The role of the UK tax system in an anti-poverty strategy:

Economic principles and practical reforms

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Supported by

Brewer is also a Research Fellow at the Institute for Fiscal Studies, and was a member of the Task Group helping the JRF produce their Anti-Poverty Strategy. They are very grateful to Fran Bennett, Chris Goulden, and Barra Roantree for comments on earlier drafts, and to Fran Abrams for copy-editing.

1. Introduction

This report, aimed at anti-poverty campaigners, provides a guide to the economic arguments behind tax design. It suggests how best to engage in economic debates about the UK tax system from a poverty perspective. It also highlights some specific reforms that are likely to lead to a fairer and more efficient tax system as well as making a worthwhile contribution to an anti-poverty strategy. It focuses on key design issues rather than on detailed rules and operational issues.

The two most important consequences of the tax system are that it raises a substantial amount of revenue for the government to spend and that it affects the distribution of income (although, as we shall see, it has much more impact on the top half of the income distribution than the bottom). These are clearly vital considerations for an Anti-Poverty Strategy (APS) but aside from these the direct impact of the tax system on poverty is actually fairly small. So, other than for revenue-raising, taxes are likely to have a small role in an APS. But it is still useful to consider ways in which anti-poverty campaigners or those designing anti-poverty strategies should think about tax design and engage in debates about tax policy.

The rest of this paper is organised as follows: Section 2 gives a brief overview of how economists think about good tax design, discusses some of the value judgements or assumptions that are made when discussing tax policy and poverty, and offers guidance on how one should think about the different ways in which the tax system affects poverty. Section 3 considers the main taxes in the UK and discusses the arguments for and against specific reforms and their inclusion in an APS. In doing so, we consider most aspects of the UK tax system that raise revenue for government. These include personal direct taxes (Income Tax and the taxation of savings);National Insurance contributions (because they function very similarly to a form of direct taxation); the taxation of housing; the taxation of non-housing wealth (chiefly pensions and savings); the taxation of businesses and environmental taxes.

We do consider tax allowances, but we do not consider the role of the child and working tax credits. the role that the benefits and tax credit system could play in reducing poverty is discussed in the working age part of the final APS, and we do not look at the tax treatment of childcare as this has been considered in a separate review commissioned by the Joseph

Rowntree Foundation (JRF).[1] Section 4 concludes, summarising the recommendations. An annex summarises recent analysis by the Office for National Statistics (ONS) on the distributional impact of the UK tax system.

We take a UK view of the tax system: Box 1 summarises which parts of the tax system have been or are shortly to be devolved. Readers wanting further details on specific taxes are referred to the guide produced by the Institute for Fiscal Studies (IFS).[2] Comprehensive discussion of how the design and operation of the UK tax system disadvantages people on low incomes can be found, for example, on the website of the Low Incomes Tax Reform Group, and we do not discuss those any more here.

Most of this paper was written before June 23, and we do not consider in detail the impact of Brexit. In brief, the main implication for taxes that directly affect households is that the UK may now be freer to change the structure of Value Added Tax (VAT), which is currently governed by EU laws but our view is that this flexibility is not enormously relevant for an APS. This note was finalised a fortnight after Theresa May became Prime Minister; it is not yet clear whether her government shares her predecessor's approach to tax policy.

The JRF commissioned this paper as part of its programme on anti-poverty strategies, which aimed to produce the first comprehensive, evidenced anti-poverty strategy for the UK.[3] Accordingly, we work with that project's definition of poverty, which is "when a person's resources (mainly their material resources) are not sufficient to meet their minimum needs (including social participation)". [4] The discussion that follows, and the opinions expressed, should not be attributed to the JRF or to members of the Anti-Poverty Strategy Task Group that helped put the strategy together.

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[1] https://www.jrf.org.uk/report/creating-anti-poverty-childcare-system.

[2] See Pope and Roantree (2014).

[3] The strategy is due to be published in September 2016 at https://www.jrf.org.uk/solve-uk-poverty.JRF (2012) gives an outline of the programme of work that led up to the strategy..

[4] https://www.jrf.org.uk/report/definition-poverty.

Box 1. Tax policy in Scotland, Wales and Northern Ireland

Over the past 20 years particular aspects of tax policy have been devolved from Westminster to individual country governments.

Since 1999 the Scottish Parliament has had the ability to vary Income Tax by 3p in the £; also known as the Scottish Variable Rate (SVR). In practice SVR has never been used (Seely, 2015). Similarly, local taxes (Council Tax and business rates) have been devolved for some time. The 2012 Scotland Act devolved three further powers: the Scottish Rate of Income Tax (from April 2016), Landfill Tax and Stamp Duty Tax (now known as the Land and Buildings Transaction Tax) both from April 2015. The Scotland Act 2016 means the Scottish Parliament now has power to set the way Income Tax is raised i.e. in terms of rates and thresholds (other than the personal allowance). It will also collect a proportion of reduced/standard rate VAT (but the VAT rate itself will remain the same throughout the UK), and will have powers to set the rate of Air Passenger Duty (APD) and the Aggregates Levy (Seely, 2015).

In Wales, the devolved taxes are local taxation (Council Tax and business rates). The Wales Act 2014 states that Land Transaction Tax and Landfill Disposals Tax will be devolved from April 2018 (Mansour and Winckler, 2015). Wales has used its control over Council Tax to introduce a new band for the most expensive properties, and to undergo a revaluation in 2003.

In Northern Ireland, the devolved taxes are local taxation (Council Tax and business rates). The long haul rate of APD has been devolved; there have also been exemptions to increases in the Climate Change Levy, and a different arrangement for the Aggregates Levy (Mansour and Winckler, 2015). The UK government has passed legislation (The Corporation Tax (Northern Ireland) Act 2015) which gives Northern Ireland control over Corporation Tax from April 2017. This will be set to 12.5% by April 2018 but is conditional on the Northern Ireland government reforming (among other things) aspects of welfare, which it is currently doing (Lepoev, 2016).

2. How should we think about the role of the tax system in an anti-poverty strategy?

In this section, we begin by giving a brief overview of how economists think about good tax design. We then try to make transparent some of the value judgements or assumptions that are made when discussing tax policy and poverty. Finally we offer guidance on how one should think about, and trade off, the different ways in which the tax system might affect poverty. All of this is intended as a prelude to our discussion of specific tax reforms in Section 3.

2.1 Introduction: Principles of good tax design[5]

Economists thinking about tax design usually start from the view that most taxes distort behaviour, and that this is usually undesirable. By "distort behaviour", we mean that individuals or businesses will be likely to make different choices in a world with taxes than in a world without taxes This is because taxes change prices (e.g. VAT), affect how much income individuals have (e.g. Income Tax), or affect the payoffs to undertaking various activities (e.g. Corporation Tax). These distortions are usually thought to be undesirable given the premise that, left to their own devices, markets produce efficient outcomes (although it is clearly possible to contest this premise).

Of course, some tax-induced distortions are intentional, and may lead to social benefits: the classic case is where an individual's consumption or production of a good affects others, which is known as an externality. Where there are externalities, unregulated markets will produce inefficient outcomes. In these instances, taxes – such as on polluting activities or on tobacco or alcohol consumption – or subsidies – such as on early-years childcare – may be welcome precisely because they do distort behaviour.

Even though they inevitably distort behaviour, taxes are used by all governments to raise revenue and to reduce inequality. The economist's approach to tax reform, then, is to achieve these objectives at as little cost to society as possible, or to minimise the inevitable distortions caused by the tax system. Economists refer to this as "optimal tax design", where an optimal tax system "balances efficiency losses against the government's desire for redistribution and the need to raise revenue" (p36, Mirrlees et al. (2011). The insight provided by optimal tax theory is that it is possible to trade off (in an exact way) the desire to achieve an acceptable distribution of income with the desire to raise revenue and to reduce distortions. But this is possible only if one quantifies how much one cares about these different objectives, and even the Mirrlees Review of tax reform (Mirrlees et al. (2011)

[5] This is drawn from the Mirrlees et al. (2011), specifically chapter 2. A more political and policy-focused review can be found in The Commission on Taxation and Citizenship (2000). See also Bennett (2012).

admits that optimal tax theory has its limitations. Much of the academic work is highly technical and mathematical; and even the most complicated mathematical models have to ignore some of the ways that the tax system distorts behaviour, or some of the policy objectives that real-world governments might pursue.

In the absence of an exact solution provided by optimal tax theory, a key aim is to achieve a neutral tax system. [6] The Mirrlees Review defines this as follows:

> "[A] neutral system minimizes distortions over people's choices and behaviour. In general, it therefore minimizes welfare loss. In a non-neutral tax system, people and firms have an incentive to devote socially wasteful effort to reducing their tax payments by changing the form or substance of their activities." (p40, Mirrlees et al. (2011)

The approach taken by this paper then, is not to solve an optimal tax theory problem, but to take the insights from optimal tax theory and the principle of neutrality, and consider how they would apply in an APS.

2.2 Value judgements and tax reforms

In this section, we try to make transparent some of the considerations or assumptions that are often made when discussing tax policy and poverty. For example, when discussing the merits of a given tax change and its role in an APS, different policy makers might have different views on:

- how one thinks poverty is best assessed, and in particular on how much weight is placed on individuals' own circumstances compared with those of the family or household in which they currently live.
- Whether one mostly sees the tax and benefit system (including tax credits) as separate systems, or whether one mostly thinks about the combined impact on people's incomes. [7]

Consider the standard way in which the distributional impact of tax and benefit reforms are discussed in UK policy debates, as typified by the usual IFS (or Resolution Foundation, or Institute for Public Policy Research, or HM Treasury) analysis of Budget statements. The typical analysis shows the percentage change in household income caused by the tax change

[6] Tax systems should seek to be cheap to run and comply with, fair (in various dimensions), and transparent (indeed, these are desirable attributes for all government policies, where they do not compromise other objectives).

[7] Policy-makers may also have different views on the political feasibility of (and their opinion of the importance of the political feasibility of) a given tax change, and on the importance of having a well-designed tax system that is cheap to administer and easy for individuals to comply with.

on households at various parts of the income distribution. This analysis embeds many important but contestable assumptions. Most of these derive from the assumption that an individual's well-being is best represented by the equivalised household income; and this assumption in turn assumes or implies:

- that taxes and benefits are equivalent, and that what matters is the net impact of both systems on household income
- that the best measure of resources is disposable income (and not consumption, or deprivation), despite well-known issues with the accuracy of reports of very low incomes in household surveys
- that the best measure of resources is a snapshot of current income (and not an assessment of lifetime income)
- that income within a household is effectively shared out equally between its members, so that they all have a comparable standard of living
- that the equivalence scale is a sensible way to correct for the fact that two can live more cheaply than one ("economies of scale"), and that adults and children require different amounts of resources

In this section, we discuss some of these considerations in more detail.[8]

2.2.1 Measuring poverty: Individuals vs families

In the UK, most direct tax liabilities depend only on the circumstances of the individual, rather than the family or household. But, as highlighted in the introduction, the JRF definition of poverty is that whether an individual is in poverty depends upon whether "resources (mainly their material resources) are not sufficient to meet their minimum needs", and these resources are understood to depend in part on the individual's family and household circumstances.

Given this, tax cuts may seem a poor method by which to help households in poverty, even where the tax cuts are tightly targeted at those with low taxable incomes. This mismatch occurs because some people paying little or no tax live in families or households which are a long way from poverty at the present time (for example, second earners in a family, or young adults living in a household with other individuals). This logic would then lead one to

[8] We do not discuss what is the best concept of income to use, nor practical issues concerning how to measure it; we omit such a discussion in part because the JRF's definition of poverty does not seek to specify precisely how income should be measured, and because it does acknowledge that it is important to consider the experience of poverty over the lifecycle, which implies that poverty is based on more than just a snapshot of current income.

favour using the benefit system, and the means-tested benefit system in particular, rather than the tax system, to boost the incomes of households at risk of poverty.

But there are several points that would justify a different conclusion.

First, if one takes a lifetime perspective to measuring poverty (or a lifetime perspective to reducing poverty), then it may well be the case that some individuals at risk of lifetime poverty are in households deemed not to be poor at the current moment in time. This point is made in, for example, Bennett and Daly (2014). This argument, we think, has the most force when considering policies to encourage second earners to work. Although second earners are often not in low-income households, encouraging second earners to work may well help reduce future levels of poverty that might arise if the primary earner stops work, or the household splits up. However, as we discuss elsewhere, we think that the tax system is less good at affecting incentives to work than the benefit system, and it is not clear that this argument has much force when considering tax cuts whose primary aim is to increase household incomes, where there is no link between the tax cut and future incomes.

Second, there is evidence that men and women spend money in different ways, and this may give a reason for governments to have views over the distribution of income, or the control over income, within families.

Finally, the JRF definition of poverty recognises that whether an individual is in poverty now depends on more than just that individual's household's total equivalised net income. The definition recognises that it is possible for an individual in a high-income household to be deemed to be in poverty at the current time if that person is denied the resources they need.. With this definition, it is possible that tax cuts could in such situations improve the income controlled by second earners in well-off households, and so could reduce levels of this form of poverty.

2.2.2 The equivalence of taxes and benefits

The fact that the UK's tax and benefit systems are trying to achieve different functions and operate separately from each other means that some individuals will pay some of their income in direct taxes and then receive some, all, or more of that back through benefits or tax credits.

The role of the tax system in an APS depends in part on whether one considers this to be problematic, or whether one views differently tax cuts and increases in cash benefits that have identical impacts on a household's income. For example, an approach typically associated with the IFS (and certainly taken by Dilnot, Kay and Morris (1984) and others (see for example Brewer et al. (2010) is that there is no meaningful difference between the tax system and the benefit system: all that matters is how the combined impact of taxes paid less benefits received for each household affects their income and incentives.

If one is happy to consider the overall impact of the tax and benefit system, then one is likely to prefer to use the benefits system in a pockets-based approach to reducing poverty rather than the tax system. As we discussed in Section 2.2.1, it is difficult to use the tax system to deliver large or well-targeted increases in incomes for those in poverty, but the nature of the benefit system means it can used in a much more targeted way. Indeed, the implication is that one should primarily use the benefit system, at least when considering how to design a pockets-based approach to reducing poverty, and use the tax system only to achieve other objectives.[9]

However, most UK politicians seem to treat taxes and benefits differently when debating reforms to either. The 2010-2015 coalition government introduced a cap on total spending on many social security benefits, for example, but no such cap exists for the costs of tax allowances and reliefs. If one believes that the tax and benefit system should be viewed separately and that the systems are not morally equivalent (i.e. reducing taxes is preferable to increasing cash benefits), then tax cuts will have a larger role in an APS. However, as we discussed in 2.2.1, this has drawbacks: a tax-cutting approach to reducing poverty can never increase someone's income above its pre-tax level, and tax cuts are a more expensive way to reduce poverty than increasing benefit spending.[10]

The view we take in section 3 is that taxes and benefits are close to being equivalent to each other in practice, but we recognise that there are often political constraints which mean that it may be easier to seek tax cuts than increases in benefit spending.[11] Box 2 discusses what this argument means about how we should measure the tax burden on households,

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[9] A recent review of the link between family income and children's outcomes concluded that "None of the studies directly tested whether the source of income matters for children's outcomes, [but] nothing in their findings suggested that the source is relevant. Many studies examined increases in income as a result of benefit changes and found positive effects on a range of children's outcomes, similar to the smaller number of studies examining other sources of income change." (Cooper and Stewart, 2013, although the quote is from the summary at https://www.jrf.org.uk/report/does-money-affect-children%E2%80%99s-outcomes).

[10] Although, in making this comparison, we are taking the view that foregoing £1m of tax revenue is as expensive for the government to afford as a £1m increase in spending.

[11] Given that we view taxes and benefits as being close to being equivalent to each other in practice, then you might think that we favour integrating taxes and benefits. Certainly there are good arguments for an integrated tax and benefit system: it should lead to a more transparent and coherent system, which in turn would ensure individuals had a clear understanding of entitlements and incentives. However, at present there are many reasons why a fully-integrated system seems unlikely, including: the strong political desire to keep the tax system based on individual, not family, circumstances, and the strong priority placed in the UK on having the benefit system react quickly to current circumstances. Given these, and the relative ease governments have in using the tax system to extract money from households at fairly low administrative cost, it seems sensible to combine broad-based taxation with targeted redistribution through the benefits system.

and the often-repeated claim that the tax burden on the bottom quintile is larger than on all other groups.

Box 2: Measuring the tax burden

If we accept that it is only the combined effect of the tax and benefit system that matters, then we should avoid measuring "the tax burden" as tax payments as a share of income. For example, it is commonly claimed that households in poverty pay a greater proportion of their income in tax than the rich.[12] The claim is true only if you consider the tax system in isolation from the benefit system. In other words, if you add up each household's own private pre-tax income plus their entitlement to state benefits, then it does seem to be the case that the poorest fifth lose more of that pre-tax income to the direct and indirect tax system than the richest fifth (although there are also complications caused by looking both at indirect and direct taxes, similar to the discussion of how we should best measure the progressivity of indirect taxes).

But, we think that it is more meaningful to consider the combined impact of the tax and benefit system on someone's income. For example, consider a person whose £120 weekly income all comes from state benefits, and who spends all their money on goods on which the 20% rate of VAT is liable. Such a person effectively loses £20 of their income to VAT, and the standard calculation would conclude that the tax burden on this person was 16.7%. But if the government abolished VAT and reduced state benefits to £100, then the individual would be just as well off as before, but with a tax burden of 0%. On the other hand, a consideration of the combined effect of the tax and benefit system would conclude in both cases that the tax and benefit system has redistributed £100 worth of stuff (measured at a pre-tax price) to the individual. For more details, see the IFS rebuttal to these sort of claims from 2010; the precise numbers are now different, but the logic is still sound (http://www.ifs.org.uk/publications/4813).

[12] For example, http://www.independent.co.uk/news/uk/politics/the-graph-that-shows-how-the-poor-are-paying-more-than-the-rich-in-tax-10353982.html or https://www.theguardian.com/money/2014/jun/16/british-public-wrong-rich-poor-tax-research.

2.3 In what ways is the tax system relevant to an APS?

Tax policy almost always involves making trade-offs. Because a specific tax change has different sorts of impacts, its merits will depend on the relative importance one attaches to these different objectives. The most important impacts of the tax system for an APS are that it:

- raises revenue to fund government spending
- influences overall inequality in society
- helps shape the size and structure of the economy
- directly affects household budgets
- seeks to incentivise or discourage certain behaviours (such as energy taxes), which then affects household budgets
- determines the incentive to earn more faced by individuals (as measured by the marginal or average effective tax rates)

In this section, we discuss the various ways in which the tax system might be relevant to an APS.

2.3.1 Tax revenues and an Anti-Poverty Strategy

The main purpose of the tax system is to raise revenues for government spending. This means the desirability of a specific tax reform to an APS will depend in part on its cost or yield, and on whether one is seeking a net rise in the tax burden to fund policies for an APS.[13]

Alternatively, an anti-poverty campaigner advocating higher spending on government programmes might be interested in knowing how best to raise the additional money. There are several approaches that an APS could take:

- one could advocate any sort of tax reform that did not increase the tax liabilities of those in poverty

[13] Some tax reformers take the view that, when considering the desirability of specific reforms, the impacts on revenue is relatively unimportant, as it is “simple” to change one of the three broad-based taxes (Income Tax, VAT or National Insurance) to achieve any desired level of government revenues. Under such an approach, if a tax reform reduced government revenues, then one would consider the desirability of this specific tax reform combined with a rise in (say) VAT that left government revenues unchanged. In practice, though, there are political constraints on introducing tax rises (At least, when doing so overtly. Figure11.1 of Adam and Roantree (2015) shows how past Chancellors have increased net tax revenues; the ideal time to do this, it appears, is immediately after a general election).

- one could advocate specific tax reforms that corrected distortions or removed unfairnesses in the current tax system and that, by a happy coincidence, also raised revenues
- or one could seek to spread the burden as thinly as possible by raising money through broad-based tax rises, such as increases in the main rate of VAT, National Insurance contributions (if one is prepared to see these like a tax; see Section 3.1) or Income Tax

The approach taken by us in Section 3 is not to pursue the first of these; instead, Section 3 looks at some of the tax reforms that could correct distortions as well as raising revenues, and we discuss the advantages and disadvantages of changes to the broad-based taxes (Income Tax, National Insurance contributions and VAT), as these are some of the least economically-painful ways of raising taxes.

2.3.2 The link between income inequality and poverty

After raising revenues for government spending, the next most important thing that the tax system does is to affect the shape of the income distribution, and therefore overall income inequality.

As we show in the annex (citing analysis by the ONS), the current UK tax system has far more impact on the shape of the middle and top of the income distribution than it has on the bottom. This is partly because the relatively high level of the Income Tax personal allowance means that few low earners pay Income Tax, and it is partly because low earners are not the same as individuals in households with a low income. It also reflects that the amount of redistribution that can be achieved at the bottom of the distribution through the pure tax system is limited, because taxes can never increase people's income above their pre-tax, private (or "market") income.[14] This means that the merit of specific tax reforms depends in part on whether one is seeking changes to overall inequality, over and above those changes in inequality that would arise if poverty were reduced. Put another way, tax reforms will be likely to have a larger role in an APS if one is seeking to change the shape of the income distribution not only below the poverty line, but also above the poverty line.

We can think of two possible ways in which the way that the tax system affects the whole income distribution might be relevant to an APS.

[14] So-called "refundable" tax credits can increase people's income above their pre-tax, private (or "market") income. Our view is that the tax credits in existence in the UK have really been means-tested cash benefits, as there is little or no link with taxable income and people's tax liabilities, as there is in the US's Earned Income Tax Credit (EITC), for example.

First, there could be some structural relationship between poverty and overall inequality in disposable income. For example, greater inequality might make those with more resources more protective of them, because they have further to fall; or greater affluence might mean the rich no longer need to rely on public services, which in turn reduces their willingness to contribute to them, and so deepening poverty, or making it harder to escape from poverty, for others. [15]

Second, and much less interestingly, changes in inequality could have a direct, mechanical, impact on poverty, depending on the measure of poverty chosen. For example, any tax change that reduces median disposable income, and that has an impact on the equivalised income of households with less than 60% of median income that is smaller (in proportional terms) than on the equivalised income of the median household, would reduce the number of people in households in relative poverty on this measure. Of course, the definition of poverty adopted for the JRF's anti-poverty strategy is not a simple fraction of median income – it involves resources being insufficient to meet needs – but there is still a relativistic aspect to that definition. Because "needs" are in part socially determined, levying higher taxes on the non-poor majority could reduce the socially-determined level of needs, and thus reduce poverty.

Finally, we note that the recommendation made in the Mirrlees Review (Mirrlees et al. (2011) that "in achieving the overall objectives of the tax system, it is important to consider all taxes (and transfer payments) together as a system" because "[it] is the redistributive impact of the system as a whole which needs to be measured and judged. Not every tax needs to be progressive." In narrow economic terms, this is correct. However, the argument is not always understood or accepted by politicians or the public, and so, for good or ill, it may be politically easier to reform a regressive tax to make it more progressive than it is to make an already-progressive tax even more progressive.

2.3.3 The link between the tax system, the size of the economy and poverty

Changes to the tax system can affect the size and composition of the economy, and this might be relevant for an APS. A standard idea is that tax cuts encourage investment and employment, and this boosts GDP, which is to the benefit of all. However, it is not at all clear that, amongst developed countries, those with higher per-capita GDP have any more

[15] This broad topic will be the subject of future research at the LSE's International Inequalities Institute (http://www.lse.ac.uk/InternationalInequalities/researchProgramme/Research-programmes.aspx).

success in achieving low levels of relative poverty,[16] nor is there any correlation in the UK between GDP growth and poverty (indeed, the relative nature of the main measure of poverty means it tends to rise in booms[17]). And there is also debate about the influence that the tax system can have on the economy: for example, Thomas Piketty, Emmanuel Saez, and Stefanie Stantcheva find that changes in the rate of tax on the top 1 per cent have no impact on growth rates. [18]

Our view is that tax cuts will be (at the very least) expensive ways to achieve increases in growth rates, and that there is little reason to think that higher growth would reduce relative poverty.[19] We do think, though, that the state of the labour market is very important for poverty, and for the experiences of individuals in poverty: unemployment is very damaging both for an individual's health and for their long-run labour market position. Where possible an APS should probably seek, then, a tax system that supports (or does not inhibit) employment for those likely to be at risk of poverty. But the social security system and employment support policy are together likely to have far more impact on the employment of those at risk of poverty than the tax system.

2.3.4 Pockets: The tax system and household incomes

The APS recognises that some anti-poverty policies help by improving "pockets", or that they improve individuals' current financial position, and that some help instead (or as well) by improving people's future prospects.

Clearly, one very obvious way in which the tax system is relevant for an APS is the impact taxes have on the incomes of households below or close to the poverty line. And, as we said earlier, one example of a tax system that supports an anti-poverty policy would be one that reduces the tax liabilities of households in poverty. But our view is that the direct impact of the tax system on poverty is actually fairly small, and this is the main reason why we think taxes are likely to have a small role in an APS, beyond raising revenue.

[16] There is a very large literature on the link between growth and poverty, but it focuses on middle or low-income countries, and typically does not use relative measures of poverty.
[17] See Muriel and Sibieta (2009) for evidence from the 1970s through 1990s. In the post-financial crash recession, poverty and inequality fell initially (as earnings from employment fell, compressing the income distribution), but then rose as the labour market recovered and austerity affected income from social security benefits and tax credits.
[18] See http://www.voxeu.org/epubs/cepr-dps/optimal-taxation-top-labor-incomes-tale-three-elasticities or Piketty et al (2014).
[19] We suspect that a pro-growth strategy would be likely to feature increases in tax revenues to increase investments in infrastructure or skills and education, but there is a discussion of pro-growth tax reforms in Adam and Johnson (2012).

The evidence supporting this is in the annex, which summarises analysis by the ONS and shows that the tax system in the UK has far more impact on incomes of households in the middle and top of the income distribution than it does on households towards the bottom. This is especially the case for direct taxes on individuals' income, like Income Tax and National Insurance). Instead, it is the size and structure of the social security system (including tax credits) that has the most influence on household incomes at the bottom of the income distribution.

Furthermore, as we discuss more in Section 3, many commonly-advocated proposals to reduce taxes so as to reduce the amount of tax paid by those in poverty have substantial drawbacks. For example:

- Income Tax cuts, or a higher Income Tax personal allowance, will help boost the incomes of some households in poverty, but such reforms will be likely to boost the incomes of some households above the poverty line by more[20] (although, as we discuss in Section 2.2, taking a lifetime or gendered view of poverty would increase somewhat the anti-poverty credentials of Income Tax cuts.)
- cuts to VAT would lower poverty rates (by reducing the cost of living), but would be of more benefit to better-off households than those in poverty, thus effectively (albeit slightly) increasing overall inequality
- cuts to sin taxes or fuel duties would lower poverty rates by reducing the cost of living, but might then lead to undesirable increases in the use of alcohol or tobacco or gambling, or increases in congestion or CO_2 emissions (see Box 3 for further discussion)

[20] For example, a bespoke analysis for the authors done by the Resolution Foundation shows that, of 4.5 million households in the UK below 60% of median (Before Housing Costs) income in 2012-13, 3.5 million did not contain a person paying income tax, so only 22% have someone paying income tax (and this rises only to 27% if we consider working-age households).

Box 3: How should anti-poverty campaigners think about environmental or other taxes designed to alter behaviour?

Environmental taxes often appear to be regressive, and there are regular calls for them to be reduced because of the burden they place on low-income households. In reality motoring taxes are not regressive because car ownership is skewed to the rich, but VAT on domestic fuel and power is regressive.

Our view is that best way to approach environmental taxes, or other indirect taxes designed to achieve changes in behaviour such as those on alcohol and tobacco, is to set the rates as part of a review of all aspects of environmental (or health) policy. This could perhaps follow the polluter pays principle and then, if necessary, direct taxes and benefits could be used to compensate losers as desired. If this is not feasible, then a general approach to setting the appropriate level of environmental taxes could involve trading off environmental objectives, given what alternative environmental policies are available, with distributional or anti-poverty objectives, given what anti-poverty policies are available.

2.3.5 Prospects: The tax system and incentives

As discussed in the previous sub-section, tax cuts that reduce tax liabilities or lower the cost of living are examples of anti-poverty policies that work by improving “pockets” directly. But because the tax system affects the pay-off to an individual for undertaking activities that increase their earnings – such as moving into work, working more hours, seeking a better-paid job or taking steps to improve their qualifications and skills - then the tax system may also have a role to play in reducing poverty by improving “prospects” - such as incentivising moves into paid employment, or encouraging growth in earnings).

The standard way to think about how the tax system affects these activities is to calculate the effective tax rate[21] that would apply to changes in an individual’s earnings. The resulting calculations are often known as “marginal effective tax rates” when the change in earnings is small, or “average effective tax rates” when the change in earnings is large. (If the tax rate is calculated on the change in earnings caused by someone moving into work it is known as the “participation tax rate”[22]).

[21] An “effective tax rate” considers not just how tax liabilities change when earnings change, but also benefits and tax credits.
[22] See, for example, Brewer et al (2013).

As is well known, some of the highest marginal effective tax rates (METRs) are faced by individuals in the bottom half of the income distribution, including those in poverty[23], and so a prospects-based approach to reducing poverty might well seek reductions in Income Tax and National Insurance for low- income households.[24] However, reductions to the rate of withdrawal of means-tested benefits and tax credits would be a much cheaper way of reducing the number of people facing very high METRs. [25] Additionally, some reductions in Income Tax or National Insurance contributions, even if slanted towards those on low pay, can have perverse impacts on relative measures of poverty (if the median household gains by more as a percentage of income than households in poverty), or, more generally, might boost the pockets of those in poverty but end up having an overall inequality-increasing impact on the income distribution. For this reason, and notwithstanding the discussion in Section 2.2 that one's view of the desirability of using the tax system to incentivise work would increase if one took a lifetime approach to reducing poverty, we put relatively little weight on the prospects-based approach to reducing poverty when considering possible tax changes in an APS.

3. Putting principles into practice: Some notes on specific taxes and specific tax reforms

In this section we consider the main taxes in the UK, and discuss the arguments for and against specific reforms and their inclusion in an APS. In doing so, we consider most aspects of the UK tax system, including tax allowances, that raise revenue for government. These include Income Tax; National Insurance; VAT and other indirect taxes affecting households; environmental taxes; the taxation of land and housing; the tax treatment of pension saving and pension income; and the taxation of business. We focus on key design issues, rather than detailed rules and operational issues.

As we have already argued we think that, aside from raising revenue, the role of tax in an APS is likely to be small. Our aims in this section are to give an overview of key issues in tax design affecting the main UK taxes. We highlight reforms that could provide a useful contribution to an APS and also contribute to a fairer tax system. In doing so, we hope to aid anti-poverty campaigners wishing to engage in economic debates about tax reform.

[23] See for example, Brewer et al (2011).

[24] Please note that this is a different argument from the "trickle-down" type argument sometimes advocated; that tax cuts for the non-poor would reduce distortions, strengthen incentives, and thus boost the economy, all of which would help those in poverty.

[25] See chapter 5 of Mirrlees et al. (2011). This is even more true under Universal Credit (UC) because of its use of a net income taper: a reduction in the main rate of income tax by 5ppts reduces the overall METR faced by someone on UC who pays income tax and NI from just 76.2% to 74.4%, i.e. by just 35% of the headline fall of 5 ppts.

3.1. Income Tax and National Insurance

Income Tax and National Insurance are two of the three biggest revenue-raising instruments directly affecting households (with the third being VAT). Historically, the two have very different origins and functions, with National Insurance being part of a social insurance system, and Income Tax being a contribution to general government revenues. There is scope to debate whether this distinction is relevant today. On the one hand, National Insurance contributions remain important for determining an individual's entitlement to the State Pension (but there are few working-age benefits remaining that are directly linked to an individual's history of paying National Insurance contributions), and there remains a public perception that payments of National Insurance are somehow different from payments of Income Tax. On the other hand, any consideration of the way that the tax system affects incomes and incentives has to consider the combined impact of Income Tax and National Insurance contributions.

In this section, we do not address the long-standing (and difficult) issue of whether it would be a good thing for an APS if the UK's benefit system had a larger contributory element[26]; instead, we treat National Insurance as if it were another tax. We first discuss the different rates of Income Tax and National Insurance, and then discuss the tax-free allowance, other reliefs and allowances. Box 4 discusses the advantages and disadvantages of moving to a joint Income Tax system.

[26] Simplifying tremendously, it is argued that a greater contributory element to the benefit system would increase public and political acceptance for benefits to be more generous. The downside is that the beneficiaries from this increased generosity would be likely to include many households not considered to be in poverty. On the other hand, contributory, non-means-tested benefits can provide an important independent source of income for adults in couples.

Box 4: Should we have a joint or individual tax system?

There are good arguments in favour of moving to a system of joint income taxation.[27] If one accepts that living standards are best assessed by the total income of a family, and that it is right for the tax system to affect inequality in living standards, then it would be more efficient to have a tax system that depended on the joint income of a couple than just on an individual's own income. (Compared to the current system, a joint tax system would allow us to raise more tax from families that contain a low-income individual living with a high income partner). Arguments against joint taxation can be of a practical nature: a joint tax system that appeared to penalise couples might result in individuals fraudulently claiming to be living alone, just as appears to happen with tax credits[28]. They can be of a principled nature: some people have a firm belief that the tax system should be based on individual's ability to pay. Or they can be based on an objection to the fact that joint taxation would require husband and wife (and cohabiting partners) to disclose their financial details to each other: it is argued this could be a threat to women's autonomy (it reduces men's autonomy too, but the pre-1990s UK tax system was sexist in treating wife's earnings as belonging to the husband). There would also be changes in the marginal rates of taxation facing people living in couples, which would affect incentives to work or to earn more, and which would probably affect women more than men. The pattern of these changes would depend on the precise design of a joint taxation system, and so it is difficult to say what the impact would be on poverty.

The political support behind the idea of independent taxation in the UK is extremely strong, and advocates of joint taxation are hindered by the fact that the pre-1990 system of joint taxation was sexist, with married men filing tax returns on behalf of themselves and their wives. But systems of joint taxation do not have to be sexist in the way they operate: couples can jointly file a tax return, as happens with tax credits. Our view is that an APS should be in favour of a move to a system of joint income taxation, on the grounds that it would allow the tax system to redistribute more efficiently, especially at the top and middle of the income distribution. On the other hand, the contribution that such a change would make to reducing poverty is very small because the proportion of individuals in poverty who actually pay tax is very low. The political will for such a move is practically non-existent, so this should not be a priority.

[27] See, for example, the commentary by Hilary Hoynes in response to chapter 2 of Adam et al (2010).
[28] See Brewer and Shaw (2006) and Adam and Brewer (2010).

3.1.1 The main rates of Income Tax and National Insurance contributions

Increases in the main rates of Income Tax and National Insurance are sensible ways to raise revenue for an APS, because they are broad-brush and hard-to-evade taxes. We note that there is an increasing trend for politicians of all parties to rule out such changes. We think that this is unhelpful: ruling out rises in the main rates of taxes in no way prevents governments from increasing the total tax take. Instead, it usually constrains them to using more complicated or more economically-harmful tax rises than they need to.

There are currently three main rates of Income Tax: 20%, 40% and 45%. The choice over which of the 20% or 40% rate to increase should be based mainly on distributional considerations: it is difficult to argue that tax changes of one or two percentage points have much of an impact on incentives. The higher rate of 45% applies to income above £150,000. When the previous government cut this rate from 50% to 45% it argued, based on HMRC analysis of what happened when the rate rose from 40% to 50%, that this would reduce revenues only by a very small amount. This suggests that the revenue-maximising top rate of Income Tax is somewhere between 45% and 50%, and so increases above 45% would be unlikely to raise much revenue. If it is desired to raise more tax from those with incomes above £150,000, then it would be more effective instead to clamp down on opportunities for tax avoidance. One example of this was the very large cut in the annual pension allowance for those with very high earnings that now effectively prevents the very rich from using pensions to defer taxation (see section 3.5).

There is one large anomaly in the current structure of Income Tax and National Insurance, and that is that the rate of employee National Insurance contributions falls from 12% to 2% when earnings rise above the upper earnings limit (UEL) of £827 per week in 2016-17, approximately the point where individuals start to pay the 40% rate of Income Tax. This means that the combined Income Tax and employee National Insurance contributions rate rises from 32% (20%+12%) to 42% (40%+2%) at this point. This suggests that there may be an argument for increasing the UEL to £100,000[29] or £150,000 per year. Or, - radically and perhaps counter-productively, given what we think we know about the revenue-raising top rate of tax- without limit. This reform could raise up to £10 billion depending on the scale of behavioural response or avoidance and where the new UEL is set.

[29] We suggest this figure because the income tax personal allowance is withdrawn from those with incomes between £100,000 and (currently) £122,000, and this leads to an effective marginal rate of 62% over this band of income, which is already very high (60% income tax and 2% National Insurance contributions).

3.1.2 The Income Tax personal allowance and the National Insurance thresholds

For Income Tax, the priority of the current Conservative government and the previous coalition government was to increase the personal allowance. Although this may have the superficial appeal of taking low-earning individuals out of the tax system[30], it is a very poorly-targeted anti-poverty policy. Even if the impact of the rise is partially or totally offset for higher-rate tax payers[31], the bulk of the revenue foregone goes to people not in poverty, and, of those in poverty, the money goes to the not-so-poor rather than the very-poor. Increasing the personal allowance therefore tends to increase the gap in income between the bottom and the middle of the income distribution, and so tends to increase the usual measures of relative poverty. Increasing the personal allowance does reduce METRs for a few, but, as discussed in section 2, the reduction in METRs is very small given the total cost, and there are almost certainly better targeted and cheaper ways to cut METRs for those in poverty (by changing in-work tax credits or Universal Credit). For example, the Green Budget 2014 indicated that if the taper rate at which UC was withdrawn, or the amount a family could earn before UC was withdrawn, was increased, then such measures would directly benefit working families in the bottom three income deciles more than increasing the tax free allowance to £12,500, would strengthen the gains to work, and would cost £10 billion per year less. However, such measures would mean that more families would be eligible for UC, weakening these newly-eligible families' work incentives.

And this general point has become even truer in recent years. First, after a long period of time where the personal allowance effectively rose with inflation, the past eight years have seen a very large increase in the Income Tax personal allowance, relative to prices or earnings. The current Conservative government plans to increase it to £12,500 by 2020, which is close to the level of earnings for someone working full-time on the National Living Wage (and considerably above the earnings of someone aged under 25 on the National

[30] In reality, there is very little gain to taking someone out of tax altogether: the time and money cost to a low-earning individual of being liable to income tax is very low given that we have PAYE, and the additional time and money cost to employers and HMRC of extracting income tax from one more person is also negligible.

[31] When the personal allowance is raised by (say) £1,000, by default the point at which people start to pay the 40% rate of tax also rises by £1,000, and this means that people who would normally pay the 40% rate of income tax gain by twice as much as those who pay the 20% rate of income tax. One can prevent this by simultaneously reducing the point at which people start to pay the 40% rate of tax, either by an amount that means that these higher-rate taxpayers gain by as much as those who pay the 20% rate of income tax, or by an amount that means that these higher-rate taxpayers do not gain at all. The drawback of doing this is that more people are now facing the 40% rate of income tax. In any case, as the personal allowance is effectively withdrawn from those with incomes above £100,000 (so that is completely withdrawn from those with an income above £100,000 plus twice the value of the personal allowance), rises in the personal allowance have no impact on those with incomes above (approximately) £125,000.

Minimum Wage).[32] Each time the personal allowance rises, the fraction of those in poverty that gain directly falls, as more and more low earners are taken out of Income Tax altogether. Second, as Universal Credit is tapered away against net income, 65% of any increase in income gained by a higher personal allowance is then tapered away from Universal Credit recipients. Given these drawbacks, it is very hard to see why further increases in the personal allowance would be a priority in an anti-poverty strategy. Indeed, cuts in the personal allowance could be appropriate ways to raise revenue.

Further rises in the Income Tax personal allowance are, then, a very poorly-targeted anti-poverty policy. They also do little to take low earners out of the tax system at least, not if we consider National Insurance to be part of the tax system. The then Labour government in 2007 sought to align the primary threshold (the point at which employee National Insurance contributions become liable on earnings) with the Income Tax personal allowance; a policy which was very soon undone when Alastair Darling, as Chancellor, introduced a set of changes to help offset the abolition of the 10p tax rate. But the policy of governments since 2010 has been to keep the National Insurance primary threshold unchanged in real terms while the Income Tax allowance has accelerated away. It follows, then, that increases in the primary threshold would be a less badly-targeted anti-poverty policy than increases in the personal allowance (and we note that increasing the primary threshold in the National Insurance system does NOT reduce workers' entitlement to social insurance benefits or their effective contributions to the State Pension: entitlement to these depends on having earnings above the "lower earnings limit", which is lower than the primary threshold (and so employees with earnings above the lower earnings limit but below the primary threshold do not pay any National Insurance contributions but do gain entitlements or credits to National Insurance benefits: it's as if the National Insurance system had an initial 0% band above the "lower earnings limit"). Re-aligning the primary threshold (and the secondary threshold, the point at which employers start to pay employer National Insurance on earnings) with the Income Tax personal allowance would be a moderately helpful simplification for employees and employers.

[32] See http://www.resolutionfoundation.org/media/blog/the-tax-free-minimum-wage-a-gimmick-or-a-real-giveaway-2/. The personal allowance in 2020 looks likely to remain considerably lower than the amount that a single person currently needs to earn to achieve the Minimum Income Standard level (£17,100 in July 2015, although this would fall slightly were the personal allowance to be raised above £12,500). See https://www.jrf.org.uk/report/minimum-income-standard-uk-2015.

3.1.3 Expanding the Income Tax base by removing reliefs or allowances

There are various reliefs and allowances in operation which could be abolished to raise additional revenue (see https://www.gov.uk/government/statistics/main-tax-expenditures-and-structural-reliefs). There are three broad reasons why these allowances exist:

- to help ensure neutrality or avoid double taxation (for example, most of the "reliefs" on saving and pensions, the "double taxation" relief and foreign dividends exemption)
- because the effort required from HMRC or from individual taxpayers to tax the income in question would be disproportionately large
- to pursue a specific policy objective (for example: the transferable personal allowance for some married couples; Income Tax relief for charities; exemption from tax of income from many state benefits; exemption of the earnings of pensioners from National Insurance)

We do not recommend the blanket removal of reliefs which fall into the first two categories, but if one did not support the intended objectives behind some of the reliefs in the third category, then one could certainly argue for their removal. We would argue that the transferable personal allowance for married couples is unnecessary, although removing it is forecast to raise only £245m in 2015-16. If proponents of an APS believed that there is no practical difference between Income Tax and National Insurance, then National Insurance could be extended to those over the State Pension age who are still in work (as we discuss in Section 3.1.5) And we argue later on that the National Insurance Employment Allowance is unnecessary.

We discuss in Box 5 whether the taxation of state benefits needs to be changed; our conclusion is that the current system is broadly sensible, with most earnings-replacement benefits being taxable in the same way that earnings are taxable, but so-called "extra cost" benefits being free of tax.

Box 5: Should social security benefits be taxed differently?

Of particular relevance to an APS is the question of whether state benefits should be taxable. A coherent approach, and one that is nearly followed throughout by the current system, would be to make all earnings-replacement benefits taxable (in the same way that earnings are taxable), but keep so-called "extra cost" benefits free of tax. This different treatment would reflect the different rationales for those benefits: Statutory Maternity Pay (SMP), for example, is intended to replace the earnings foregone when caring for a baby, and it should therefore be taxed as earnings (which it is, although SMP does not count as earnings for the purposes of assessing entitlements to tax credits, which does not seem sensible). On the other hand, Disability Living Allowance (DLA), for example, is intended to offset or compensate for the inevitable costs of being disabled, costs that do not vary with income. Because its aim is to reduce differences in living standards between those with and without disabilities regardless of their income, its value to the recipient should therefore not decline with income. Because individuals do have some degree of choice over whether or not to have children, though, it is not clear whether or not child benefit should be viewed purely as an extra cost benefit, and so it is less clear that it is the role of the state to compensate all families for some of the additional costs incurred when children are present. In the other direction, one can view child benefit as recognising that the community should share with parents the cost of bringing them up, as children represent an investment in the future of society, in which those without children also have an interest).

One difficulty in making disability benefits or child benefit liable for Income Tax is that the Income Tax system is based on an individual's own income. This means that simply making child benefit taxable would have no impact on a mother who has no other sources of income, for example, even if she is married to a higher-rate taxpayer. It is for this reason that HMRC currently has a rather complicated set of rules to impose an additional charge on adults in families where either adult earns more than £50,000 and where either adult received child benefit that serves to offset their entitlement to child benefit: these rules in effect are a form of joint taxation, as they require couples to disclose their financial arrangements to each other when completing tax returns).[33]

[33] There are no better alternatives to the current messy system of withdrawing child benefit that would remove child benefit from roughly the same families that pay the additional charge now. One way that would remove child benefit from better off families without introducing a new means test or a form of joint income taxation would be to abolish child benefit and increase the child elements of Universal Credit or the child tax credit by offsetting amounts. But this would remove child benefit from considerably more families than have to pay the additional tax charge at the moment. See Brewer and Joyce (2012) for more details.

3.1.4 National Insurance

Section 3.1.1 discussed the issues that should be considered when contemplating the main rates of employee National Insurance. There are also several features of the National Insurance system that are not shared with Income Tax and which are worth noting. As we discuss above, the approach one takes to National Insurance will depend in part on whether one is viewing it akin to a tax, like Income Tax, or whether one is viewing it as payment towards a social insurance system.

Those over the State Pension age. Those in work and over the State Pension age are not liable to make National Insurance contributions. This is hard to justify if National Insurance is thought of like a tax. Revenue could be raised by introducing National Insurance contributions on this group. It would clearly make pensioners who earn more than the NI primary threshold worse off, although many of these will not be in poverty, and pension credit would rise to offset partially the losses amongst those in work and on a low enough income to be entitled to means-tested support.

The self-employed. Individuals who are self-employed are subject to National Insurance contributions on their labour market earnings, but at a lower rate than employees. Furthermore, self-employed individuals pay no equivalent to employers' National Insurance contributions. This means that they pay less National Insurance on their earnings in total than do employees. And, although self-employed individuals do not have access to some contributory benefits that employees do, they will benefit as much from the single-tier State Pension, by far the most important social security benefit that depends on past National Insurance contributions. Overall, this means that the National Insurance system favours the self-employed relative to employees.[34] To make the system fair would ultimately require a rise in the National Insurance contributions rate paid by the self-employed relative to that paid by employees.[35] If this was done by increasing the rate paid by the self-employed, and if there was no change in behaviour, then this would raise a significant amount of revenue (several billions of pounds a year). But such a change would induce self-employed individuals to report lower incomes to HMRC, or to incorporate so as to pay Corporation Tax on profits, rather than National Insurance on their earnings). Because of this, we agree with IFS researchers who concluded that this change "still has considerable appeal, but is not

[34] The Government has announced its intention to reform National Insurance for the self-employed by abolishing Class 2 NI. Not all details of this reform are available at the time of writing, but it does not look likely that this will increase the effective NI rate on the self-employed.

[35] There are some National Insurance benefits for those of working age that are not available to the self-employed: in principle, some of these could be extended to the self-employed (it is difficult to design an unemployment benefit for the self-employed), or the level of NI for the self-employed could be set slightly below that of employees.

unambiguously desirable".[36] Of course, such a reform would be justified on the grounds of ensuring fairness in the tax system, rather than as an attempt to reduce poverty. The impact on poverty depends entirely on the proportion of those in poverty who are self-employed and liable to pay National Insurance, and it is notoriously difficult to use household income surveys to assess the living standards of the self-employed.[37] Obviously self-employed individuals below or close to the poverty line would be negatively affected if they reported enough income to be liable to pay National Insurance, but the policy would level the playing field between low-paid employees and self-employed individuals, and would raise revenue. If it was felt necessary to reduce the impact on poverty, then one offsetting reform would be to reduce the minimum income rules that apply to the self-employed in Universal Credit.[38]

Employer's National Insurance. Together with Income Tax and employee National Insurance, employers' National Insurance forms a tax wedge between the total cost of employing a worker (gross salary + employer National Insurance) and the take-home pay of the employee (gross salary – Income Tax – employee National Insurance).[39] In theory, changes to employer National Insurance should eventually have the same labour market impact as changes to employee National Insurance or Income Tax: cuts in any of these taxes make it cheaper for employers to offer their employees a given level of take-home pay, and so cuts to any of them should either boost employment or increase take-home pay.[40] [41] There is also a good case for using cuts in employer National Insurance as a job protection policy during a recession, as they make it cheaper for employers to continue employing people without employers having to implement nominal wage cuts. However, cutting either of employer or employee National Insurance is an expensive way to encourage job creation, and we do not think it should be a priority in an APS Indeed, a rise in employer or employee

[36] Adam and Roantree (2015).

[37] This point is made in many publications, including Brewer et al (2009), who find that self-employed people have considerably better living standards than their reported income would suggest when compared with employees or those out of work.

[38] These rules mean that, after a certain period of time, the self-employed are treated as if they had earnings of a certain value, even if they declare a lower amount. This can be seen as an anti-fraud policy, or reflective of a desire not to use Universal Credit subsidise unprofitable self-employment.

[39] A tax wedge is the gap between the amount effectively spent by the employer to hire someone and the amount effectively received by the employee, and captures both employer NI and income and employee NI. Say an employer wants his employees to receive an effective hourly rate of £8 an hour after paying tax. A rise in income tax would mean that the employer would need to raise gross wages to offset the additional tax payments to maintain the £8 an hour net wage. Similarly, a rise in employee NI would mean that the employer has to pay more NI to maintain the £8 an hour net wage.

[40] A proposed rise in employer NI is typically called a "jobs tax", although it's just as much a tax on jobs as employee NI or income tax on earnings.

[41] One important twist to this so called "equivalence" arises for employers who are paying wages close to the minimum wage, where there is no scope to cut wages: in this case, cuts in employee NI can only boost take-home pay, but cuts in employer NI may cut employers' costs, boost take-home pay, or boost employment.

National Insurance is nearly as good a way of raising money for an APS as rises in Income Tax or VAT.

We also suggest that the National Insurance employment allowance be abolished, something that would raise a small amount of revenue. This policy eliminates the first £3,000 of liability to employers' National Insurance. In theory, this slightly reduces the cost of employing workers, which might increase overall employment, and thus perhaps reduce poverty, but the restriction to the first £3,000 of employers' National Insurance means that only very small employers will see any meaningful change in the incentives to hire people or to increase workers' earnings, and there is a considerable level of deadweight.[42] Our view is that there are better ways to increase employment or reduce poverty, and it is not clear what would be lost by scrapping this policy.

3.1.5 Summary of recommendations on Income Tax and National Insurance

1. Because they are broad-brush and hard-to-evade taxes, increases in the main rates of Income Tax and National Insurance are sensible ways to raise revenue for an APS, although there is an increasing and unhelpful trend for politicians to rule out such changes.

2. There are a number of unfairnesses or inconsistencies in the Income Tax and National Insurance system that, when removed, would increase revenues. If it needed to raise revenues, an APS could consider:
    - Increasing the upper earnings limit in National Insurance (this is the point at which employee National Insurance contributions fall from 12% to 2%) to £100,000 or £150,000. This reform could raise several billion pounds.
    - Increase National Insurance contributions made by the self-employed.
    - Increase National Insurance contributions made by those in work and over the State Pension age.

3. Increases in the Income Tax personal allowance, and cuts in the rate of Income Tax, are ineffective anti-poverty policies. A better, but still not good, policy would be to increase instead the National Insurance primary threshold while it remains lower than the Income Tax personal allowance. If there are to be cuts in Income Tax or National Insurance (and regardless of whether this is by higher allowance or lower

[42] Large employers still get the £3,000 reduction in liability to employers' NI, but this will surely have no impact on their hiring practices.

rates), an APS should increase UC work allowances by an amount that ensures UC recipients gain as much as non-recipients.

A number of recent exemptions to Income Tax and National Insurance seem hard to justify. An APS should consider abolishing the transferable personal allowance for married couples, and the National Insurance employment allowance, though neither of these moves would raise large amounts of revenue.

3.2. VAT

VAT is commonly said to be a regressive tax. As discussed at length in the annex, we do not think this is accurate. In fact, VAT is a very slightly progressive tax, because the items of expenditure which are exempt, zero- or reduced-rated make up a larger fraction of the spending of households in poverty than they do of better-off households (see, for example, Table 1).[43] This means, then, that cutting VAT is not, therefore, a sensible priority for an anti-poverty strategy: it would reduce the cost of living, but it would in fact slightly increase inequality in living standards, because it would be worth more to richer households. In fact, increasing VAT is a good way to raise money for an APS, or a good deficit-reducing measure for someone concerned about poverty. This is both because it is a broad-based but progressive tax, and also because many households in or at risk of poverty receive income streams which usually (or, perhaps, "used to", as we clarify below) rise automatically to compensate them in part for any resulting increase in the cost of living. This automatic insulation from the impact of VAT rises occurs when state benefits are indexed to inflation. Before 2010, such rises were as good as automatic, but in recent years, they have been more of a matter of discretion. In theory, a household whose income all comes from state benefits would be insulated from a VAT rise if benefit rates rose in line with the "usual" uprating rules. In practice, the rise in benefits would happen with a delay. (And because the rise in the measure of inflation is based on an average basket of goods across the population, the rise would also be sufficient to compensate households on average; some would get too much and some would get too little).

Currently, some items of expenditure attract a zero rate of VAT. For some of these, the original justification was to protect those on low incomes or to pursue some other, similar, distributional objective (for example, the zero rating of food, children's clothes, water and sewerage services, and the reduced rate on the domestic use of fuel and power). But there

[43] For more detail, see Adam and Roantree (2015) or Carrera (2010).

is a standard textbook result from economics that it is less efficient to use the VAT system to achieve distributional (i.e. anti-poverty) goals than it is to use personal taxes or the benefit system. The implication of this result is that, if it is possible to use the benefit system to help particular groups, VAT should then be extended to items that are currently zero-rated (chiefly food, but also children's clothes and housing), the reduced rate on domestic fuel and power should be removed, and any adverse distributional consequences should be offset through changes to direct taxes or (more likely) cash benefits. The point demonstrated in the Mirrlees Review (Mirrlees et al (2011) is that this recommendation is not made simply to have an elegant, simple VAT system (although it is the case that treating different goods differently always leads to additional administration and compliance costs as HMRC and manufacturers argue over, for example, what is a biscuit and what is a cake) but that such a move can still raise money for the government even after compensating low-income households. To be precise: if VAT was applied to children's clothes, and child benefit increased by an amount sufficient to ensure that most low-income households were broadly unaffected, then the government would still have money left over (from the VAT rise less increased spending on child benefit) because high income households with children would tend to be worse off after this change, as they spend more on children's clothes than do households in poverty.[44] Of course, removing zero-rating seems to have become politically impossible, in part because there will always be some households who do not benefit enough from the compensation package, and one can doubt that a full compensation package (in the form of increases in main benefit rates) would be introduced. So we recognise that this may seem an odd tax reform to feature in an APS. In any case, the aim of such a reform is not to reduce poverty directly, but to free up tax revenues without worsening poverty.

3.3 Environmental taxes

As discussed in Box 3, environmental taxes often appear to be regressive, and there are periodic calls for them to be reduced because of the burden they place on low-income households. Our view is that the right way to think about environmental taxes, or other indirect taxes such as those on alcohol and tobacco, is to consider the rates as part of a review of all aspects of environmental policy, perhaps following the "polluter pays" principle, and then, if necessary, using the direct tax and benefit system to compensate losers if desired.

[44] A quantified example is given in Crawford et al (2010). This shows the combined effect of eliminating the current reduced and zero-rate of VAT and using about half the revenue to increase by 15% all income support, income-based jobseeker's allowance and tax credit rates, along with the associated housing benefit and Council Tax benefit thresholds.

Our recommendation, therefore, is that, rather than calling for those environmental policies to be removed (unless they are not environmentally justified!) an APS should instead call for policies to compensate low-income households for the burden of environmental policies. Indeed, the corollary of this argument is that a more sensible environmental policy would remove the reduced rate on domestic fuel and power (i.e. the government should charge the full rate of VAT), using some of the extra VAT receipts to pay for a compensation package (or an energy efficiency package) that should leave low-income households broadly unaffected -just as with the hypothetical rise in VAT on children's clothes, discussed in Section 3.2.[45] Of course, such a move may not garner political or public support, and, as the impact on those in poverty is likely to be small, this should not be a priority for an APS, but it probably should feature in a coherent climate change strategy.

3.4 Land and housing

Historically the taxation of land and property in the UK has been an important part of the tax base, but the current tax treatment of land and housing in the UK is a bit of a mess. Below, we discuss in some detail how housing tax could be reformed to make it both fairer and more economically sensible. However, although the high cost of housing is a key cause of poverty, we think it unlikely that the reforms discussed below would have major direct impacts on households in poverty. Some of them could lead to land and housing being used more efficiently, or distributed more efficiently, but it is not immediately clear that any of them would have major impacts on the cost of housing. None, therefore, should be a priority for an APS.

3.4.1 How should land and property be taxed?

The principles of neutrality and optimal tax design discussed in Section 2.1 suggest that land and property should be taxed in the following way:

- Land is an ideal commodity to tax. Because land is in fixed supply, taxing land should not have any impact on how much land is available to buy or sell. Instead, the impact of taxing land would just be to make landowners worse off, but would have no impact on the final (post-tax) price of land. This means that no distortions would be created by taxing it

[45] Indeed, Preston et al (2013) discuss how to implement a general carbon tax whilst protecting households in poverty.

- Stamp Duty (and any other tax that applies to transactions) should not exist[46]
- The ideal tax treatment of property (meaning the buildings that sit on the land) should depend on how the property is used:
    - Property used by businesses is an input into the production process and therefore it should not be taxed (other than the taxation of the land upon which it sits, as recommended above)[47]
    - Domestic property should be taxed, but working out the appropriate level is difficult, as we discuss below

The principle of neutrality means that domestic property should be taxed in the same way as other, similar goods, in order that the tax system does not affect people's choices about how much housing to own. But domestic property has elements of both a consumption good (for its occupant) and an investment good (for its owner), and this complicates the analysis substantially.[48] For example, domestic property – whether it is owned outright or rented – can be thought of as a consumption good because it provides shelter and a home. Neutrality suggests it should therefore be taxed at a similar rate to other consumption goods, by, for example, charging VAT on all rentals, or reintroducing to the rest of the UK the system of domestic rates that operates in Northern Ireland and existed elsewhere before 1990. But domestic property can also be seen as an investment good, and neutrality suggests that it should therefore be taxed in a similar way to other investments. This would be achieved by not taxing the purchase of housing, but then taxing the resulting income in the same way as we tax other income from other investments, and then taxing the capital gain made when the property was sold. Clearly, then, achieving neutrality between both consumption and investment goods is impossible.

[46] Stamp Duty discourages what the Mirrlees Review (Mirrlees et al (2011) calls "mutually beneficial transactions". By this it mean that the existence of Stamp Duty will mean that some homes will be owned by people who do not value the property more than all other individuals. This is a clear example of an economically-inefficient outcome. The historical advantage of Stamp Duty is that it is an easy tax to administer, because it is easy to observe when property is sold, and there is a readily-available valuation of the property.

[47] This is another standard textbook result from economics. In general, it is better to levy a tax on the final product sold by business than it is to levy taxes on the goods and services bought by businesses in order to produce the final product. By not levying taxes on the goods and services bought by businesses, we at least ensure that the tax system is not distorting the decisions made by businesses on how best to produce whatever they are producing.

[48] Most goods are consumption goods: people buy consumption goods because they derive some direct benefit from owning or consuming them. An investment good is one that people want to buy because it provides a stream of future income.

3.4.2 How does the current tax treatment of housing compare to the ideal?

Alongside Stamp Duty (which we have already said should not exist), the main tax on domestic property is Council Tax.[49] Because Council Tax is payable by whoever is responsible for the cost of the accommodation (i.e. the homeowner, if they live in their own property, or the tenant, if it is a rental property), then it effectively acts as a tax on the consumption of housing. As we argued above, it is a good thing to tax the consumption of housing, just as we tax the consumption of other goods and services, but the current design of Council Tax means that it has important shortcomings. These include:

- it is based (in England and Scotland, but not Wales), on 1991 property values, and so the relative level of tax paid by different people in the same area will not reflect the current relative values of their property
- it is not a pure housing tax, because there are discounts for single person occupants and for students. If the aim is to tax housing, then these exemptions are not justified.
- the link between the value of the property and liability to Council Tax means that the tax is regressive with respect to property prices (a doubling of property values does not double Council Tax liability). Proposals for a mansion tax would provide a partial solution to this problem, but one that is considerably less elegant than rebasing Council Tax on current values and making liabilities a flat proportion of property values: see Adam and Roantree (2015).

Cuts to Council Tax benefit/rebate introduced by the coalition government also mean that many more low-income households now have to pay some Council Tax. We do not think that a property tax needs to exclude low-income households: what matters is the distributional impact of the combined tax and benefit system, not of individual taxes, but it is certainly the case that Council Tax can be an expensive tax for local authorities to collect, and this might suggest pragmatically that it could be better to find a way to exempt more households on a low income.

Of course, Council Tax was not intended solely to be a housing tax: it was intended as a way to fund local government, and taxing property is ideal way to fund local government, as domestic properties can't be moved. This is one of the reasons why the formal liability rests with the occupant, not the owner (so as to give all residents a stake in the financial decisions made by their local authority). It is also worth noting that, when introduced, Council Tax was

[49] Except in Northern Ireland, which has domestic rates. Local taxation is devolved: Wales has used its devolved power to base Council Tax on more up to date valuations, and to introduce a new higher band. Consecutive SNP governments in Scotland have used their devolved power to freeze Council Tax bills, but have so far made no structural changes to Council Tax.

seen as a lot fairer than its predecessor, the community charge (which was a per-person levy with no regard for ability to pay). Box 6 discusses the old idea of having a local Income Tax as a way to fund local government, replacing Council Tax.

3.4.3. How do we move to a more coherent taxation of land and property?

The principles outlined above would suggest:

- Council Tax should be replaced with a "housing services tax", incident on all homeowners, and levied at some fraction of the notional rent (similar to the domestic rates system), and intended as a substitute for VAT. This would deal with many of the shortcomings of Council Tax (as we said above, such a system would be similar to the domestic rates that still exist in Northern Ireland, and existed in the rest of the UK until 1990).[50] The Mirrlees review recommended that "Ideally, the tax rate might be set at -20-%, since it is intended to substitute for VAT on the consumption of housing; but a more pragmatic medium-term goal might be to replace the revenue currently provided by Council Tax and Stamp Duty on residential properties, which would probably imply a slightly lower rate than this." (Mirrlees et al (2011))
- a land value tax on all land, and the abolition of business rates
- some form of tax incentive to landlords (as they are currently over-taxed compared to home-owners) [51]
- abolition of Stamp Duty.

These tax changes would remove some of the unjustifiable distortions that exist in the current tax treatment of housing, but it is not clear what impact they would have on the housing market (nor what the incidence would be between homeowners/landlords and renters). They are also not intended to raise significant amounts of revenue, and it is therefore not clear whether they would have a significant part to play in an APS. Furthermore, it is also the case that this full set of changes looks politically challenging (to say the least!). More realistically, then, an anti-poverty strategy should probably seek the following changes to Council Tax (noting that it is a devolved matter):

- alter the formula for calculating Council Tax so the amounts levied rise proportionately to the assessed values

[50] A tax reform similar to this was considered in the JRF-commissioned work by Chris Leishman and others. A summary is available at http://www.jrf.org.uk/publications/council-tax-impacts.
[51] And this recommendation was made before the current Conservative government effectively increased taxes on buy-to-let landlords.

- base Council Tax on current house prices (i.e. conduct a revaluation, as Wales did some time ago)

From the point of view of seeking fairness in the housing market, it would also be sensible to support the gradual abolition of the single person discount to Council Tax, as it gives an unwarranted incentive for single people to live in large houses. However, considered in isolation this reform would put some people or particular groups (such as single pensioners) into poverty.

An anti-poverty strategy should also:

- support calls to introduce a land value tax (the Mirrlees Review concluded that this should not be ruled out as administratively infeasible), thereby allowing business rates to be abolished, and support calls to introduce the replacement of Council Tax by a housing services tax

Box 6: what about a local Income Tax?

At various times, there have been calls to replace Council Tax with a local Income Tax (it was the policy of the Liberal Democrats and the SNP at various points in the previous decade). Such a reform has several aspects to it.

The main arguments in favour of a local Income Tax are that it would remove Council Tax, which is a poorly designed and regressive tax, and replace it with a progressive tax (Income Tax). This is indeed true, and could be seen as an advantage. However, moving the tax burden from housing to income would make housing even more tax-privileged compared to other goods (and presumably resulting in gains for those who currently own property). Such a change would also replace a tax where liability is easy to determine (although it can be expensive to collect, especially from those whose liabilities are low) with one that would certainly be more difficult to determine and police, as England currently does not have any concept of an individual's official place of residence. And we should remember that unfair taxes can be dealt with not just through scrapping them, but also by altering other parts of the tax and benefit system so as to offset their unfairness.

As has been highlighted, an alternative and more appealing option would be to replace Council Tax with a fair and better designed tax on property such as a 'housing services tax' as described in 3.4.3. However, even if this is not an option, then the case for local Income Tax is not overwhelming: it might be fairer, but it would further tax-privilege housing, and it would certainly be a more complicated tax to administer.

3.5 Pensions and savings [52]

In the case of the taxation of pensions and savings, neutrality describes a regime where the tax system does not affect people's decisions over whether to take the reward from work (earnings) as income now, or as income in the future (e.g. after retirement). This is achieved by taxing savings only once. There are two main ways of ensuring that taxes are only levied once:

- tax income when it is earned, but then do not tax the returns if this income is invested, and do not tax it when it is withdrawn. This describes the tax treatment of money saved in an ISA

[52] We discuss only the tax treatment of pensions and savings, and no other aspects of pensions policy.

- do not tax income when it is earned if it is immediately saved, do not tax the returns on investments, but then levy tax on withdrawals. This describes the principle behind the tax treatment of pensions, although there are various exceptions to this that we discuss later

Examples of non-neutrality are regimes that subject pension income to double taxation. For example this could be by taxing it when it is originally earned and then again when it is taken as income in retirement, or by making it more tax efficient to save (in a pension, or in other forms) compared to spending the money now. As we discussed in Section 2, the tax system does not need always to be neutral, but neutrality is the natural starting point, and the onus should be on policy-makers to defend departures from neutrality.

This way of thinking about the tax treatment of pensions is different from the one used in UK discussions until quite recently, where tax relief on pensions was seen as an unwarranted tax break that chiefly benefitted the better-off, rather than a necessary feature of the tax system to achieve neutrality. This may reflect that, until the very recent and dramatic expansion in the annual limit on contributions to tax-free ISAs, the UK taxed income from savings too harshly and so, compared with other forms of savings, pensions looked tax-privileged. In fact, neutrality requires all income from savings (or at least the return from relatively low-risk assets) to be free of tax, rather than tax relief being limited to certain products, like ISAs. If the UK tax system had always treated income from savings in a way closer to neutrality, then the public and politicians might be less likely to see tax relief on pensions as unwarranted.

In fact, the tax treatment of pensions has always been intended to be broadly neutral. This is achieved by having payments into a pension fund attract tax relief, and this means that earnings which are immediately put into a pension fund are not taxed, and the income from a pension is then taxed in retirement. But there are several main ways in which neutrality is not maintained, or does not appear to be maintained:

- 25% of the value of a defined contribution (DC) pension can be taken as a tax-free lump sum. This provides an additional tax incentive to save in a pension over what is required to achieve neutrality, because this money is not taxed when originally earned nor when taken as income in retirement.
- Neither payments made by an employer into a pension fund nor income taken out of a pension pot in retirement are liable to National Insurance contributions. This provides a substantive tax incentive for employees to have their employers pay

money into their pension pots for them instead of being paid salary, and it means that payments made by employers into pension pots are under-taxed.

- In the other direction, tax relief on payments to a pension pot are subject to annual and lifetime limits, which means that the tax system subjects larger pension funds to double taxation. When introduced, these limits were a small feature of the pension tax system, but they have been growing more relevant since 2010. For example, the personal allowance has been cut from £50,000 to £40,000 for all individuals, and then cut further for those whose earnings are above £150,000, and the Lifetime Allowance has been cut from £1.8 million in 2010 to £1 million. These changes dramatically reduce the ability of the wealthy to defer tax on their earnings by putting money into a pension.
- Some individuals who are higher-rate tax payers may get tax relief at 40% when paying money into a pension, and then subsequently pay the basic rate of Income Tax of 20% when they start to receive their pension. This – sometimes known as "tax smoothing" – can appear to be an unjustified tax cut. The underlying feature of the tax system that leads to these apparent anomalies is the fact that the UK has a progressive Income Tax system, and that tax liabilities are based on annual income (rather than on lifetime income). This gives an incentive to all individuals to smooth out their income over as many years of their life as possible (because, to give an example, the tax paid on £100,000 earned in 1 year is more than the total tax paid on 2 years' income of £50,000 p.a. and there would be no Income Tax at all paid on 10 years' income of £10,000 p.a.). The way that pension tax relief works is entirely consistent with this; the fact that we have tax relief on pensions simply makes it easier for individuals to engage in this form of tax smoothing.[53] Common responses to this are to limit the amount of amount of tax relief to the basic rate. As we discuss later, this is misguided as well as being an extremely complicated policy to implement. As it happens, the Government's recent cuts to the lifetime allowance and the annual allowance, and the especially large cuts for those with earnings above £150,000, will reduce the number of wealthy people who will be benefitting from this form of tax smoothing.

The first two issues meant that saving in a pension was, for a long time, tax-advantaged compared with other types of saving. However, the very recent cuts in the lifetime and annual pension allowances have limited the extent to which people can benefit from this generous tax treatment. At the same time, governments since 2010 have considerably

[53] We could portray this in another way, arguing that pensions tax relief allows more individuals to avoid the tax "penalty" that hits those individuals who have annual incomes that vary considerably over their lifetimes compared to those with more stable incomes. Fairness is in the eye of the beholder!

reduced the tax paid on savings outside a pension, by substantially increasing the annual limits on tax-free products such as ISAs (where the annual limit is due to reach £20,000 from April 2017) and by introducing the Lifetime ISA (Lisa).[54] Overall, recent policy has been to limit the extent to which high earning individuals can use the tax-privileged status of pensions, and has increased the attractiveness of non-pension saving products. Indeed, the 2016 Budget states that for an individual who is self-employed and paying the basic rate of tax, saving in a Lisa and ISAs is at least as generous as saving in a private pension, and more so if the individual expects to pay tax in retirement (Budget, 2016: 47) (however, having an employer make contributions to your pension via salary sacrifice is still the most tax efficient method of saving for retirement).

One original justification for pensions being tax-advantaged relative to non-pension saving was that “extra” tax incentives (such as the tax-free lump sum) were needed to persuade people to save in a pension. Doing so has the twin disadvantages to savers of locking up money until retirement, and requiring savers to buy annuities when they retire. The fact that we now have pension freedom – so that pensioners do not need to spend their pension pots on annuities – means there are few good arguments for pension savings being more tax privileged than savings in (for example) a Lisa/ISA. This very recent convergence of the tax treatment of pension and other forms of saving is, therefore, broadly sensible. However, to obtain full neutrality, then the tax treatment of pensions and savings would need to change as we set out below.

Given this discussion, we suggest that an APS take the following approach to the taxation of savings and pensions:

- not to call for reductions in tax relief on individuals’ payments to pension pots, despite their appeal. Such reductions would introduce some double taxation of income put into a pension. It would also be very complex, administratively. The appeal of such a policy is that the resulting tax rise is incident only on those who are well-off enough to pay higher-rate tax now, and have enough income to save. However, such a policy is undesirable in that it introduces a tax incentive not to save; better ways to extract more tax revenues from the better-off would be rises in the higher rate of Income Tax, cuts in the higher-rate threshold, or increases in employee National Insurance contributions for higher earners [55]

[54] A Lisa is available to anyone under the age of 40. It allows the individual to save up to £4,000 a year and receive a 25% bonus from the government for every pound they put in. Similar to a pension, the Lisa encourages savers to defer their income to later on in their life: money in a Lisa can be withdrawn without penalty only if withdrawn after the age of 60 or used to fund the purchase of a first property.

[55] As the IFS said in the run up to the 2015 general election: “The Labour party proposes to restrict relief [on contributions to a private pensions] to the basic rate only for people with incomes above £150,000. This has

- seek the reduction of the tax-free lump sum. If it is necessary to tax-favour savings in a pension, then this should be done with a different policy, rather than one which favours those who want to withdraw a lump sum over those who wish to withdraw money gradually
- call for contributions made by employers into a pension fund to be liable to both employee and employer National Insurance. This would be a major reform, both in term of revenue – the IFS cite an HMRC figure for 2010-11 which says that this exemption costs the government £13bn a year – and complexity – it would require HMRC to place a value on DB schemes[56]
- In principle, there should be no annual limits on contributions to pension pots, and lifetime limits should affect only the very richest (if anyone), as a form of anti-avoidance. This means that the current lifetime limits should be increased by at least inflation each year

None of these would have much direct impact on households in poverty, though. Some would raise revenue, some would seek a more neutral tax system, and some might improve confidence in and support for the tax system. Other than the revenue-raisers, we cannot imagine that many of these would be a priority for an APS.

3.6 Taxes on business

A business can be thought of as something conjured up by accountants that, very loosely, receives money from its customers, and spends money on its suppliers and employees. Any difference between the two – profits – are then eventually given to its owners, including its shareholders. This should make clear that businesses cannot be said to pay any taxes: instead, all taxes are effectively paid for by individuals, as an increase in a tax levied directly on business has to ultimately affect one or more of the business's customers (if it increases its prices), its employees (if it cuts wages), or its owners (if its profits are reduced). This in turn means that business should not be seen as a guilt-free, or distortion-free, source of tax revenues. Ultimately, changing taxes on businesses will have implications for the income distribution of income and for poverty (and, as we discussed in Section 2, it is usually a good idea to avoid having taxes that distort how business produce goods and services).

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the merit of limiting a bad policy to a smaller group of people." A discussion of whether tax relief on contributions to pensions should be cut can be found in Adam and Roantree (2015).

[56] The IFS say that the sensible longer run reform would be to levy National Insurance contributions on pension income but provide National Insurance relief on employee and employer pension contributions.

In this section, we offer a few brief observations on the main taxes affecting businesses (we discussed employers National Insurance contributions in Section 3.1), and the economic arguments in favour of various reforms. In general we think that reforming taxation of businesses is unlikely to have much of a direct impact on households in poverty, and so should not be a priority for an APS, but such reforms might help improve confidence in and support for the tax system.

Corporation Tax is a tax on profits, and the direct impact of a Corporation Tax cut is to give a boost to the income of those who own businesses, including share-holders. In principle, lower Corporation Tax encourages businesses to undertake more profit-generating activities, which might boost economic activity (i.e. growth). In practice, as we discussed in Section 2, general Corporation Tax cuts are a very expensive way to boost profit-generating activities. In fact, policy on Corporation Tax over the past few decades has mostly been focused on securing tax revenues, rather than with any regard to real economic activities. For example, successive UK governments have cut the headline rate of Corporation Tax chiefly to reduce businesses' incentive to avoid tax through moving profits overseas or other tax wheezes (or to increase the incentive for multinationals to take their profits out of higher tax countries and put them into the UK). If only to protect government revenues, an APS should certainly support moves that reduce the ability of companies to avoid Corporation Tax.[57] Because the boundary between earnings and profits is a little fuzzy (e.g. self-employed people can either pay Income Tax on their earnings, or incorporate and pay Corporation Tax on their profits), rates of Corporation Tax should not diverge too much from rates of Income Tax.

Because the Exchequer would benefit if employers paid higher wages, there are sometimes calls for firms to be incentivised to pay higher wages, or to become Living Wage employers.[58] There is no single model for this recommendation, but there are a number of problems with most of them. First, HMRC does not know the hourly wage paid by employers to its employees: it knows only the total earnings of employees and not how many hours are worked. Second, a reduction in Corporation Tax that is linked to paying the Living Wage helps only profit-making companies: it does nothing to affect the incentives faced by non-profitable companies, by not-for-profit organisations such as charities or public sector bodies), or by employers that are not incorporated businesses. Third, such schemes would typically suffer from problems of deadweight and or abuse. As a result, we are not convinced these would be worthwhile.

[57] See Miller and Pope (2016) for a thorough discussion of the flaws of how the current Corporation Tax regime treats multi-nationals.
[58] E.g. http://www.bbc.co.uk/news/uk-24786397.

Finally, and as already mentioned, **business rates** are an inefficient tax on a means of production, and should ideally be replaced by a land value tax.

4. Conclusion

This report has considered the role of taxation in an APS, focusing on key design issues, rather than detailed rules and operational issues. We have suggested how to engage in economic debates about the UK tax system with a poverty perspective, and we have highlighted some specific reforms that are likely to lead to a fairer and more efficient UK tax system, as well as making a worthwhile contribution to an anti-poverty strategy. We have made three main points:

- the tax system will play a relatively small role in an APS, outside of raising revenues that can be spent on anti-poverty programmes or direct redistribution. This is because the tax system has relatively small direct impacts on households in poverty.
- some tax reforms commonly advocated as helping those in poverty are either extremely inefficient ways of reducing poverty, or have other, undesirable, side effects.
- various parts of the UK tax system would benefit from a substantial overhaul and redesign. Although the intention of these reforms is not explicitly to help those in poverty, some of them would tend to shift the tax burden slightly away from households in poverty and towards the rich, and of course all in society could ultimately benefit from a more efficient tax system. But, as many of these would be politically unpopular, an APS would probably not want to exert too much effort in their advocacy.

In the short-run, an APS could:

- try to persuade politicians keen on increasing the Income Tax personal allowance instead to increase benefits, or to increase the National Insurance primary threshold. If Income Tax or National Insurance is cut, then UC work allowances should be increased at the same time
- reform Council Tax to make it relate to current property values, and to be closer to a proportional tax on property values

Revenues to spend in an APS can be raised in a relatively efficient manner through increases in the main rates of Income Tax, National Insurance contributions or VAT: these are all broad-brush taxes which are relatively easy to collect and difficult to evade. There are other reforms which would improve the efficiency or coherence of the tax system and also raise money:

- increasing the upper earnings limit in National Insurance
- increasing National Insurance contributions made by the self-employed (if necessary compensating them through UC)
- increasing National Insurance contributions made by those in work and over the State Pension age (if necessary compensating them through pension credit)
- making payments made by employers into pension pots liable for both employee and employer National Insurance contributions

In the longer-run, an APS should support moves to:

- make most income from savings free of tax
- dramatically reform the taxation of land and housing, with a housing services tax notionally replacing Council Tax, and a land tax on all types of land notionally replacing business rates
- make Income Tax depend on the joint income of couples
- remove the reduced- and zero-rates of VAT, provided that some of the revenues are spent on a compensation package

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Annex: How much tax is paid by those in poverty?

An excellent guide to how much tax individuals in different parts of the income distribution pay is provided by the ONS's annual publication, "The Effects of Taxes and Benefits on Household Income".[59] The tables summarised in this report are from the June 2014 edition, and cover 2012/13. Of course, the ONS's analysis imbeds assumptions very similar to those underpinning the IFS-style distributional analysis which is discussed in section 2, including that an individual's well-being is best represented by the equivalised household income (or, sometimes, equivalised income of the "benefit unit"). This assumption in turn assumes or implies:

- that taxes and benefits are equivalent, and what matters is the net impact of both systems on household income
- the best measure of resources is disposable income (and not consumption, or deprivation), despite known issues with those reporting very low incomes to surveys
- the best measure of resources is a snapshot of current income (and not an assessment of lifetime income)
- all income within a household is effectively shared out equally between its members, such that all reach a comparable standard of living
- the Modified OECD equivalence scale[60] is a sensible way to correct for the fact that two can live more cheaply than one, and that adults and children require different amounts of resources

Table 1 reproduces some of the key facts by income decile and also by income and spending quintile. Given the qualifications listed above, we can see from Table 1 that Income Tax and National Insurance are progressive taxes, and that Council Tax (even net of Council Tax benefit/support) is regressive.

For the indirect and intermediate taxes, it also shows that, when assessed as a fraction of disposable income, all indirect taxes are broadly regressive. However, we would argue that standard distributional analysis – that expresses payments of indirect taxes as a fraction of disposable income to give the "indirect tax burden" – can give a misleading impression of the progressivity of indirect taxes. There are two reasons for this. First, there is evidence that some (but certainly not all) households that report very low incomes are under-

[59] http://www.ons.gov.uk/ons/rel/household-income/the-effects-of-taxes-and-benefits-on-household-income/index.html).
[60] www.oecd.org/eco/growth/OECD-note/EquivalenceScales.pdf

reporting their incomes to the survey.[61] If a household under-reports its income to the survey, then this will bias up an estimate of its “indirect tax burden”, and furthermore, such income-under-reporting households are more likely to be found at the bottom of the reported income distribution. In principle, the same data inaccuracies might also affect estimates of the “direct tax burden”, but in practice the impact will be minimal if the household’s reports of its tax paid are consistent with the reports of its income. Second, it is normal for income and expenditure for a given household to be different from each other when measured over short periods, due to short-term fluctuations in both. If income fluctuates around a trend, but households spend according to their long-run average level of income, then households with temporarily high income will seem to be spending less than their income and so have a temporarily low indirect tax burden. Meanwhile households with temporarily low income will seem to be temporarily spending more than their income, and so have a temporarily high indirect tax burden. In both cases, a more accurate impression of their true tax burden would be obtained by taking a longer-run perspective, in which income and spending would be much closer to each other. This longer-run perspective would give a lower indirect tax burden for the low-income household and a higher indirect tax burden for the high-income household. Also by definition/construction, those households with temporarily low income tend to be at the bottom of the reported income distribution, and those households with temporarily high income tend to be at the top of the reported income distribution (or, at least, the former will be found, on average, lower down the distribution than the latter). The combined effect of these two observations can be seen in the ONS analysis: households in the bottom income decile spend more on alcohol and air travel, and are more likely to own their own home, than households in the 2nd income decile.

It is for these two reasons that it has been argued (including by the authors) that the distributional impact of indirect taxes is better assessed by examining the payment of indirect taxes as a fraction of expenditure. Others at IFS agree, and the ONS also acknowledges this issue.[62] [63] When assessed as a fraction of expenditure, the ONS analysis shows that VAT, alcohol duties, and motoring taxes (duties on fuel plus Vehicle Excise Duty

[61] See Brewer et al. (forthcoming), for example.

[62] See pp15-16 of http://www.ons.gov.uk/ons/rel/household-income/the-effects-of-taxes-and-benefits-on-household-income/2012-13/art--etb-analysis-and-methodology.html)

[63] Carrera (2010) also looks at this issue, and introduces another way of assessing the impact of indirect taxes, which is to measure the indirect tax burden as a percentage of disposable income, but then to assess progressivity by ranking households according to their expenditure. This leads to broadly the same conclusions as measuring incidence by assessing taxes as a burden of expenditure and ranking households by expenditure. Although measuring the indirect tax burden as a percentage of disposable income will be wrong (it will give too high a number) for those households that under-report their income, these under-reporting households will be spread across the distribution of expenditure, rather than concentrated at the bottom of the income distribution, thus reducing their extent to which the measure of progressivity is biased as a result.

(VED)) are each broadly progressive, but duties on tobacco, and all other indirect and intermediate taxes considered together, are each regressive.[64] Analysed in this way, VAT appears to be (broadly) progressive because those items which are zero or reduced rated make up a larger fraction of the shopping basket of low-spenders than high-spenders. Duties on tobacco appear to be regressive because low spenders spend a larger fraction of their shopping basket on tobacco than high spenders; the reverse is true for alcohol. VED and duties on fuel are (together) progressive for similar reasons.

[64] "All other indirect and intermediate taxes" is a mixed bag, containing all other indirect taxes (Television licences, Stamp Duty on house purchase, Customs Duties, betting taxes, Insurance Premium Tax, Air Passenger Duty, Camelot National Lottery fund) but also a much larger category of what the ONS call "intermediate taxes", which are indirect taxes paid by businesses (e.g. rates on commercial and industrial property, motor vehicle duties paid by businesses, duties on hydrocarbon oils paid by businesses, employers' contributions to National Insurance, customs (import) duties paid by businesses, stamp duties paid by businesses, VAT (on the intermediate stages of exempt goods), independent commission franchise payments, landfill tax paid by businesses, Consumer Credit Act fees, Bank Levy). Because the final incidence of a tax cannot be on a business, the methodology followed by ONS allocates the burden of these taxes to households by assuming that these taxes serve to put up the price of goods and services (that means that these taxes seem economically similar to normal indirect taxes charged to the final consumer). However, assessing to what extent these intermediate taxes actually raise the prices of goods paid by different sorts of households is very difficult, and the ONS admit that using different assumptions could easily make these taxes seem progressive, and this is why we do not consider them further in this paper.

Table 1: Tax by income decile

	Bottom	2nd	3rd	4th	5th	6th	7th	8th	9th	Top	All
Income Tax and National Insurance as % original income	14.7%	10.9%	12.0%	13.2%	15.4%	16.5%	17.7%	18.8%	20.1%	22.8%	19.0%
IT and NI as % pre-tax income	6.1%	5.0%	6.7%	8.5%	11.4%	13.7%	15.6%	17.1%	19.0%	22.3%	16.1%
IT and NI as % disposable income	7.1%	5.5%	7.4%	9.7%	13.4%	16.5%	19.0%	21.3%	24.1%	29.3%	19.8%
IT, NI and Council Tax as % original income	38.9%	24.3%	21.4%	20.3%	20.4%	20.6%	20.9%	21.6%	22.4%	24.3%	22.6%
IT, NI and CT as % pre-tax income	16.3%	11.2%	11.9%	13.0%	15.1%	17.1%	18.4%	19.7%	21.2%	23.8%	19.1%
IT, NI and CT as % disposable income	18.7%	12.4%	13.3%	14.9%	17.7%	20.6%	22.5%	24.5%	27.0%	31.2%	23.5%
VAT as % disposable income	15.6%	10.2%	9.2%	9.0%	9.0%	9.1%	8.7%	8.3%	8.2%	7.2%	8.6%
Duty on alcohol as % disposable income	1.9%	1.2%	1.1%	1.2%	1.0%	1.2%	1.0%	1.1%	1.0%	0.7%	1.0%
Duty on tobacco as % disposable income	3.3%	1.7%	2.0%	1.5%	1.2%	1.3%	1.2%	1.0%	0.4%	0.2%	1.0%
Duty on hydrocarbon oils & VED as % disposable income	4.0%	2.5%	2.5%	2.4%	2.4%	2.2%	2.2%	2.1%	1.8%	1.1%	2.0%
Other indirect taxes as % disposable income	4.3%	2.7%	2.3%	1.9%	1.9%	1.8%	1.9%	1.9%	1.9%	1.7%	2.0%
Intermediate taxes as % disposable income	4.5%	2.7%	2.4%	2.2%	2.1%	2.0%	1.8%	1.8%	1.7%	1.4%	1.9%

	Bottom	2nd	3rd	4th	5th	6th	7th	8th	9th	Top	All
From ONS Table 14, quintile groups only											
VAT as % expenditure	8.3%		8.8 %		9. 1%		9.1 %		8.9%		8.9%
Duty on alcohol as % expenditure	1.0 %		1.1 %		1.1 %		1.1 %		1.0 %		1.1 %
Duty on tobacco as % expenditure	1.6 %		1.7 %		1.2 %		1.1 %		0.3 %		1.0 %
Duty on hydrocarbon oils & VED as percentage of expenditure	2.1 %		2.4 %		2.3 %		2.3 %		1.6 %		2.0 %
Other indirect taxes as percentage of expenditure	**7.2 %**		**6.8%**		**6.2 %**		**6.1%**		**5.9 %**		**6.3 %**

Notes: Author's calculations from Table 2a and 14 of http://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/datasets/theeffectsoftaxesandbenefitsonhouseholdincomefinancialyearending2014.

Original income is defined as income from employment, private pensions, investments and other non-government sources. Gross income is defined as original income plus the sum of cash benefits received. Disposable income is gross income minus direct taxes paid. Other indirect taxes include: Television Licence, Stamp Duty on house purchase, Customs Duties, betting taxes, Insurance Premium Tax, Air Passenger Duty, Camelot National Lottery fund and others. Intermediate taxes include: commercial and industrial rates, Employers' NI contributions, duty on hydrocarbon oils, VED and others