to see a rationale beyond an attempt to transfer tax receipts earned in another jurisdiction from their tax authority's to your own. The argument that the value is in part created by the consumers' prosperity and the market infrastructure is weak. Consumers are prosperous only because they are also productive producers and consumption is more neutrally taxed via broad-based consumption taxes, such as VAT. And any (financial) value created by an overseas digital business through sales generated by advertising to UK consumers is captured to the extent that consumption taxes apply (any products or services that are covered by VAT, in the case of the UK).

There are also questions about whether attempting to tax value creation more by consumption location rather than process location would be advantageous for the UK treasury. The British economy is more dependent on intangible exports than most and not just in financial services, which have been excluded from the current BEPS agreement. Pharmaceuticals, entertainment and architecture and creative industries are among British intangible exports. There are obvious risks to the UK exchequer from this principle being extended. As Macfarlanes head of policy (and former chief secretary to the treasury) David Gauke put it, wouldn't the UK "rather be able to tax the profits where the value is created not where the customers are? In the long term, that might suit us better."[93]

Capturing untaxed profits.

By exploiting differences in tax legislation, companies have been able to hold earnings that are not taxed anywhere, typically a US company which held its profits in a holding company in a tax haven. Consumers' tax authorities did not tax the profits, because the value was not created in their countries. It may not have been taxed by a European distribution company's authority, such as in

[91] European Commission, *Questions and Answers on a Fair and Efficient Tax System in the EU for the Digital Single Market*, 21 March 2018, ec.europa.eu/commission/presscorner/detail/en/MEMO_18_2141, (accessed 18 March 2022).
[92] Statista, *Market capitalization of the biggest internet companies worldwide as 2021 (in billion U.S. dollars)*, February 2021, www.statista.com/statistics/277483/market-value-of-the-largest-internet-companies-worldwide/, (accessed 18 March 2022).
[93] Gauke, D., *twitter.com/DavidGauke/status/1220048238935494658*, 22 January 2020, (accessed 19 March 2022).

Ireland. Neither will it have been taxed in the tax haven. And because the profits had not yet been repatriated to the principal US company for distribution to shareholders, they were not taxed by the US's Internal Revenue Service, either. It is said that this distorts economies in favour of intangible and especially digital operators and more generally deprives tax authorities of the appropriate level of rights to tax profits which helps to fund public services, including those on which digital operators rely for a market.

A problem with this is that foreign earnings for American companies have been taxable since 2017, albeit at a lower rate of 10.5 per cent (subsequently increased to 12.5 per cent), due to tax reforms undertaken by the previous president.[94] If US companies' overseas profits are the target, it is a smaller one than it once was.

What proposals for reform have been made?

Proposals to reform or abolish business rates and introduce an online services tax are discussed in the high street retailing tax section. But beyond proposals addressing physical retailing, reforms fall into two groups: the 'base erosion and profit shifting' (BEPS) reforms and digital services taxes.

BEPS

In 2015, G20 finance ministers agreed standards for national tax systems aimed at reducing tax avoidance through 'base erosion and profit shifting' (BEPS) tools and requested that the OECD begin a project to explore details of implementation. In 2011 they announced 130 and then 136 countries (of the 139) had reached a final agreement on a 'two pillar' approach to corporate taxation of multinational enterprises.

The first pillar is a new set of rules that allows countries to tax a fraction (25 per cent) of a overseas multinational company's global profits above a threshold based on where the users live rather than where the value was created, providing the company is both large enough (a global turnover larger than €20 billion) and profitable enough (pre-tax profits over 10 per cent of revenues) to qualify and that the company earns enough revenues in the country (€1 million if the country has a GDP larger than €40 billion, or €250,000 if not).[95]

The second is an agreed minimum tax rate of 15 per cent. It will work by allowing the tax authority of parent companies to levy 'top up' taxes if a foreign subsidiary is charged less than the minimum rate, thereby significantly weakening the incentive for countries to offer lower rates intended to attract subsidiaries of foreign multinational companies.

This agreement between finance ministers puts the world "in striking distance of full global agreement to halt the race to the bottom for corporate taxes"[96], according to president Biden. A *Financial Times* editorial asserted that "no one wins from a Wild West tax system where everyone is trying to make gains at another's expense".[97] But Julian Morris has questioned the 'race to the bottom' narrative, however, pointing out that corporate tax receipts and total receipts more broadly have both grown as a share of GDP. He also suggested that it could reduce receipts by up to £7 billion.[98]

The major legal firm Clifford Chance picked up the point about revenues: "Many of the non-OECD countries involved in the process, and many NGOs, want to see a fundamental redistribution of

[94] Tax Foundation, *Preliminary Details and Analysis of the Tax Cuts and Jobs Act*, December 2017.
[95] OECD, *Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*, October 2021.
[96] The White House, *Statement by President Joe Biden on Today's Agreement of 130 Countries to Support a Global Minimum Tax for the World's Largest Corporations*, 1 July 2021, www.whitehouse.gov/briefing-room/statements-releases/2021/07/01/statement-by-president-joe-biden-on-todays-agreement-of-130-countries-to-support-a-global-minimum-tax-for-the-worlds-largest-corporations/, (accessed 21 March 2022).
[97] *Financial Times*, G7 tax accord is a game-changing opportunity, Financial Times, 6 June 2021.
[98] Morris, J., *Draining Our Pockets: How the global tax cartel could cost Britons billions*, 26 October 2021.

taxing rights away from the developed world and towards the developing world. They, not unreasonably, see the BEPS focus on taxing "where the value is created" as in practice allocating taxing rights to rich countries. However this creates some difficulty for developed-world policy makers, whose populaces expect OECD initiatives to result in more tax being paid to their treasuries, not less.”[99]

Ending a ‘race to the bottom’ may seem more beneficial to those charged with spending the money than taxpayers required to pay it. Even to the extent that it was true, anti-competitive practices among jurisdictions may not lead to the best outcomes for all the reasons usually associated with cartels and monopolies. Removing competitive pressure risks weakening the incentive for jurisdictions to offer competitive environments and efficient services.

Nonetheless, president Biden’s statements suggest this concern does not dominate his administration’s thinking: “When countries compete against each other to attract multinationals’ profits and activities by lowering their corporate rates, the result is a race to the bottom that makes it difficult for the United States–and other countries–to raise enough revenue to support necessary investments, and allows countries to try to gain a competitive edge by undercutting each other’s tax systems.”[100]

One interesting aspect of the ‘taxing rights’ section of the BEPS proposals is how they operate as a hybrid between a profits and a consumption tax. Like a VAT or sales tax they are charged according to where the consumption occurs. But the rate charged on the consumption is determined by the worldwide profitability of the firm. This means it is neither one nor the other. It is not a profit tax because the profit assessment is global and the basis is set by sales. Nor is it entirely a consumption tax because the rate is not fixed across companies (or across the goods and services consumed). Indeed, a decision to undertake a project in one country will affect tax liabilities for subsidiaries throughout the world otherwise completely unconnected to the project in question.

Digital services tax

The United Kingdom’s digital services tax imposes a 2 per cent charge on gross revenues of multinational enterprises operating search engines, social media platforms and online marketplaces if their global revenues from those activities exceed £500 million and more than £25 million of them are derived from UK users. It came into force in April 2020 as a way of extracting tax from large digital economy multinationals in lieu of the BEPS agreement (see above) on corporate profit taxes and many other countries have also implemented similar schemes including Italy, France, Poland and Spain. The March 2020 budget confirmed that the government “will repeal the DST once an appropriate global solution is in place”.[101]

An agreement among the US, UK, France, Italy, Austria and Spain to withdraw the tax when the BEPS proposals are implemented prompted the US to withdraw its threat of retaliatory import tariffs.[102]

The case for digital services taxes is essentially the same as that made for the G20/OECD BEPS proposals: a fairer allocation of ‘taxation rights’ or a way for tax authorities in advanced economies with disappointing performance in the digital economy to extract more tax revenue from that sector without raising rates overall, depending on perspective.

Unlike the BEPS proposals, the digital services tax is a straightforward consumption tax because it is levied on revenues (rather than profits) at a flat rate above a threshold, although aimed at an area of the economy deemed to be profitable and insufficiently taxed by its proponents.

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[99] Clifford Chance, *The OECD proposal to revolutionise worldwide taxation: our assessment*, June 2019.
[100] U.S. Department of the Treasury, *The Made in America Tax Plan*, April 2021.
[101] HM Treasury, *Budget 2020*, March 2020.
[102] HM Treasury, *UK agrees transition toward new global tax system*, 21 October 2021, www.gov.uk/government/news/uk-agrees-transition-toward-new-global-tax-system, (accessed 19 March 2022).

What reforms resolve the problems best?

Because the digital services tax is merely a temporary, transitional tax intended to serve as a place-holder until an international agreement on allocation of 'taxing rights' to multinational enterprises' profits is implemented, policy makers should first consider what the best approach is to that.

Reform of international corporate taxation to reallocate 'taxing rights' from the location of the value creation to the location of the value of the user, the fundamental reform of the BEPS proposals, along with a minimum rate, depends on values placed on the relative importance of economic efficiency, administrative simplicity, fairness of corporate entities' share of the tax burden and the implications for revenues of an economy's ability to generate income from intangible assets, particularly digital ones.

Intangible exports

Due to its especially large service sector and share of intangible exports, the UK treasury is particularly vulnerable among large, advanced economies to the risk of foreign jurisdictions' taxation of UK companies outweighing the receipts the UK treasury might gain from foreign companies. While the current proposals exempt the financial sector, which is a particular strength of the UK economy, it may not last and the UK's other strengths, notably pharmaceuticals, entertainment and the creative industries mean some analysts expect the UK exchequer to lose up to £7 billion if implemented.[103] To the extent to which concerns are justified, other objectives would need to outweigh the risks to the UK economy and treasury from switching the basis of corporate taxation from one where the UK has more control (value creation) to one where it has less (consumption location).

Fairness

Perhaps the strongest case for such reform is found in support of pursuing a fairer distribution of the tax burden. Since the 'global intangible low tax income' rules were introduced in 2017 the issue is much less substantive than it previously was regarding 'untaxed' profits but there remains widespread sentiment that profitable large digital economy multinationals are paying less than they might be able to afford while companies in the non-digital economy are more likely to be in financial distress.

Reform could mean that developing economies may be able to tax multinationals more, at the expense of advanced economies, and profit tax liabilities within a country might be closer to revenues within that country, even if profits are not because they are created by intangible value in other jurisdictions. Nonetheless, jurisdictions would still be subject to some competitive force in taxation rates and rules as withdrawing from a market would clearly remain an option. Setting up a subsidiary in a market with a relatively low profit margin potential may become less attractive if that market's tax authority can base its taxable profits assessment on more profitable operations in other markets. They would need to be sure that the lower profit margin was indeed artificial 'profit shifting' rather than genuinely lower returns if they were not to dissuade economic activity more than they had intended.

[103] Morris, J., *Draining Our Pockets: How the global tax cartel could cost Britons billions*, 26 October 2021.

Administrative simplicity

The BEPS agreement facilitates a supplementary set of corporate tax rules and regulations on top of existing ones. This will inevitably mean greater complexity of the system. Given the explosive growth of tax complexity and the associated costs of compliance over recent decades, together with the public concerns about tax which fundamentally arise from complexity and its associated opacity, any view of the BEPS proposals would be negatively scored to the extent to which simplicity and transparency are a policy objective.

Efficiency

The objective of an economically efficient tax system presents a more mixed set of trade-offs and considerations. For example, if users are less mobile than value creators then shifting the burden somewhat from value creators to users should reduce the distortions and economic cost of a given quantity of tax burden. Professor Devereux welcomed the agreement on these grounds, saying "such a move is justified by the relative immobility of a third party purchaser of goods and services. That reduces economic inefficiencies created by tax-induced distortions to real location decisions and it also reduces options for shifting profit."[104]

But on the other hand by reducing the pressure on a government to keep spending as tightly controlled that efficiency gain may be reduced or even reversed by a larger efficiency loss from switching more economic activity from the private to the public sector.

Similarly, switching from a profits tax to a profits plus hybrid profits-consumption tax may offer a marginal efficiency gain by removing some of the tax burden from value creation and onto value consumption but the relatively small scale of the change limits the upside while introducing a second layer of tax introducing a complexity cost that is essentially binary. Either two systems are operating simultaneously or only one is.

Ideally from an efficiency perspective, a tax on corporate income would tax distributions. Undistributed income would be untaxed to remove barriers to investment (and therefore productivity growth), as recommended by Heath et al (and Booth et al). Under that system, foreign multinationals would only face the incentive to shift profits out of the UK if they were intended to be distributed on for consumption in a lower tax jurisdiction. The tax penalty for retention to reinvest in the UK would be eliminated.

Taxing profits by their allocation to locations where the revenue accrues is likely to remove incentives to shift profits between jurisdictions within a group. However, it may not address incentives to disguise profits as sales to apparently unconnected third parties in lower tax jurisdictions and comes at the cost of maintaining profits taxes. As the OECD itself noted in 2010, "corporate taxes are the most harmful type of tax for economic growth, followed by personal income taxes and then consumption taxes, with recurrent taxes on immovable residential property being the least harmful tax".[105]

The only more economically efficient system than a distributions tax would be one which did not tax corporate income, namely broad-based, flat consumption taxes, poll taxes and land value taxes. These all have drawbacks of their own, though, such as regressivity, potential size of revenues and administrative inefficiency when attempting to tax distributed corporate income in the hands of the recipient rather than the corporation. If evasion and avoidance increase disproportionately with the rate of a tax, they would be lower under a system with the burden split between a consumption and income tax than one where it all fell under one or the other.

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[104] Devereux, M., *Pillar one: first step towards a destination-based tax?*, Tax Journal, www.taxjournal.com/articles/pillar-one-first-step-towards-a-destination-based-tax, (accessed 21 March 2022).
[105] OECD, *Tax Policy Reform and Economic Growth*, 2010.

Objectives

A government which emphasised economic efficiency and administrative simplicity sufficiently strongly to reject the OECD's BEPS proposals would therefore also reject a digital services tax as a temporary measure until their implementation. But given its nature as a relatively arbitrary consumption tax whose incidence falls on UK consumers, there is little justification for it anyway beyond its role as an international negotiating ploy to advance the cause of user-location-based profits taxation.

The likely incidence on British consumers may partly explain why the US dropped its threats to impose retaliatory tariff on the UK (and others), which raises questions about its effectiveness for that purpose and especially at the expense of the UK's own consumers. The only remaining justification for a digital services tax is the fairness notion of a sector perceived to be underpaying tax being seen to formally pay something, or at least something more.