- Tax raising in the UK is exceptionally centralized, with only 5% of revenues raised locally; and it has become more centralized over time, notably with the move of business rates from local to central control.

The tax and benefit system as a whole redistributes significantly from rich to poor. But whether tax and benefit reforms have contributed to or counteracted the sharp increase in income inequality seen in the UK over the last thirty years is hard to determine definitively, in part because it depends on what is meant by 'reform'. The tax and benefit system in 2008 does more to reduce inequality than if the system of thirty years ago had remained in place with tax thresholds and (more importantly) benefit rates increased in line with inflation, but does less to reduce inequality than if the rates and thresholds of the 1978 system had kept pace with GDP per capita. Within this period, though, Labour's reforms have been clearly more progressive than the Conservatives': Labour's reforms since 1997 have had a similar effect on overall inequality as increasing benefit rates in line with GDP, while the Conservatives' reforms were roughly equivalent to increasing them in line with inflation.

On the other hand, reforms under the Conservatives did more to strengthen financial work incentives than those under Labour. The Conservatives' tax and benefit reforms unambiguously strengthened average incentives for people to be in work and for those in work to increase their earnings. Reforms since 1997, however, have had much less impact on incentives to be in work—on average, they are now slightly stronger than they would have been if Labour had increased the benefit rates they inherited in line with growth in the economy, and much the same as if they had increased benefit rates in line with inflation—and Labour's reforms have weakened average incentives for those in work to increase their earnings. All of these broad trends, however, hide substantial variations across the population.

The tax system influences the amount that people save and the form in which they do so. Owner-occupied housing and Individual Saving Accounts (ISAs) are not subject to personal income taxes; pensions are effectively subsidized by the provision of a 25% tax-free lump sum and by the exemption of employer pension contributions from National Insurance contributions (although deferral of tax from the point at which earnings are paid into a pension fund to the point at which they are withdrawn from the fund means that the attractiveness of saving in a pension depends a great deal on whether an individual's marginal tax rate is different at those two points). Pensions, ISAs, and housing cover the significant saving activity of the bulk of the population, but other forms of saving are discouraged by income tax and capital gains tax—and to a markedly greater extent than the statutory tax rates might suggest, because no allowance is given for inflation. The decline of inflation from the very high rates prevalent thirty years ago has been a major factor reducing the extent to which the tax system biases the choice between different saving vehicles. Policy reforms have also reduced these distortions by reducing the highest income tax rates, introducing tax-free saving vehicles such as ISAs, and abolishing the subsidies offered through tax relief for life assurance and mortgage interest. The result of all this is that saving is now less likely to be heavily taxed, and less likely to be subsidized, than in the past.

Like different forms of personal saving, different forms of business investment are treated differently by the tax system. In the UK, as around the world, debt-financed investment is treated more favourably than equity-financed investment, and investment in plant and machinery is treated more favourably than investment in industrial buildings. Both of these distortions have been reduced since 1979.

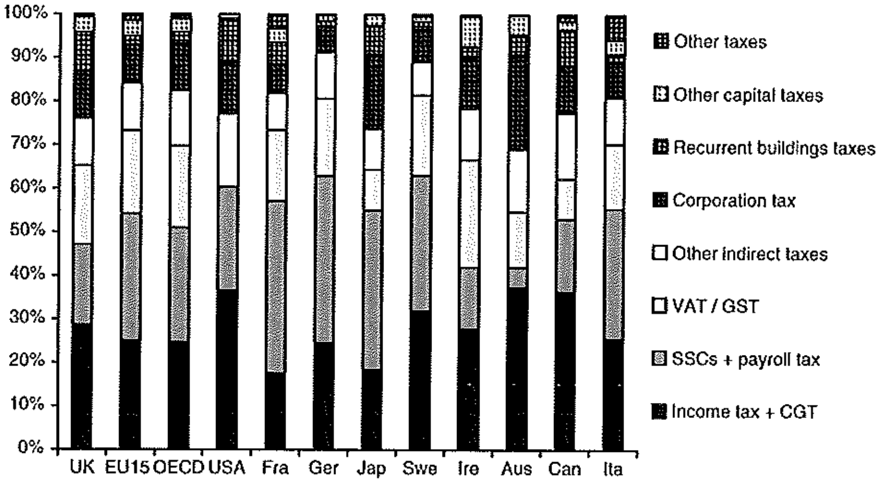
1.1. INTRODUCTION

This chapter provides a description and assessment of the UK tax system, placing it in historical, international, and theoretical contexts. We begin in Section 1.2 by outlining the evolution of the size and composition of tax revenues in the UK since 1978 and comparing this to developments in other OECD countries. Section 1.3 describes what has happened to the design of major taxes over the same period and compares this to worldwide trends in tax reform. The economic analysis of these developments is taken up in Section 1.4, which assesses their effects on the income distribution and incentives to work, save, and invest. Section 1.5 concludes with a summary of the main issues raised. An appendix describes each of the main taxes in 2008–09.

1.2. THE LEVEL AND COMPOSITION OF REVENUES

Total UK government receipts are forecast to be £545.5 billion in 2008–09, or 37.3% of UK GDP.[1] This is equivalent to roughly £10,900 for every

[1] All 2008–09 revenue figures in this chapter are 2008 Pre-Budget Report forecasts.



Notes: All taxes and social security contributions (SSCs). GST = General Sales Tax.
Sources: OECD (2008a).

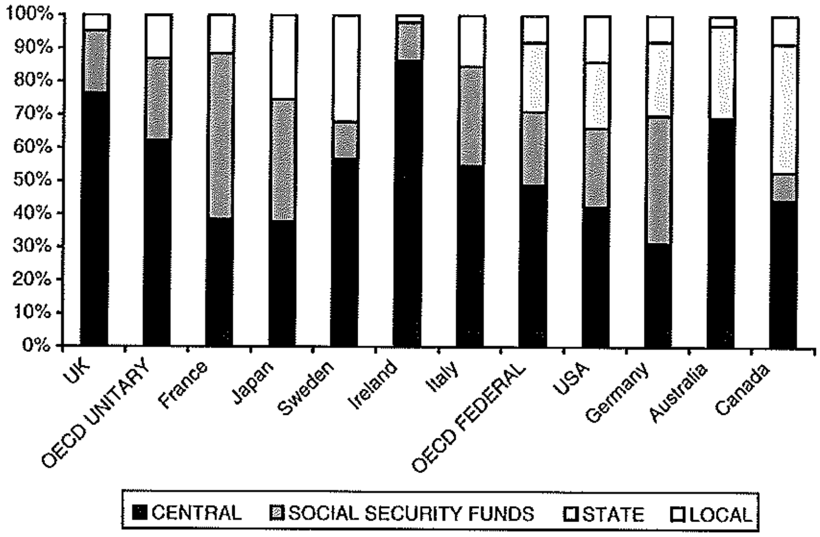
Figure 1.4. The composition of tax revenues, 2006

low (but not lowest) share of social security contributions[3] and its relatively high share of recurrent taxes on buildings (although these are also relatively high in the USA, Japan, and Canada). It is also somewhat above average in the share of personal income tax, but several countries have even higher shares.

Figure 1.5 compares the distribution of revenues by levels of government in the UK to the averages of OECD unitary countries and OECD federal countries, and a selection of individual unitary and federal countries.[4] This comparison shows that the UK has a particularly large share of revenue going to central government, a share that is exceeded only by Ireland. This is reflected in the fact that UK local authorities are particularly dependent on grants from central government rather than tax revenues of their own.

[3] This category also includes payroll taxes (which do not give entitlement to contributory benefits) for those few countries that have them. The most significant example in this set of countries is Australia, which does not have social security contributions but does levy payroll taxes.

[4] This figure attributes revenue to levels of government on the basis of their legal entitlement to the revenue rather than their control over the tax rate (or base). Thus the state level of government in both Germany and Australia receives a substantial part of their revenues from taxes whose rates are set at national level (although in consultation with state governments). In contrast, UK business rates are not classed as local because central government has complete discretion as to how the revenue is allocated.



Sources: OECD (2008a).

Figure 1.5. Tax revenues by level of government, 2006

1.3. DEVELOPMENT OF THE MAJOR TAXES SINCE 1978

Table 1.2 lists some of the most important changes in the UK tax system seen since 1978.[5] It is clear that the tax system is now very different from the one that existed then. The income tax rate structure has been transformed, the taxation of saving has been repeatedly adjusted, the National Insurance contributions system has been overhauled, the main VAT rate has more than doubled, some excise duty rates have risen sharply while others have fallen, the corporate income tax system has been subject to numerous reforms, and local taxation is unrecognizable. Figure 1.3 and the associated discussion in Section 1.2 show how these changes have been reflected in the composition of aggregate government revenue (although there have been other factors that have played a part, such as the effect of property and stock markets on stamp duty revenues).

[5] For a timeline of the main tax changes announced in each Budget and Pre-Budget Report since 1979, see <http://www.ifs.org.uk/ff/budget_measures.xls>.