A survey of the UK tax system

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Thomas Pope
Barra Roantree

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*Updated by Thomas Pope and Barra Roantree**

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***Addresses for correspondence:** thomas_p@ifs.org.uk, barra_r@ifs.org.uk

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Contents

1. Introduction 3
2. Revenue raised by UK taxes 4
3. The tax system 6
   3.1 Income tax 6
   3.2 National Insurance contributions (NICs) 14
   3.3 Value added tax (VAT) 17
   3.4 Other indirect taxes 20
   3.5 Capital taxes 25
   3.6 Corporation tax 28
   3.7 Taxation of North Sea production 32
   3.8 Bank levy 33
   3.9 Council tax 34
   3.10 Business rates 35
4. Summary of recent trends 38
   4.1 How did we get here? 38
   4.2 Personal income taxes 41
   4.3 Taxation of savings and wealth 50
   4.4 Indirect taxes 55
   4.5 Taxes on companies 60
   4.6 Local taxation 62
5. Conclusions 64

1. Introduction

This briefing note provides an overview of the UK tax system. It describes how each of the main taxes works and examines their current form in the context of the past 30 years or so. We begin, in Section 2, with a brief assessment of the total amount of revenue raised by UK taxation and the contribution made by each tax to this total. In Section 3, we describe the structure of each of the main taxes: income tax; National Insurance contributions; value added tax and other indirect taxes; capital taxes such as capital gains tax and inheritance tax; corporation tax; taxes on North Sea production; the bank levy; council tax; and business rates. The information given in these subsections relates, where possible, to the tax system for the fiscal year 2014–15.

In Section 4, we set the current system in the context of reforms that have taken place over the last 30 years or so. The section examines the changing structure of income tax and National Insurance contributions and developments in the taxation of savings, indirect taxes, taxes on companies and local taxation.[1]

Much of the information in this briefing note is taken from the HM Revenue & Customs (HMRC) website.[2] Information relating to tax receipts is from the Office for Budget Responsibility (OBR)'s *Economic and Fiscal Outlook* published alongside Budget 2014.[3] Occasionally, sources can be inconsistent because of the different timing of publications or minor definitional disparities.

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[1] There is more information on historical tax rates on the IFS website at http://www.ifs.org.uk/tools_and_resources/fiscal_facts.

[2] https://www.gov.uk/government/organisations/hm-revenue-customs.

[3] See http://budgetresponsibility.org.uk/economic-fiscal-outlook-march-2014/.

2. Revenue raised by UK taxes

Total UK government receipts are forecast to be £648.1 billion in 2014–15, or 37.7% of UK GDP. This is equivalent to roughly £12,400 for every adult in the UK, or £10,000 per person.[4] Not all of this revenue comes from taxes: taxes as defined in the National Accounts are forecast to raise £606.0 billion in 2014–15, with the remainder provided by surpluses of public sector industries, rent from state-owned properties and so on.

Table 1 shows the composition of UK government revenue. Income tax, National Insurance contributions and VAT are easily the largest sources of revenue for the government, together accounting for almost 60% of total tax revenue. Duties and other indirect taxes constitute around 11% of current receipts, with fuel duties of £26.8 billion the largest component. The only other substantial category is company taxes, which come to 11% of current receipts, predominantly corporation tax and business rates.

There has been some variation over time in the composition of government receipts and the size of receipts as a proportion of GDP. These topics are returned to in Section 4.

[4] Using table A1-1 of Office for National Statistics, *Principal Population Projections (2012-Based)*.

Table 1. Sources of government revenue, 2014–15 forecasts

	Revenue (£bn)	*Percentage of total receipts*
Income tax (gross of tax credits)	166.5	*25.7*
Tax credits counted as negative income tax by HM Treasury[a]	–2.7	*–0.4*
National Insurance contributions	110.0	*17.0*
Value added tax[b]	110.7	*17.1*
Other indirect taxes		
Fuel duties	26.8	*4.1*
Tobacco duties	9.9	*1.5*
Alcohol duties	10.4	*1.6*
Betting and gaming duties	2.3	*0.4*
Vehicle excise duty	5.9	*0.9*
Air passenger duty	3.2	*0.5*
Insurance premium tax	3.2	*0.5*
Landfill tax	1.3	*0.2*
Climate change levy	2.0	*0.3*
Aggregates levy	0.3	*0.0*
Customs duties	2.8	*0.4*
Capital taxes		
Capital gains tax	5.4	*0.8*
Inheritance tax	3.9	*0.6*
Stamp duty land tax	12.7	*2.0*
Stamp duty on shares	3.1	*0.5*
Company taxes		
Corporation tax (net of tax credits)	40.5	*6.2*
Petroleum revenue tax	1.2	*0.2*
Business rates	26.9	*4.2*
Bank levy	2.7	*0.4*
Council tax	27.6	*4.3*
Other taxes and royalties	29.4	*4.5*
Net taxes and National Insurance contributions	**606.0**	***93.5***
Interest and dividends	19.3	*3.0*
Gross operating surplus, rent, other receipts & adjustments	22.8	*3.5*
Current receipts	**648.1**	***100.0***

[a] Most of the cost of tax credits is counted as government spending rather than a reduction in income tax revenue. See pages 12–14 for details.

[b] Net of (i.e. after deducting) VAT refunds paid to other parts of central and local government; these are included in 'Other taxes and royalties'.

Note: Figures may not sum exactly to totals because of rounding.

Source: Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2014 (http://www.budgetresponsibility.org.uk/economic-fiscal-outlook-march-2014/).

3. The tax system

3.1 Income tax

The tax base

Income tax is forecast to raise £166.5 billion in 2014–15, but not all income is subject to tax. The primary forms of taxable income are earnings from employment, income from self-employment and unincorporated businesses, jobseeker's allowance, retirement pensions, income from property, bank and building society interest, and dividends on shares. Incomes from most means-tested social security benefits are not liable to income tax. Many non-means-tested benefits are taxable (e.g. basic state pension), but some (e.g. disability living allowance) are not. Gifts to registered charities can be deducted from income for tax purposes, as can employer and employee pension contributions (up to an annual and a lifetime limit), although employee social security (National Insurance) contributions are not deducted. Income tax is also not paid on income from certain savings products, such as National Savings certificates and Individual Savings Accounts (ISAs).

Allowances, bands and rates

Income tax operates through a system of allowances and bands of income. Each individual has a personal allowance, which is deducted from total income before tax to give *taxable* income. The majority of taxpayers (those born after 5 April 1948) receive a basic personal allowance of £10,000, while older taxpayers are entitled to a higher age-related allowance (ARA) (see Table 2).[5] Budget 2014 announced that, from 2015–16, a married person with some unused personal allowance will be able to transfer up to 10% of that allowance to a higher-earning spouse, as long as the higher earner is not paying higher- or additional-rate income tax.

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[5] Budget 2012 announced that these age-related allowances would be abolished for new claimants from 6 April 2013 and frozen at their 2012–13 levels until the basic personal allowance (for those born after 5 April 1948) reaches these levels through statutory indexation (see below) and discretionary increases. In 2015–16, this basic personal allowance will rise to £10,500, meaning there will be just two personal allowances: one for those born after 5 April 1938 and one for those born before.

Table 2. Personal allowances, 2014–15

Type of allowance	*Allowance (£ per year)*[a]
Aged 65 or under	10,000
Aged 66–75	10,500
Aged 76 or over	10,660

[a] For higher-income individuals, personal allowances are reduced or eliminated as described in the text.

Source: HM Revenue & Customs, https://www.gov.uk/government/publications/rates-and-allowances-income-tax/rates-and-allowances-income-tax.

In the past, married couples were also entitled to a married couple's allowance (MCA). This was abolished in April 2000, except for those already aged 65 or over at that date (i.e. born before 6 April 1935). For these remaining claimants, the MCA does not increase the personal allowance; instead, it simply reduces final tax liability by up to £816.50.

Each of these allowances is withdrawn from taxpayers with sufficiently high incomes. An age-related allowance is withdrawn at a rate of 50 pence in the pound for income exceeding the ARA limit – £27,000 in 2014–15 – until it is reduced to the basic personal allowance at an income level of £28,000 (£28,320 in the case of the higher ARA). Regardless of age, the personal allowance is reduced by 50 pence for every pound of income above £100,000, gradually reducing it to zero for those with incomes above £120,000.

The MCA, however, begins to be withdrawn at income levels above £28,320 at a rate of 5 pence in the pound until the relief reaches the minimum amount of £314 at income levels of £38,370. For couples married before 5 December 2005, the MCA is given to the husband, while for those married on or after 5 December 2005 or in a civil partnership, it is given to the higher-income spouse. However, the minimum allowance can be transferred from one spouse to the other, or they can claim half each.

In addition, as of 2014–15, child benefit begins to be withdrawn once income exceeds £50,000. For every £100 earned above £50,000, 1% of child benefit is withdrawn, so that it is reduced to zero for those with incomes above £60,000.

Taxable income (i.e. income above the personal allowance) is subject to different tax rates depending upon the band within which it falls. The first £31,865 of taxable income is subject to the basic rate of 20%. Taxable income between the basic-rate limit of £31,865 and the higher-rate limit of £150,000 is subject to the higher rate of 40%, and the additional rate of 45% is payable on taxable income above £150,000. Higher-rate tax is payable on income above £41,865 (the personal allowance plus the basic-rate limit) and additional-rate tax is payable on income above £150,000 (those with incomes this high have had their personal allowance eliminated, as described above, meaning that all their income is taxable).[6]

Savings income and dividend income are subject to slightly different rates of tax.[7] Savings income is taxed at 20% in the basic-rate band, 40% in the higher-rate band and 45% above £150,000, like other income, except that savings income that falls into the first £2,880 of taxable income is subject to a lower tax rate of 10%.[8] Dividend income is taxed at 10% up to the basic-rate limit, 32.5% between the basic-rate limit and the additional-rate limit, and 37.5% above that. However, this is offset by a dividend tax credit, which reduces the effective rates to 0%, 25% and 30.6% respectively. This means that, for basic-rate taxpayers, company profits paid out as dividends are taxed once (via corporation tax on the company profits) rather than twice (via both corporation tax and income tax). When calculating which tax band different income sources fall into, dividend income is treated as the top slice of income, followed by savings income, followed by other income.

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[6] The withdrawal of personal allowances effectively creates extra tax rates in the system. Those facing withdrawal of the age-related allowances have an effective marginal income tax rate of 30% as they lose 50p of their allowance for each additional pound of income, which is worth 10p (20% of 50p), as well as paying income tax at a rate of 20p in the pound. Similarly, those facing withdrawal of the MCA lose 5p on top of the basic rate for each additional pound of income, creating a 25% marginal income tax rate for those claiming the allowance whose income is between £28,320 and £38,370. Those with incomes between £100,000 and £120,000 lose 50p of personal allowance for each additional pound of income, which is worth 20p (40% of 50p), meaning that their overall marginal income tax rate is 60% once this is added to the 40% higher rate of income tax. In addition, as of 2014–15, child benefit is reduced by 1% for every £100 of earnings above £50,000. This creates additional tax rates that depend on the amount of child benefit received, and so the number of children.

[7] Note that income from pensions is treated as earned income, not savings income.

[8] Budget 2014 announced that, from April 2015, the 10% rate will be abolished and replaced with a 0% rate for savings income that falls into the first £5,000 of taxable income.

Of a UK adult population of around 52.4 million, it is estimated that there will be 29.9 million income tax payers in 2014–15. Around 4.6 million of these will pay tax at the higher rate, providing 38.5% of total income tax revenue, and 343,000 taxpayers will pay tax at the additional rate, providing 28.9% of total income tax revenue.[9]

Most bands and allowances are increased at the start (in April) of every tax year in line with statutory indexation provisions, unless Parliament intervenes. These increases are announced at the time of the annual Budget and are in line with the percentage increase in the retail price index (RPI) in the year to the previous September. Increases in personal allowances and the starting-rate limit are rounded up to the next multiple of £10, while the increase in the basic-rate limit is rounded up to the next multiple of £100. The additional-rate limit and the £100,000 threshold at which the personal allowance starts to be withdrawn are frozen in nominal terms each year unless Parliament intervenes.

Taxation of charitable giving

One deduction that can be made from income tax relates to charitable giving. There are two ways in which people can donate money to charities tax-free: Gift Aid and payroll giving schemes.

Gift Aid gives individuals (and companies) tax relief on donations. Individuals make donations out of net (after-tax) income and, if the donor makes a Gift Aid declaration, the charity can claim back the basic-rate tax paid on it; higher- and additional-rate taxpayers can claim back from HM Revenue & Customs (and keep) the difference between basic-rate and higher-rate or additional-rate tax. In 2013–14, charities received £1.04 billion under the Gift Aid scheme on £4.13 billion of donations and, in addition to this, higher- and additional-rate taxpayers received £500 million in relief on charitable donations from HMRC.[10]

Under a payroll giving scheme (Give-As-You-Earn), employees nominate the charities to which they wish to make donations and authorise their

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[9] Source: Tables 2.1 and 2.6 at https://www.gov.uk/government/collections/income-tax-statistics-and-distributions.

[10] Source: Tables 10.2 and 10.3 at https://www.gov.uk/government/collections/charitable-donations-and-tax-reliefs-statistics.

employer to deduct a fixed amount from their pay. This requires the employer to contract with an HMRC-approved collection agency, and tax relief is given by deducting donations from pay before calculating tax due. The cost of the payroll giving scheme was estimated to be £40 million in 2013–14.[11]

Payments system

The Pay-As-You-Earn (PAYE) system of withholding income tax from earnings (and from private and occupational pensions) involves exact cumulative deduction – i.e. when calculating tax due each week or month, the employer considers income not simply for the period in question but for the whole of the tax year to date. Tax due on total cumulative income is calculated and tax paid thus far is deducted, giving a figure for tax due this week or month. The cumulative system means that, at the end of the tax year, the correct amount of tax should have been deducted – at least for those with relatively simple affairs – whereas under a non-cumulative system (in which only income in the current week or month is considered), an end-of-year adjustment might be necessary.

Since April 2013, employers have been obliged to report salary payment to HMRC in real time, rather than just at the end of the year. With HMRC calculating and deducting tax based on real-time knowledge of individuals' income from all sources, HMRC hopes that administration will be more accurate more promptly and with less hassle for individuals and employers.[12] A longer-term plan, envisaged in a consultation document published in 2010, involves employers being removed from the tax collection process altogether.[13] Instead, gross pay would be sent to an HMRC computer, which would then calculate the appropriate amount of tax payable, with the net salary being passed on to the employee's bank

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[11] Source: https://www.gov.uk/government/collections/charitable-donations-and-tax-reliefs-statistics.

[12] There could also be benefits beyond income tax from this: for example, it might become possible to adjust benefit and tax credit awards automatically when income changes, eliminating the need for individuals to notify the government separately. The government intends its new universal credit, discussed below, to use such a system for calculating entitlements.

[13] See HM Revenue & Customs, *Improving the Operation of Pay As You Earn (PAYE)*, HMRC Consultation Document, London, 27 July 2010.

account. While such developments may bring great improvements, they can also go badly wrong. Much depends on how successfully government can bring in new administrative and IT systems given limited resources allocated to such projects. About 90% of income tax revenue is collected through PAYE.

Tax on bank interest is collected through a simpler withholding system, which operates under the assumption that this income is not subject to higher-rate tax. Those with more complicated affairs – such as the self-employed, those with very high incomes, company directors and landlords – must fill in a self-assessment tax return after the end of the tax year, setting down their incomes from different sources and any tax-privileged spending such as pension contributions or gifts to charity; HMRC will calculate the tax owed given this information. Tax returns must be filed by 31 October if completed on paper or by 31 January if completed online; 31 January is also the deadline for payment of the tax. Fixed penalties and surcharges operate for those failing to make their returns by the deadlines and for underpayment of tax.

PAYE works well for most people most of the time, sparing two-thirds of taxpayers from the need to fill in a tax return. However, in a significant minority of cases, the wrong amount is withheld – typically when people have more than one source of PAYE income during the year (e.g. more than one job/pension over the course of the year), especially if their circumstances change frequently or towards the end of the year. Such cases can be troublesome to reconcile later on, which is one reason the government has embarked on a programme of modernisation for PAYE.[14]

In 2009, the UK government introduced the National Insurance and PAYE Service (NPS), bringing together all of an individual's PAYE and National Insurance (NI) information in a single database; previously, there were 12 separate regional databases, income tax and NI records were kept separately, and different income streams of the same individual were

[14] For an assessment of PAYE, see J. Shaw, J. Slemrod and J. Whiting, 'Administration and compliance', in J. Mirrlees, S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles and J. Poterba (eds), *Dimensions of Tax Design: The Mirrlees Review*, Oxford University Press for IFS, Oxford, 2010, http://www.ifs.org.uk/publications/7184 and the associated commentaries by R. Highfield and by B. Mace (same volume).

recorded separately. In time, NPS should significantly improve administration, but its introduction has been marked by what could politely be called 'teething troubles' as the new system uncovered (and then handled badly) errors missed by the system it was replacing; one result was that nearly 6 million taxpayers were informed that they had either overpaid or underpaid tax in the previous two years.

Tax credits

The Labour government of 1997–2010 oversaw a move towards the use of tax credits to provide support that would previously have been delivered through the benefit system. Since April 2003, there have been two tax credits in operation – child tax credit and working tax credit. Both are based on family circumstances (apart from the married couple's allowance, the rest of the income tax system operates at the individual level) and both are refundable tax credits, meaning that a family's entitlement is payable even if it exceeds the family's tax liabilities.

Child tax credit (CTC) provides means-tested support for families with children as a single integrated credit paid on top of child benefit. Families are eligible for CTC if they have at least one child aged under 16, or aged 16–19 and in full-time non-advanced education (such as A levels) or approved training. CTC is made up of a number of elements: a family element of £545 per year, a child element of £2,750 per child per year, a disabled child element worth £3,100 per child per year (payable in addition to the child element) and a severely disabled child element worth £1,255 per child per year (payable in addition to the disabled child element). Entitlement to CTC does not depend on employment status – both out-of-work families and lower-paid working parents are eligible for it – and it is paid directly to the main carer in the family (nominated by the family itself).

Working tax credit (WTC) provides in-work support for low-paid working adults with or without children. It consists of a basic element worth £1,940 per year, with an extra £1,990 for couples and lone parents (i.e. everyone except single people without children). Single claimants working at least 30 hours a week are entitled to an additional £800 payment, as are couples with at least one child who jointly work at least 30 hours with one working at least 16 hours. Lone parents, couples where at least one partner is entitled to carer's allowance, workers over 60, and workers with a disability are eligible for WTC provided at least one adult works 16 or more hours per week. Couples with children are eligible if they jointly work at least 24 hours per week, with one partner working at least 16 hours per week. For those without children or a disability, at least one adult must be aged 25 or over and working at least 30 hours per week to be eligible. All childless claimants without a disability will therefore be entitled to the 30-hour premium. There are supplementary payments for disability. In addition, for families in which all adults work 16 hours or more per week, there is a childcare credit, worth 70% of eligible childcare expenditure of up to £175 for families with one child or £300 for families with two or more children (i.e. worth up to £122.50 or £210). The childcare credit is paid directly to the main carer in the family. The rest of WTC is paid to a full-time worker (two-earner couples can choose who receives it); originally, this was done through the pay packet where possible, but this proved rather burdensome for employers, and so since April 2006 all WTC has been paid directly to claimants.

A means test applies to child tax credit and working tax credit together. Families with pre-tax family income below £6,420 per year (£16,010 for families eligible only for CTC) are entitled to the full CTC and WTC payments appropriate for their circumstances. Once family income exceeds this level, the tax credit award is reduced by 41p for every £1 of family income above this level. The main WTC entitlement is withdrawn first, followed by the childcare element of WTC, then the child and disability elements of CTC and finally the family element of CTC. This means that a family without any eligible childcare costs or disabilities will exhaust their entitlement to tax credits once their total income exceeds around £24,050 if they have one child, around £30,750 if they have two children or around £37,450 if they have three children.

HMRC paid out £29.3 billion in tax credits in 2013–14, of which £23.0 billion was CTC and £6.3 billion WTC. Of this, £2.7 billion is counted as negative taxation in the National Accounts, with the remaining £26.6 billion classified as public expenditure. However, many families are paid more (and some less) than their true entitlement over the year, mostly because of administrative errors or because family circumstances changed to reduce their entitlement (e.g. spending on childcare fell) and HMRC did not find out early enough (or did not respond quickly enough) to make the necessary reduction in payments for the rest of the year. The scale of this problem has been reduced since the first two years of operation of CTC and WTC, but HMRC still overpaid between £1.82 billion and £2.19 billion (and underpaid between £0.07 billion and £0.32 billion) in 2012–13.[15,16] As at April 2014, 4.7 million families containing 7.8 million children were receiving tax credits (or the equivalent amount in out-of-work benefits). Of these, 2.2 million receive just child tax credit, 0.6 million receive just working tax credit and 1.9 million receive both.

The government intends to replace tax credits (and other means-tested benefits for those of working age) with a single benefit called universal credit by the end of 2017. While claims to universal credit are now being made in certain pilot areas, the roll-out to further areas and more claimant groups is running considerably behind schedule.[17]

3.2 National Insurance contributions (NICs)

National Insurance contributions act like a tax on earnings, but their payment entitles individuals to certain ('contributory') social security benefits.[18] In practice, however, contributions paid and benefits received bear little relation to each other for any individual contributor, and the link has weakened over time. Some contributions (19.7% of the total in

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[15] Source: HM Revenue & Customs, *Annual Report and Accounts 2013–14*, 2014, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/330670/HMRC-annual-report-2013-14.pdf.

[16] For more on the operational problems with tax credits and attempts to solve them, see M. Brewer, 'Tax credits: fixed or beyond repair?', in R. Chote, C. Emmerson, R. Harrison and D. Miles (eds), *The IFS Green Budget: January 2006*, IFS Commentary C100, London, 2006, http://www.ifs.org.uk/publications/3552.

[17] For more details on universal credit, see A. Hood and L. Oakley, 'A survey of the GB benefit system', IFS Briefing Note BN13, 2014, http://www.ifs.org.uk/publications/1718.

[18] For details of contributory benefits, see A. Hood and L. Oakley, 'A survey of the GB benefit system', IFS Briefing Note BN13, 2014, http://www.ifs.org.uk/publications/1718.

2014–15[19]) are allocated to the National Health Service; the remainder are paid into the National Insurance Fund. The NI Fund is notionally used to finance contributory benefits; but in years when the Fund was not sufficient to finance benefits, it was topped up from general taxation revenues, and in years when contributions substantially exceed outlays (as they have every year since the mid-1990s), the Fund builds up a surplus, largely invested in gilts: the government is simply lending itself money. These exercises in shifting money from one arm of government to another maintain a notionally separate Fund, but merely serve to illustrate that NI contributions and NI expenditure proceed on essentially independent paths. The government could equally well declare that a quarter of NICs revenue goes towards financing defence spending, and no one would notice the difference.

In 2014–15, NICs are forecast to raise £110.0 billion, the vast majority of which will be Class 1 contributions. Two groups pay Class 1 contributions: employees as a tax on their earnings (primary contributions) and employers as a tax on those they employ (secondary contributions). Class 1 contributions for employers and employees are related to employee earnings (including employee, but not employer, pension contributions), subject to an earnings floor. Until 1999, this floor was the lower earnings limit (LEL). In 1999, the levels at which employees and employers started paying NI were increased by different amounts. The resulting two floors were named, respectively, the primary threshold (PT) and the secondary threshold (ST). The LEL was not abolished, but became the level of income above which individuals are entitled to receive social security benefits previously requiring NI contributions. The rationale was that individuals who would have been entitled to these benefits before 1999 should not lose eligibility because of the overindexation of the NI earnings floor. Between 2001–02 and 2007–08, the PT and ST were aligned at the level of the income tax personal allowance, but further reforms resulted in this alignment being broken.

[19] Source: Appendix 4 of Government Actuary's Department, *Report by the Government Actuary on the Draft Social Security Benefits Up-Rating Order 2014; the Welfare Benefits Up-Rating Order 2014; and the Draft Social Security (Contributions) (Re-Rating and National Insurance Fund Payments) Order 2014*, 2014, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/275294/36532_GAD_Report_Web_Accessible.pdf.

Employee NICs are paid at a rate of 12% on any earnings between the PT (£153 in 2014–15) and the upper earnings limit (UEL, £805 in 2014–15), and at 2% on earnings above the UEL. Employer NICs are paid at a flat rate of 13.8% on earnings above the ST (set at £153 per week in 2014–15).[20] From April 2014, employers can claim back up to £2,000 in NICs payments through the employment allowance. Those employers with a liability of less than £2,000 will therefore pay no NICs at all.[21]

NICs are lower for those who have contracted out of the state second pension (formerly the State Earnings-Related Pension Scheme, SERPS) and instead belong to a recognised defined benefit private pension scheme. The percentage levied on earnings between the LEL (£111 per week in 2014–15) and the upper accrual point (UAP, £770 per week in 2014–15) is currently reduced by 1.4 percentage points for employee contributions and by 3.4 percentage points for employer contributions.[22] Note that since the rebate applies from the LEL but contributions start at the PT/ST, there is a small range in between where the NICs rate is negative and so some people receive a net payment from the government. Members of defined contribution pension schemes are (as of 6 April 2012) no longer permitted to contract out of the state second pension. The Pensions Act 2014 legislated that a flat-rate pension would be introduced for all who reach the state pension age after April 2016, replacing the two-tiered system. There will no longer be the option of contracting out for defined benefit schemes.[23] Table 3 summarises the Class 1 contribution structure for 2014–15.

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[20] The Autumn Statement 2013 announced that, from 2015–16, employer NICs on employees aged under 21 would be abolished.

[21] This allowance operates as a tax rebate of £2,000 (or an employer's total NICs liability, whichever is lower) for all eligible firms. For details on eligibility, see https://www.gov.uk/employment-allowance.

[22] Before 2009, the contracted-out rebate applied between the LEL and the UEL.

[23] See https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/181229/single-tier-pension.pdf.

Table 3. National Insurance contribution (NIC) rates, 2014–15 (%)

Band of weekly earnings (£)	*Employee NICs*		*Employer NICs*	
	Standard rate	*Contracted-out rate*	*Standard rate*	*Contracted-out rate*
0–111 (LEL)	0	0	0	0
111–153 (PT/ST)	0	–1.4	0	–3.4
153–805 (UEL)	12	10.6	13.8	10.4
Above 805	2	2	13.8	13.8

Note: Rates shown are marginal rates, and hence apply to the amount of weekly earnings within each band. Contracted-out rate applies to defined benefit pension schemes, i.e. contracted-out salary-related schemes (COSRSs). Members of defined contribution pension schemes – i.e. contracted-out money-purchase schemes (COMPSs) – are not permitted to contract out.
Source: HM Revenue & Customs, https://www.gov.uk/government/publications/rates-and-allowances-national-insurance-contributions.

The self-employed pay two different classes of NI contributions – Class 2 and Class 4. Class 2 contributions are paid at a flat rate (£2.75 per week in 2014–15) by those whose earnings (i.e. profits, since these people are self-employed) exceed the small earnings exception, currently £5,885 per year. Class 4 contributions are paid at 9% on any profits between the lower profits limit (£7,956 per year in 2014–15) and the upper profits limit (£41,865 per year in 2014–15), and at 2% on profits above the upper profits limit. This regime for the self-employed is much more generous than the Class 1 regime, and the self-employed typically pay far less than would be paid by employee and employer combined.

Class 3 NI contributions are voluntary and are usually made by UK citizens living abroad in order to maintain their entitlement to benefits when they return. Class 3 contributions are £13.90 per week in 2014–15.[24]

3.3 Value added tax (VAT)

VAT is a proportional tax paid on all sales. Before passing the revenue on to HMRC, however, firms may deduct any VAT they paid on inputs into their products; hence it is a tax on the *value added* at each stage of the production process, not simply on all expenditure. The standard rate of VAT has been 20% since 4 January 2011; previously, it was 17.5%. In

[24] Those living abroad can also pay Class 2 contributions if they were employed or self-employed immediately before leaving the country, have lived in the UK continuously for three years or have three years' worth of contributions in the past, and are employed or self-employed abroad.

1994–95, a reduced rate was introduced for domestic fuel and power, originally 8% but now 5%. The reduced rate has since been extended to cover women's sanitary products, children's car seats, contraceptives, certain residential conversions and renovations, certain energy-saving materials, and smoking cessation products. A number of goods are either zero-rated or exempt. Zero-rated goods have no VAT levied upon the final good, and firms can reclaim any VAT paid on inputs as usual. Exempt goods have no VAT levied on the final good sold to the consumer, but firms cannot reclaim VAT paid on inputs; thus exempt goods are in effect liable to lower rates of VAT. Table 4 lists the main categories of goods that are zero-rated, reduced-rated and exempt, together with estimates of the revenue forgone by not taxing them at the standard rate in 2013–14.

Only firms whose sales of non-exempt goods and services exceed the VAT registration threshold (£81,000 in 2014–15) need to pay VAT. Since April 2002, small firms (defined as those with total sales of no more than £230,000, including VAT, and non-exempt sales of no more than £150,000, excluding VAT, in 2014–15) have had the option of using a simplified flat-rate VAT scheme. Under the flat-rate scheme, firms pay VAT at a single rate on their total sales and give up the right to reclaim VAT on inputs. The flat rate, which varies between 4% and 14.5% depending on the industry, is intended to reflect the average VAT rate in each industry, taking into account recovery of VAT on inputs, zero-rating and so on. The intention was that, while some eligible firms would pay more VAT and some would pay less by using the flat-rate scheme, all would gain from not having to keep such detailed records and calculate VAT for each transaction separately. But, in practice, it is not clear how great the administrative savings are, since firms must keep similar records for other purposes and many now make the extra effort of calculating their VAT liability (at least roughly) under both the standard scheme and the flat-rate scheme in order to decide whether it is worth joining (or leaving) the flat-rate scheme.

VAT is expected to raise £110.7 billion in 2014–15.

Table 4. Estimated costs of zero-rating, reduced-rating and exempting goods and services for VAT revenues, 2013–14

	Estimated cost (£m)
Zero-rating of:	
Food	16,600
Construction of new dwellings*	8,050
Domestic passenger transport	4,050
International passenger transport*	300
Books, newspapers and magazines	1,700
Children's clothing	1,800
Water and sewerage services	2,200
Drugs and supplies on prescription	2,950
Supplies to charities*	300
Certain ships and aircraft	750
Vehicles and other supplies to disabled people	700
Cycle helmets*	15
Reduced rate for:	
Domestic fuel and power	5,200
Women's sanitary products	45
Contraceptive products	10
Children's car seats	20
Smoking cessation products	20
Energy-saving materials*	20
Certain residential conversions and renovations*	200
Exemption of:	
Rent on domestic dwellings*	8,650
Supplies of commercial property*	500
Private education*	2,600
Health services*	2,950
Postal services	200
Burial and cremation	200
Finance and insurance*	2,800
Betting and gaming and lottery duties*	1,950
Exemption for cultural admission charges*	35
Small traders below the turnover limit for VAT registration*	1,800
Total	66,615

* These figures are particularly tentative and subject to a wide margin of error.

Note: The figures for all reduced-rate items are estimates of the cost of the difference between the standard rate of VAT and the reduced rate of 5%.

Source: HMRC statistics, https://www.gov.uk/government/collections/tax-expenditures-and-ready-reckoners.

3.4 Other indirect taxes

Excise duties

Excise duties are levied on three major categories of goods: alcoholic drinks, tobacco and road fuels. They are levied at a flat rate (per pint, per litre, per packet etc.); tobacco products are subject to an additional *ad valorem* tax of 16.5% of the total retail price (including the flat-rate duty, VAT and the *ad valorem* duty itself). Since flat-rate duties are expressed in cash terms, they must be revalorised (i.e. increased in line with inflation) each year in order to maintain their real value. Table 5 shows the rates of duties levied as of April 2014. Excise duties are forecast to raise £47.1 billion in 2014–15.

Table 5. Excise duties, April 2014

Good	*Duty (pence)*	*Total duty as a percentage of price (%)*	*Total tax as a percentage of price (%)*[a]
Packet of 20 cigarettes:			
specific duty	368.2	60.9	77.6
ad valorem (16.5% of retail price)	136.8		
Pint of beer	41.5	14.2	30.9
Wine (75cl bottle)	205.0	48.3	65.0
Spirits (70cl bottle)	790.2	49.0	65.7
Unleaded petrol (litre)	58.0	42.4	61.7
Diesel (litre)	58.0	42.7	59.3

[a] Includes VAT.

Note: Assumes beer (bitter) at 3.9% abv, still wine exceeding 5.5% but not exceeding 15% abv, and spirits (whisky) at 40% abv.

Source: Duty and VAT rates from HMRC website (https://www.gov.uk/alcohol-and-tobacco-excise-duty and https://www.gov.uk/government/publications/rates-and-allowances-excise-duty-hydrocarbon-oils). Prices: cigarettes and beer from National Statistics, *Consumer Price Indices*, https://www.gov.uk/government/statistics; wine and spirits from HM Revenue & Customs, *Alcohol Bulletin*, https://www.uktradeinfo.com/Statistics/Statistical%20Factsheets/AlcoholFactsheet1013.xls, uprated to April 2014 prices from 2012 prices using wine and spirits RPI sub-index from National Statistics, *Consumer Price Reference Tables*, http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-323601; petrol and diesel from table 4.1.1 of Department of Energy and Climate Change, *Quarterly Energy Prices*, https://www.gov.uk/government/collections/quarterly-energy-prices.

Vehicle excise duty (VED) and road user levy

In addition to VAT and excise duties, revenue is raised through a system of licences. The main licence is vehicle excise duty, levied annually on road vehicles. For cars and vans registered before 1 March 2001, there are two bands based on engine size. VED is £145 per vehicle for vehicles with engines not over 1,549cc; above this size, VED is £230. Cars and vans registered on or after 1 March 2001 are subject to a different VED system based primarily on carbon dioxide emissions. For petrol cars or vans, VED ranges from zero for vehicles emitting up to 100g of carbon dioxide per kilometre to £285 for vehicles emitting more than 200g of carbon dioxide per kilometre (g/km). Vehicles registered since 23 March 2006 that emit more than 225g/km are liable for even higher rates: £485 for those emitting between 226g/km and 255g/km and £500 for those emitting more than 255g/km. Different VED rates apply for newly-registered cars for the first year of ownership; they are more heavily graduated according to the vehicle's emissions, ranging from zero for vehicles emitting 130g of carbon dioxide per kilometre or less to £1,090 for those emitting more than 255g/km. Different rates apply for alternative-fuel vehicles and for other types of vehicles, such as motorbikes, caravans and heavy goods vehicles.

In addition, from 2014–15, a new road user levy applies for heavy goods vehicles. Rather than applying only to vehicles registered in the UK (as with VED), it is based on the number of days a vehicle spends on UK roads. VED for heavy goods vehicles has been reduced such that most UK-registered vehicles should pay no more under the new system than the previous one. Instead, this adjustment means that a greater proportion of revenue will be taken from foreign-registered vehicles.

In 2014–15, VED is forecast to raise £5.9 billion.

Insurance premium tax (IPT)

Insurance premium tax came into effect in October 1994 as a tax on general insurance premiums. It is designed to act as a proxy for VAT, which is not levied on financial services because of difficulties in implementation. IPT is payable on most types of insurance where the risk insured is located in the UK (e.g. motor, household, medical and income replacement insurance) and on foreign travel insurance if the policy lasts for less than four months. Long-term insurance (such as life insurance) is exempt. Since 4 January 2011, IPT has been levied at a standard rate of 6% of the gross premium; previously, the standard rate had been 5%. If, however, the policy is sold as an add-on to another product (e.g. travel insurance sold with a holiday, or breakdown insurance sold with vehicles or domestic appliances), then IPT is charged at a higher rate of 20% (increased from 17.5% on 4 January 2011 in line with the standard VAT rate). This prevents insurance providers from being able to reduce their tax liability by increasing the price of the insurance (which would otherwise be subject to insurance premium tax at 6%) and reducing, by an equal amount, the price of the good or service (subject to VAT at 20%). Insurance premium tax is forecast to raise £3.2 billion in 2014–15.

Air passenger duty (APD)

On 1 November 1994, an excise duty on air travel from UK airports came into effect (flights from the Scottish Highlands and Islands are exempt). Following recent reforms, the rate of tax to be paid depends on the distance between London and the capital city of the destination country or territory and on the class of travel of the passenger, as shown in Table 6. As of 1 November 2011, flights from Northern Ireland pay the lowest rate of tax irrespective of the destination. Air passenger duty is forecast to raise £3.2 billion in 2014–15.

Table 6. Air passenger duty rates, April 2014

Distance between London and capital city of destination country or territory	*Standard rate (per passenger)*	*Reduced rate (per passenger)*
0–2,000 miles	£26	£13
2,001–4,000 miles	£138	£69
4,001–6,000 miles	£170	£85
More than 6,000 miles	£194	£97

Note: Reduced rate applies for travel in the lowest class of travel available on the aircraft. Standard rate applies for travel in any other class of travel. However, if a class of travel provides for seating in excess of 1.016 metres (40 inches), then the standard (rather than the reduced) rate of APD applies. Since January 2013, APD on direct flights from Northern Ireland longer than 2,000 miles has been devolved to the Northern Ireland Executive and is set at £0.
Source: HM Revenue & Customs, https://www.gov.uk/government/publications/rates-and-allowances-excise-duty-air-passenger-duty.

Landfill tax

Landfill tax was introduced on 1 October 1996. It is currently levied at two rates: a lower rate of £2.50 per tonne for disposal to landfill of inactive waste (waste that does not decay or contaminate land) and a standard rate of £80 per tonne for all other waste. The government has set a floor of £80 per tonne until 2019–20, such that the standard rate will not fall below £80 per tonne before that time.[25]

Landfill tax is forecast to raise £1.3 billion in 2014–15.

Climate change levy

The climate change levy came into effect on 1 April 2001. It is charged on industrial and commercial use of electricity, coal, natural gas and liquefied petroleum gas, with the tax rate varying according to the type of fuel used. The levy was designed to help the UK move towards the government's domestic goal of a 20% reduction in carbon dioxide emissions between 1990 and 2010. In 2014–15, the rates are 0.541 pence per kilowatt-hour for electricity, 0.188 pence per kilowatt-hour for natural gas, 1.210 pence per kilogram for liquefied petroleum gas and 1.476 pence per kilogram for coal. The tax does not apply to fuels used in the transport sector.

In 2013, the carbon price floor was introduced to tax fuels used for electricity generation (which were previously exempt from the climate change levy). In 2014–15, the carbon price floor is set at £9.55 per tonne of CO_2 produced. In Budget 2014, the floor was capped from 2016–17 until 2019–20 at £18 per tonne of CO_2 (the planned level of the floor in 2016–17).[26] Given that rates were previously due to reach £24.62 per tonne of CO_2 produced by 2017–18, this cap represents a substantial policy change.

Energy-intensive sectors that have concluded climate change agreements that meet the government's criteria are charged a reduced rate equal to 35% of the standard climate change levy. The levy is forecast to raise £2.0 billion in 2014–15.

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[25] As of April 2015, this tax will be devolved to Scotland (legislated for in the Scotland Act 2013).

[26] Generators in Northern Ireland are exempt from CPL.

Aggregates levy

Aggregates levy is a tax on the commercial exploitation of rock, sand and gravel (e.g. their removal from the originating site or their use in construction). The levy was introduced in April 2002 to reduce the environmental costs associated with quarrying. In 2014–15, it is charged at a rate of £2 per tonne and is forecast to raise £0.3 billion.

Betting and gaming duties

Until October 2001, most gambling was taxed as a percentage of the stakes laid. Since then, however, general betting duty (and pool betting duty for pool betting) has been charged at 15% of gross profits for all bookmakers and the Horserace Totalisator Board (the Tote), except for spread betting, where a rate of 3% for financial bets and 10% for other bets is applied. Pool betting duty is also charged at 15% of gross profits and bingo duty at 10% of gross profits on those activities. In all cases, 'gross profits' means total stakes (and any participation fees for bingo) minus winnings paid.

Gaming duty, which replaced gaming licence (premises) duty on 1 October 1997, is based on the 'gross gaming yield' for each establishment where dutiable gaming takes place. The gross gaming yield is money gambled minus winnings paid: this consists of the total value of the stakes, minus players' winnings, on games in which the house is the banker, and participation charges, or 'table money', exclusive of VAT, on games in which the bank is shared by players. Gaming duty is levied at marginal rates of between 15% and 50% according to the amount of gross gaming yield.

From December 2014, gambling and gaming activity will be taxed on a 'place of consumption' rather than a 'place of supply' basis. This means that it is the location of the gambler rather than the operation that will determine the tax liability. This reform will affect remote gaming operators, such as online gaming websites. Overseas operators offering remote gaming services to customers living in the UK will be liable to pay gaming duty on those profits.

Duties on betting and gaming are forecast to raise £2.3 billion in 2014–15.

3.5 Capital taxes

Capital gains tax (CGT)

Capital gains tax was introduced in 1965 and is levied on gains arising from the disposal of assets by individuals and trustees. Capital gains made by companies are subject to corporation tax. The total capital gain is defined as the value of the asset when it is sold (or given away etc.) minus its value when originally bought (or inherited etc.). As with income tax, there is an annual threshold below which capital gains tax does not have to be paid. In 2014–15, this 'exempt amount' is £11,000 for individuals and £5,500 for trusts. It is subtracted from total capital gains to give taxable capital gains. Taxable capital gains are taxed at a rate of 18% for basic-rate taxpayers and 28% for higher- and additional-rate taxpayers, subject to certain exemptions and reliefs outlined below.

The key exemption from CGT is gains arising from the sale of a main home. Private cars and certain types of investment (notably those within pension funds or ISAs) are also exempt. Transfers to a spouse or civil partner and gifts to charity do not trigger a CGT liability: in effect, the recipient is treated as having acquired the asset at the original purchase price. Gains made by charities themselves are generally exempt. CGT is 'forgiven' completely at death: the deceased's estate is not liable for tax on any increase in the value of assets prior to death, and those inheriting the assets are deemed to acquire them at their market value at the date of death. This is partly because estates may instead be subject to inheritance tax (see below).

Entrepreneurs' relief reduces the rate of CGT to 10% on the first £10 million[27] of otherwise taxable gains realised over an individual's lifetime on the sale after 5 April 2008 of certain eligible assets. These eligible assets are shares owned by employees or directors of firms who have at least 5% of the shares and voting rights, unincorporated businesses and business assets sold after the closure of a business.

It is estimated that, in 2014–15, capital gains tax will raise £5.4 billion. Although this represents only a small proportion of total government receipts, capital gains tax is potentially important as an anti-avoidance measure, as it discourages wealthier individuals from converting a large

[27] Lower limits applied to disposals before 6 April 2011.

part of their income into capital gains in order to reduce their tax liability. In 2011–12, approximately 160,000 individuals and trusts paid capital gains tax.

Inheritance tax

Inheritance tax was introduced in 1986 as a replacement for capital transfer tax. The tax is applied to transfers of wealth on or shortly before death that exceed a minimum threshold. The threshold was set at £325,000 in 2009, and Budget 2013 announced that it would remain frozen at £325,000 until 2017–18. Inheritance tax is charged on the part of the transfers above this threshold at a single rate of 40% for transfers made on death or during the previous three years, and is normally payable out of estate funds. Since 2012–13, a reduced rate of 36% has applied in cases where more than 10% of a deceased individual's estate is left to charity. Transfers made between three and seven years before death attract a reduced tax rate, while transfers made seven or more years before death are not normally subject to inheritance tax. This is set out in Table 7. Gifts to companies or discretionary trusts that exceed the threshold attract inheritance tax immediately at a rate of 20%, for which the donor is liable; if the donor then dies within seven years, these gifts are taxed again as usual but any inheritance tax already paid is deducted.

Table 7. Inheritance tax reductions for transfers before death, 2014–15

Years between transfer and death	*Reduction in tax rate (%)*	*Actual tax rate (%)*
0–3	0	40
3–4	20	32
4–5	40	24
5–6	60	16
6–7	80	8
7+	100	0

Source: HM Revenue & Customs, https://www.gov.uk/valuing-estate-of-someone-who-died/valuing-gifts.

Some types of assets, particularly those associated with farms and small businesses, are eligible for relief, which reduces the value of the asset for tax purposes by 50% or 100% depending on the type of property transferred. All gifts and bequests to charities and to political parties are exempt from inheritance tax. Most importantly, transfers of wealth between spouses and civil partners are also exempt. In addition to this, since October 2007, the inheritance tax threshold is increased by any unused proportion of a deceased spouse or civil partner's nil-rate band (even if the first partner died before October 2007). This means that married couples and civil partners can collectively bequeath double the inheritance tax threshold (i.e. £650,000) tax-free even if the first to die leaves their entire estate to the surviving partner.

HMRC estimates that the number of taxpaying death estates in 2013–14 was 26,000, equivalent to around 4.5% of all deaths.[28] The estimated yield from inheritance tax in 2014–15 is £3.9 billion.

Stamp duties

The main stamp duties are levied on securities (share and bond) transactions and on conveyances and transfers of land and property. They are so named because, historically, stamps on documents, following their presentation to the Stamp Office, indicated payment. Nowadays, most transactions do not require a document to be stamped and are not technically subject to stamp duty: since 1986, securities transactions for which there is no deed of transfer (e.g. electronic transactions) have instead been subject to stamp duty reserve tax (SDRT) and, since 2003, land and property transactions have been subject to stamp duty land tax (SDLT). This is essentially a matter of terminology, however: the rates are the same and the term 'stamp duty' is still widely used to encompass SDRT and SDLT. The buyer is responsible for paying the tax.

Table 8 gives stamp duty rates as they currently stand. For land and property transactions, there is a threshold below which no stamp duty is paid. The threshold is £150,000 for non-residential properties; for residential properties, the threshold is £125,000 (or £150,000 in certain designated disadvantaged areas). For land and property above this exemption threshold, a range of duty rates apply, depending on the purchase price, as shown in Table 8.[29] The appropriate rate of duty applies

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[28] Source: http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-327590 and http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-353343.

[29] An additional rate of 15% was announced in Budget 2012 as an anti-avoidance measure. This applied initially only to properties worth more than £2 million purchased

to the whole purchase price, including the part below the relevant threshold. As a result, a small difference in the purchase price can lead to a large change in tax liability if it moves the transaction across a threshold; this structure creates unnecessary distortions in the property market and is long overdue for reform. For shares and bonds, there is no threshold and stamp duty is levied at 0.5% of the purchase price.[30]

Table 8. Rates of stamp duty, 2014–15

Transaction	*Rate (%)*
Land and buildings:	
Up to and including £125,000[a]	0
Above £125,000[a] but not exceeding £250,000	1
Above £250,000 but not exceeding £500,000	3
Above £500,000 but not exceeding £1,000,000[b]	4
Above £1,000,000 but not exceeding £2,000,000[b,c]	5
Above £2,000,000[b,c]	7
Shares and bonds	0.5

[a] £150,000 for residential properties in certain designated disadvantaged areas. The threshold for non-residential properties is £150,000, although a 1% rate is payable if the annual rent on a leasehold property is at least £1,000 even if the purchase price is below this level.
[b] Rate is 15% for purchases by certain offshore companies and investment vehicles.
[c] Rate is 4% for non-residential properties.
Source: HM Revenue & Customs, https://www.gov.uk/government/publications/rates-and-allowances-stamp-duty-land-tax and http://www.hmrc.gov.uk/sdrt/intro/sdrtrates.htm.

Stamp duties are forecast to raise £15.8 billion in 2014–15, of which £12.7 billion is forecast to come from sales of land and property and £3.1 billion from sales of securities.

3.6 Corporation tax

Corporation tax is charged on the profits of companies, public corporations and unincorporated associations resident in the UK. The

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by certain offshore companies and investment vehicles. Budget 2014 announced a lowering of the threshold to £500,000 from 20 March 2014.

[30] From April 2015, stamp duty land tax will be replaced by the land and buildings transaction tax in Scotland. The current proposal is that, rather than the purchase price being subject to a single flat rate on the whole value of the property, a system of bands and rates will be put in place, with the rates applying only to the part of the purchase price within the applicable band. For more details, see http://www.scotland.gov.uk/Topics/Government/Finance/scottishapproach/lbtt.

profit on which corporation tax is charged comprises income from trading, investment and capital gains, less various deductions (described below), wherever in the world those profits arise. Firms operating in the UK but not resident here (i.e. operating through a permanent establishment) pay corporation tax only on their UK profits. Foreign-source dividends arising, for example, from an offshore subsidiary have been exempt from UK tax since 2009. Since 2011, resident companies have also been able to irrevocably elect to exempt foreign branch profits.[31] Trading losses may be carried back for one year to be set against profits earned in that period or carried forward indefinitely.[32]

Rates

The standard rate of corporation tax in 2014–15 is 21%, with a reduced rate of 20% for firms with profits not exceeding £300,000. For firms with profits between £300,000 and £1,500,000, a system of relief operates, such that an effective marginal rate of 21.25% is levied on profits in excess of £300,000. This acts to increase the average tax rate gradually until it reaches 21%. (See Table 9.) The standard rate is due to fall to 20% in 2015–16, achieving equality with the small business rate and thus eliminating the need for a system of marginal relief, as announced in Budget 2013.

Table 9. Rates of corporation tax, 2014–15

Profits (£ p.a.)	*Marginal tax rate (%)*	*Average tax rate (%)*
0–300,000	20	20
300,001–1,500,000	21.25	20–21
1,500,000 or more	21	21

Source: HM Revenue & Customs, https://www.gov.uk/government/publications/rates-and-allowances-corporation-tax.

[31] For more information, see H. Miller, 'Corporate tax, revenues and avoidance', in C. Emmerson, P. Johnson and H. Miller (eds), *The IFS Green Budget: February 2013*, IFS Report R74, http://www.ifs.org.uk/budgets/gb2013/GB2013_Ch10.pdf. The UK also operates controlled foreign companies (CFC) rules, which aim to prevent UK-resident firms from using favourable overseas tax regimes to reduce their UK tax liabilities.

[32] The rules for offsetting trading losses, investment losses and capital losses are complicated. More details can be found in A. Klemm and J. McCrae, 'Reform of corporation tax: a response to the government's consultation document', IFS Briefing Note BN30, 2002, http://www.ifs.org.uk/bns/bn30.pdf.

In April 2013, the government introduced a patent box: a reduced rate (10% by 2017) of corporation tax for profits made from exploiting a fully owned or exclusively licensed patent. Broadly, qualifying income includes royalty income or, when the patent is internally used, the sales income earned from a good or service that embeds a qualifying patent, net of deductions for a normal rate of return (set at 10%) and a return for marketing assets (such as trademarks, which are explicitly excluded from the patent box).[33] The patent box applies to all patents (not just those granted after 2013) and is being phased in over five years from 2013. In 2014–15, companies are only entitled to 70% of the full benefit, increasing to 80% and 90% in 2015–16 and 2016–17 respectively, becoming fully available at the 10% rate in 2017–18.

Tax base and allowances

In broad terms, current expenditure (such as wages, raw materials and interest payments) is deductible from taxable profits, while capital expenditure (such as buildings and machinery) is not. To allow for the depreciation of capital assets, however, firms can claim capital allowances, which reduce taxable profits over several years by a proportion of capital expenditure. Capital allowances may be claimed in the year that they accrue, carried forward to set against future profits or carried back for up to three years. Different classes of capital expenditure attract different capital allowances:

- In 2014–15, the annual investment allowance allows the first £500,000 of plant and machinery investment to be written off against taxable profits immediately. Remaining expenditure on plant and machinery is 'written down' on an 18% declining-balance basis.[34] The annual investment allowance has been subject to much change over the last five years. It is currently due to revert to £25,000 in January 2016.

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[33] There is a relatively complex three-stage process for calculating the patent box tax base. For further details, see L. Evers, H. Miller and C. Spengel, 'Intellectual property box regimes: effective tax rates and tax policy considerations', *International Tax and Public Finance*, published online 28 June 2014.

[34] The declining-balance method means that for each £100 of investment, taxable profits are reduced by £18 in the first year (18% of £100), £14.76 in the second year (18% of the remaining balance of £82) and so on. The straight-line method with an 8% rate simply reduces profits by £8 per year for 12½ years for each £100 of investment.

- Expenditure on commercial buildings, industrial buildings and hotels may not be written down at all. However, fixtures that are integral to a building can be written down on an 8% straight-line basis.
- Intangible assets expenditure is written down on a straight-line basis at either the accounting depreciation rate or a rate of 4%, whichever the company prefers.
- Capital expenditure on plant, machinery and buildings for research and development (R&D) is treated more generously: under the R&D allowance, it can all be written off against taxable profits immediately.

Current expenditure on R&D, like current expenditure generally, is fully deductible from taxable profits. However, there is now additional tax relief available for current R&D expenditure. For small and medium-sized companies, there is a two-part tax credit, introduced in April 2000. The first part is called R&D tax relief and applies at a rate of 125% (allowing companies to deduct a total of 225% of qualifying expenditure from taxable profits, since R&D expenditure is already fully deductible). The second part is a refundable tax credit that is only available to firms with negative profit after the credit is taken into account. Firms can give up the right to offset losses equivalent to 225% of their R&D expenditure (or to offset their total losses, if these are smaller) against future profits, in return for a cash payment of 11% of the losses given up.

An R&D tax credit for large companies was introduced in April 2002. This credit applies at a rate of 30%, allowing 130% of qualifying expenditure to be deducted from taxable income. However, from April 2013, the large company R&D tax credit has been reformed to be an above-the-line credit (explained below). The above-the-line version will replace the existing large company R&D tax credit from April 2016, but until then it will be offered alongside it as an alternative option. Rather than reducing the tax base by 30% of qualifying expenditure, the new regime provides a taxable credit of 10% of R&D expenditure to be used against the overall corporate tax liability.[35] Unlike the current system, the above-the-line credit will be

[35] The credit is taxable, such that when the main rate is 21% the value of the 10% credit will be 7.9% of R&D expenditure. For a more detailed examination of the above-the-line R&D credit, see the HM Treasury response to the consultation on this issue: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/1902

repayable such that companies without sufficient profits will be able to benefit. The value of repayable credit is capped at the value of PAYE and NICs owed by the claimant company with respect to the R&D staff cost included in the claim.[36]

Large companies are required to pay corporation tax in four equal instalments on the basis of their anticipated liabilities for the accounting year. Small and medium-sized companies pay their total tax bill nine months after the end of the accounting year.

Corporation tax will raise approximately £40.5 billion in 2014–15.

3.7 Taxation of North Sea production

The current North Sea tax regime has three layers of tax: petroleum revenue tax (PRT), corporation tax and a supplementary charge. All of these taxes are levied on measures of profit, but there are some differences in allowances and permissible deductions.

Corporation tax on North Sea production is ring-fenced, so that losses on the mainland cannot be offset against profits from continental-shelf fields. Until recently, corporation tax was otherwise the same as on the mainland, but important corporation tax reforms announced in the 2007 Budget and subsequently do not apply to ring-fenced activities: the rate of corporation tax on these activities remains at 30% (or 19% if profits are below £300,000), while capital allowances are more generous than on the mainland.

The supplementary charge is levied on the same base as corporation tax, except that certain financing expenditure is disallowed. The charge was introduced in the 2002 Budget at 10% (raised to 20% from 1 January 2006), and was increased to 32% in Budget 2011, effective immediately.

80/atl_credit_response111212.pdf. Budget 2013 increased the proposed headline rate from 9.1% to 10%.

[36] The R&D tax credit allows that a loss incurred as a result of the enhanced R&D relief can be carried forward or back in the same way as trading losses for corporate tax purposes. Under the above-the-line credit, if there remains a positive credit above the PAYE/NICs cap, then this amount can be carried forward and treated as an above-the-line credit in the following accounting period.

The government has announced that if the price of oil falls below $75 a barrel, it will reduce the rate towards 20%.[37]

There are a number of allowances and reliefs available for North Sea companies, including a 100% first-year allowance for most capital expenditure and decommissioning relief which allows the losses from decommissioning a field to be carried back, carried forward or offset against profits from another field.[38]

Overall, corporation tax receipts from the North Sea (including the supplementary charge) are forecast to be £2.5 billion in 2014–15.

PRT is only payable on oil fields approved before 16 March 1993. It is assessed every six months for each separate oil and gas field and then charged at a rate of 50% on the profits (less various allowances) arising in each chargeable period. It is treated as a deductible expense for both the corporation tax and the supplementary charge. PRT is forecast to raise £1.2 billion in 2014–15.

3.8 Bank levy

Following the financial crisis of 2008, a levy on the balance sheet of banks was introduced in January 2011 as an explicit insurance payment against the risk that they will have to be bailed out in a future financial crisis. The levy is currently set at 0.156% of banks' chargeable equity and liabilities. Certain forms of equity and liabilities are not counted for the purposes of the levy, mainly tier 1 capital and liabilities that are already insured through the government's depositor protection schemes. In Budget 2014, the government announced a consultation on potential reforms to the bank levy, with any changes arising from the review to be implemented from January 2015.

The bank levy is forecast to raise £2.7 billion in 2014–15.

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[37] See paragraph 2.102 of *Budget 2011*, https://www.gov.uk/government/publications/budget-2011. In addition, some new allowances for the supplementary charge were introduced in 2012, notably for income from new investments that increase production from existing fields.

[38] For a more detailed examination of allowances and reliefs, see box 10.3 in http://www.ifs.org.uk/budgets/gb2013/GB2013_Ch10.pdf.

3.9 Council tax

On 1 April 1993, the community charge system of local taxation (the 'poll tax', levied on individuals) was replaced by council tax, a largely property-based tax. Domestic residences are banded according to an assessment of their market value; individual local authorities then determine the overall level of council tax, while the ratio between rates for different bands is set by central government (and has not changed since council tax was introduced).[39]

Table 10. Value bands for England, September 2013

Band	*Tax rate relative to Band D*	*Property valuation as of 1 April 1991*	*Distribution of dwellings by band (%)*
A	$^2/_3$	Up to £40,000	24.7
B	$^7/_9$	£40,001 to £52,000	19.6
C	$^8/_9$	£52,001 to £68,000	21.8
D	1	£68,001 to £88,000	15.3
E	$1^2/_9$	£88,001 to £120,000	9.4
F	$1^4/_9$	£120,001 to £160,000	5.0
G	$1^2/_3$	£160,001 to £320,000	3.5
H	2	Above £320,000	0.6

Source: Department for Communities and Local Government, *Local Authority Council Taxbase – 2013 England,* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/285659/Revised_Local_authority_Council_Taxbase_England_2013.pdf.

Table 10 shows the eight value bands and the proportion of dwellings in England in each band. The council tax rates set by local authorities are usually expressed as rates for a Band D property, with rates for properties in other bands calculated as a proportion of this, as shown in the table. But since most properties are below Band D, most households pay less than

[39] Northern Ireland operates a different system: the community charge was never introduced there, and the system of domestic rates that preceded it in the rest of the UK remained largely unchanged – still based on 1976 rental values assessed using evidence from the late 1960s – until April 2007, when a major reform took effect. Domestic rates are now levied as a percentage of the estimated capital value of properties (up to a £400,000 cap) as on 1 January 2005, with the Northern Ireland Executive levying a 'regional rate' (0.3986% in 2014–15) across the whole country and each district council levying a 'district rate' (ranging from 0.2176% to 0.4281% in 2014–15). Reliefs are available for those with low incomes, those with disabilities, and those aged 70 or over living alone, among others. (Source: http://www.dfpni.gov.uk/lps/index/property_rating/rate_poundages_2014.htm.)

the Band D rate; thus, in England, the average Band D rate for 2014–15 is £1,468 but the average rate for all households is only £1,051.[40]

Property bandings in England and Scotland are still based on assessed market values as at 1 April 1991; there has been no revaluation since council tax was introduced. In Wales, a revaluation took effect in April 2005 based on 1 April 2003 property values, and a ninth band paying $2^1/_3$ times the Band D rate was introduced.

There are various exemptions and reliefs from council tax, which vary by local authority. These include a 25% reduction for properties with only one resident adult (across all local authorities) and discounts of up to 100% for vacant or unoccupied houses.[41] Properties that are exempt from council tax include student halls of residence and armed forces barracks. Low-income families can have their council tax bill reduced or eliminated by claiming council tax support. This is the responsibility of individual councils and replaced council tax benefit (which was set nationally) from April 2013.[42]

Council tax is expected to raise £27.6 billion in 2014–15.

3.10 Business rates[43]

National non-domestic rates, or business rates, are a tax levied on non-residential properties, including shops, offices, warehouses and factories. Firms pay a proportion of the officially estimated market rent ('rateable value') of properties they occupy. In 2014–15, this proportion is set at

[40] Source: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/335851/Council_Tax_Levels_set_by_Local_Authorities__Revised__August_2014.pdf.

[41] Councils have the power to charge second homes up to 100% of council tax (50% for job-related accommodation) and empty homes 150% (if long-term unoccupied). Some empty properties are entirely exempt from council tax regardless of local authority, e.g. those left empty by patients in hospitals and care homes.

[42] For more information on these reforms, see S. Adam and J. Browne, *Reforming Council Tax Benefit*, IFS Commentary C123, 2012, http://www.ifs.org.uk/publications/6183.

[43] This section takes information from http://www.parliament.uk/briefing-papers/sn06247.pdf.

48.2% in England and Scotland and 47.3% in Wales,[44] with reduced rates for businesses with a low rateable value:

- In England, businesses with a rateable value below £18,000 (£25,500 in London) are charged a reduced rate of 47.1%. This is further reduced on a sliding scale for rateable values between £6,001 and £12,000, with the liability eliminated for businesses with a rateable value not exceeding £6,000. Non-residential properties in the City of London pay an additional 0.4% on top of the English standard and reduced rate.
- In Scotland, a reduced rate of 47.1% applies to businesses with a rateable value below £35,000. This is reduced by a further 25% for businesses with a rateable value between £12,001 and £18,000 (or those with multiple properties with a combined rateable value of less than £25,000 and each property's rateable value being less than £18,000), 50% for rateable values between £10,001 and £12,000, and 100% for rateable values of £10,000 or less.
- In Wales, business rates are reduced by 25% for businesses with a rateable value between £2,401 and £7,800 and by 50% for businesses with a rateable value of £2,400 or less.

Various other reductions and exemptions exist, including for charities, small rural shops, agricultural land and buildings, and unoccupied buildings (for an initial three-month period, longer in some cases).

The normal valuation cycle runs over a five-year period. Major changes in business rates bills caused by revaluation are phased in through a transitional relief scheme in England. The latest revaluation took effect in April 2010, based on April 2008 rental values. However, the government announced the rates revaluation scheduled for 2015 will be delayed until 2017, citing a desire to avoid 'sharp changes' to rates bills.

Business rates were transferred from local to national control in 1990. Rates are set by central government (or devolved administrations in Scotland and Wales), with revenues split between local and central government since 2013–14 under a new system of local authority

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[44] Northern Ireland operates a slightly different system of regional rates (set at 33.91% in 2014–15) and locally-varying district rates (ranging from 18.09% to 31.62% in 2014–15). Source: http://www.dfpni.gov.uk/lps/index/property_rating/rate_poundages_2014.htm.

financing. Previously, revenues were paid into a central pool, meaning the net income local authorities received bore little relation to the rates revenues raised. However, under the new system brought in by the Local Government Finance Act (2012), local authorities keep between a quarter and a half of rates revenue raised from new developments, for a period of up to 10 years.[45] Another recent development in local government financing is the ability, since 2010–11, of English local authorities to levy a supplementary business rate to pay for economic development projects. Subject to certain restrictions, this supplementary rate can be levied at up to 2% on properties with a rateable value above £50,000. The first use of this additional revenue-raising power was by the Greater London Authority in 2010–11 to pay for the Crossrail project.

Business rates are expected to raise £26.9 billion in 2014–15.

[45] A complicated system of 'tariffs', 'top-ups', 'levies' and 'safety nets' serves to limit the rate at which rates revenue raised from such additional developments can benefit local authorities.

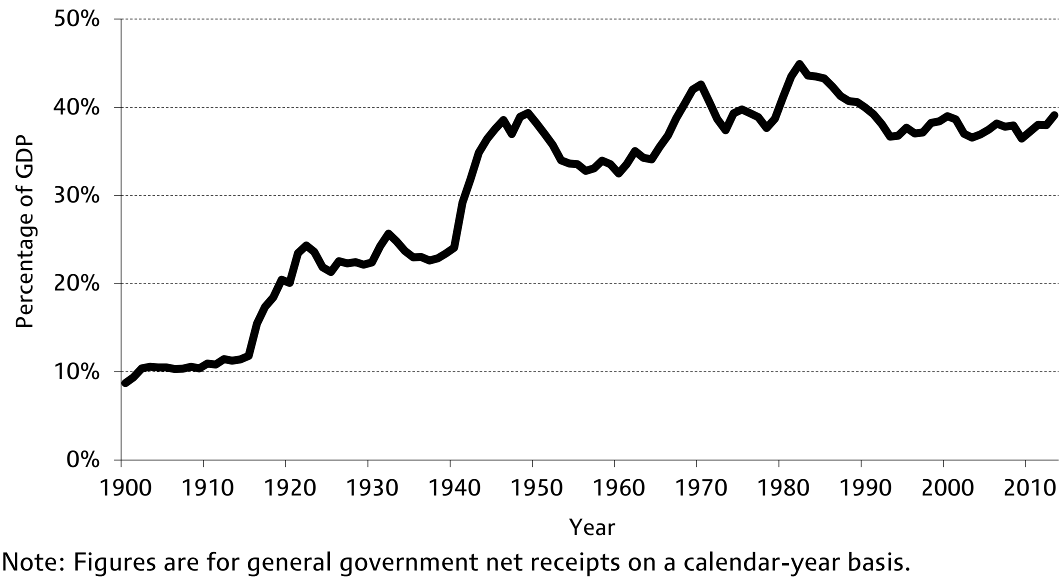
4. Summary of recent trends

4.1 How did we get here?

In previous sections, we have concentrated on the tax system in the UK as it is now; in this section, we discuss its development over recent decades. We describe and assess the major trends, looking at each part of the tax system in turn. We begin with a summary of the main changes and a description of the shifting balance of revenue.

Figure 1 shows the long-term trend in government revenues since 1900. There were sharp increases in government receipts at the times of the two world wars, as might be expected given the extra expenditure required; but in each case, taxation did not fall back to its pre-war level afterwards. Receipts rose sharply as a proportion of national income in the late 1960s, were highly volatile in the 1970s (partly reflecting large fluctuations in economic growth), fell steadily as a proportion of national income from the early 1980s until the mid-1990s and have remained fairly constant at just below 40% of GDP ever since.[46]

Figure 1. Government receipts as a percentage of GDP, 1900–2013



Note: Figures are for general government net receipts on a calendar-year basis.
Source: T. Clark and A. Dilnot, *Long-Term Trends in British Taxation and Spending*, IFS Briefing Note 25, 2002 (http://www.ifs.org.uk/bns/bn25.pdf); National Statistics series YBHA and ANBY.

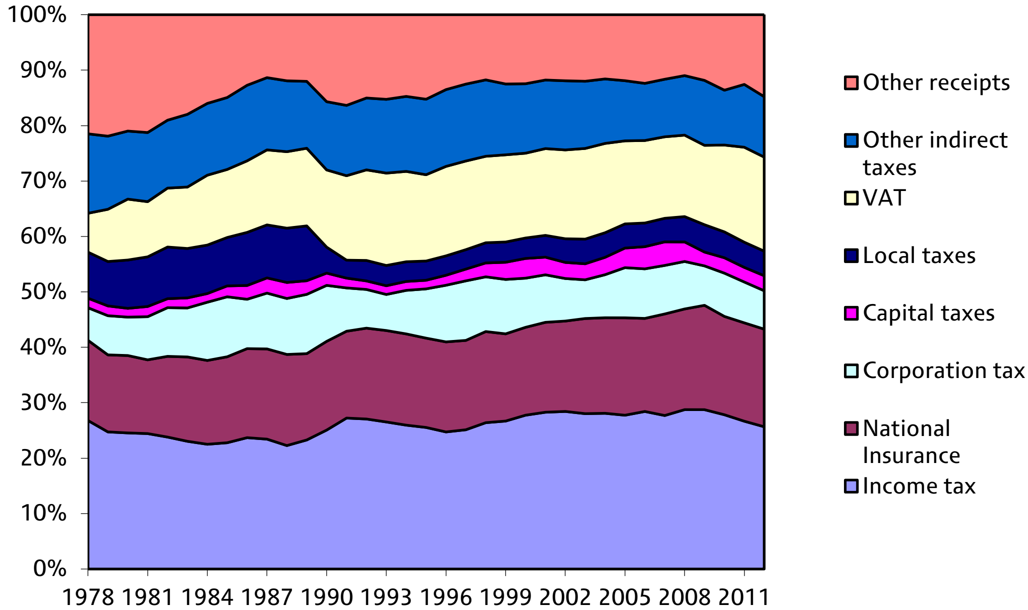
[46] For further information, see T. Clark and A. Dilnot, *Long-Term Trends in British Taxation and Spending*, IFS Briefing Note BN25, 2002, http://www.ifs.org.uk/bns/bn25.pdf.

Table 11. Summary of main reforms, 1979–2014

Income tax	Basic rate cut from 33% to 20% Top rate 98% (unearned income), 83% (earnings) cut to 40% then raised to 45% via 50% Starting rate abolished, reintroduced and abolished again Independent taxation introduced Married couple's allowance abolished, transferable marriage allowance introduced Children's tax credit and working families' tax credit introduced, then abolished Child tax credit and working tax credit introduced Mortgage interest tax relief abolished Life assurance premium relief abolished PEP, TESSA and ISA introduced
National Insurance	Employee contribution rate increased from 6.5% to 12% Ceiling abolished for employer contributions Ceiling for employees raised and contributions extended beyond it 'Entry rate' abolished Imposition of NI on benefits in kind Employers' allowance introduced
VAT	Higher rate of 12.5% abolished Standard rate increased from 8% to 20% Reduced rate introduced for domestic fuel and a few other goods
Other indirect taxes	Large real increase in duties on road fuels and tobacco Real decrease in duties on wine and spirits, little change for beer Graduated rates of vehicle excise duty based on engine size and carbon emissions introduced, road user levy introduced Air passenger duty, landfill tax, climate change levy and aggregates levy introduced
Capital taxes	Introduction and abolition of indexation allowance and then taper relief for capital gains Capital gains tax rates aligned with income tax rates, returned to flat rate, then higher rate for higher-rate taxpayers reintroduced Capital transfer tax replaced by inheritance tax Graduated rates of stamp duty on properties abolished then reintroduced Stamp duty on shares and bonds cut from 2% to 0.5%
Corporation tax	Main rate cut from 52% to 21% Small companies' rate cut from 42% to 20% Lower rate introduced, cut to 0%, then abolished R&D tax credits introduced 100% first-year allowance replaced by 20% writing-down allowance Advance corporation tax and refundable dividend tax credit abolished Patent box introduced
Local taxes	Domestic rates replaced by council tax (via poll tax) Locally-varying business rates replaced by national business rates

Note: PEP = Personal Equity Plan; TESSA = Tax-Exempt Special Savings Account; ISA = Individual Savings Account.

Figure 2. The composition of government receipts, 1978–79 to 2012–13



Note: Years are fiscal years, so 2008 means 2008–09. 'National Insurance' excludes NI surcharge when it existed, and 'VAT' is net of refunds paid to other parts of central and local government; these are both included in 'other receipts'. 'Other indirect taxes' are excise duties, environmental taxes and customs duties. 'Corporation tax' includes petroleum revenue tax, the supplementary charge and the 1997–98 windfall tax. 'Capital taxes' are capital gains tax, inheritance tax (and its predecessors) and stamp duties. 'Local taxes' are council tax, the community charge, domestic rates and business rates before 1990; from 1990, business rates are included in 'other receipts'.
Source: HM Treasury; see http://www.ifs.org.uk/tools_and_resources/fiscal_facts.

Table 11 lists some of the most important changes seen since 1979.[47] It is clear that the tax system is now very different from the one that existed then. The income tax rate structure has been transformed, the taxation of savings has been repeatedly adjusted, the National Insurance contributions system has been overhauled, the VAT rate has more than doubled, some excise duty rates have risen sharply while others have fallen, the corporate income tax system has been subject to numerous reforms, and local taxation is unrecognisable. Figure 2 shows the effect that these changes have had on the composition of aggregate government revenue.

The shares of revenue provided by different taxes have been remarkably stable since the mid-1990s. The principal change has been in the contribution of corporation tax, which has risen, fallen and then risen

[47] For a timeline of the main tax changes introduced in each Budget since 1979, see http://www.ifs.org.uk/ff/budget_measures.xls.

again. This largely reflects the changing fortunes of financial companies, whose profits were strong in the late 1990s, weaker thereafter, but then stronger again until the recession that began in 2008–09. The share of revenue coming from indirect taxes has fallen since the late 1990s, mainly because fuel duties have been cut substantially in real terms. Revenue from capital taxes increased during the period of booming stock and property markets, helped by the introduction of higher rates of stamp duty on property, but still only accounted for 4.25% of total revenue in 2007–08 before falling again in the slump in stock and property markets that began in late 2007.

There have been much bigger changes over the whole period. The most dramatic shifts have been a doubling of the share of revenue flowing from VAT and a substantial reduction in revenue from other indirect taxes. This pattern is mirrored across the developed world, with governments moving away from taxes levied on specific goods towards general consumption taxes such as VAT. The proportion of taxes raised locally has halved, largely because business rates have moved from local to national control. The share of revenue from income tax has remained virtually unchanged, despite radical structural changes.

4.2 Personal income taxes

There are two principal personal income taxes in the UK: income tax and National Insurance contributions. Capital gains tax, which has existed as a tax separate from income tax since 1965, can also be thought of as a tax on personal income, but it supplies very little revenue compared with income tax or National Insurance (see Table 1).

Income tax rate structure

The most dramatic change to income tax has been the reform of the rate structure, as illustrated in Table 12. In 1978–79, there was a starting rate of 25%, a basic rate of 33% and higher rates ranging from 40% to 83%. In addition, an investment income surcharge of 15% was applied to those with very high investment income, resulting in a maximum income tax rate of 98%. In its first Budget, in 1979, the Conservative government reduced the basic rate of income tax to 30% and the top rate on earnings to 60%. In 1980, the starting rate was abolished; in 1984, the investment income surcharge was abolished; and through the mid-1980s, the basic rate of tax was reduced. In 1988, the top rate of tax was cut to 40% and the basic rate to 25%, producing a very simple regime with three effective rates – zero up to the tax allowance, 25% over a range that covered almost 95% of taxpayers and 40% for a small group of those with high incomes.

Table 12. Income tax rates on earned income, 1978–79 to 2014–15

Year	*Starting rate*	*Basic rate*	*Higher rates*
1978–79	25	33	40–83
1979–80	25	30	40–60
1980–81 to 1985–86	—	30	40–60
1986–87	—	29	40–60
1987–88	—	27	40–60
1988–89 to 1991–92	—	25	40
1992–93 to 1995–96	20	25	40
1996–97	20	24	40
1997–98 to 1998–99	20	23	40
1999–2000	10	23	40
2000–01 to 2007–08	10	22	40
2008–09 to 2009–10	—	20	40
2010–11 to 2012–13	—	20	40–50
2013–14 to 2014–15	—	20	40–45

Note: Prior to 1984–85, an investment income surcharge of 15% was applied to unearned income over £2,250 (1978–79), £5,000 (1979–80), £5,500 (1980–82), £6,250 (1982–83) and £7,100 (1983–84). Different tax rates have applied to dividends since 1993–94 and to savings income since 1996–97. The basic rate of tax on savings income has been 20% since 1996–97, and the 10% starting rate (which was largely abolished in 2008–09) continues to apply to savings income that falls into the first £2,880 of taxable income. The basic rate of tax on dividends was 20% from 1993–94 to 1998–99 and has been 10% since 1999–2000, when the higher rate of tax on dividends became 32.5%. However, an offsetting dividend tax credit means that the effective tax rates on dividends have been constant at zero (basic rate) and 25% (higher rate) since 1993–94. The additional tax rate on dividend income has been 37.5% since 2014–15, which is an effective rate of 30.6% once the dividend tax credit is taken into account. When calculating which tax band different income sources fall into, dividend income is treated as the top slice of income, followed by savings income, followed by other income.
Source: *Tolley's Income Tax*, various years.

This very simple rate structure was complicated by the reintroduction of a 20% starting rate of tax in 1992 (in a pre-election Budget), cut to 10% in 1999 (fulfilling a pre-election promise made by the Labour Party). Budget 2007 announced the abolition again of the starting rate from 2008–09 to pay for a cut in the basic rate, though as a simplification this was limited by the decision to keep the starting rate in place for savings income. The abolition of the starting rate proved highly controversial because many low-income families lost out (although many more potential losers were protected by other reforms announced at the same time). As a result, the government announced in May 2008 that it would increase the tax-free personal allowance for 2008–09 by £600, compensating most of those losing from the reform.[48]

Reforms announced by Alistair Darling in the 2008 Pre-Budget Report and Budget 2009 resulted in a considerable complication of the income tax rate structure for those on the highest incomes. Since 2010–11, the personal allowance has been withdrawn from those with incomes greater than £100,000, creating a band of income in which income tax liability increases by 60 pence for each additional pound of income (see Section 3.1); and incomes above £150,000 are taxed at a rate of 45%.

Table 13. Personal allowance and basic-rate limit in real terms (April 2014 prices)

Year	*Personal allowance (£ p.a.)*	*Basic-rate limit (£ p.a.)*
1979–80	5,486	47,093
1984–85	5,783	44,422
1989–90	6,230	46,307
1994–95	6,109	42,026
1999–2000	6,710	43,339
2004–05	6,534	43,236
2009–10	7,828	45,216
2010–11	7,431	42,923
2011–12	8,154	38,180
2012–13	8,546	36,241
2013–14	9,675	32,805
2014–15	10,000	31,865

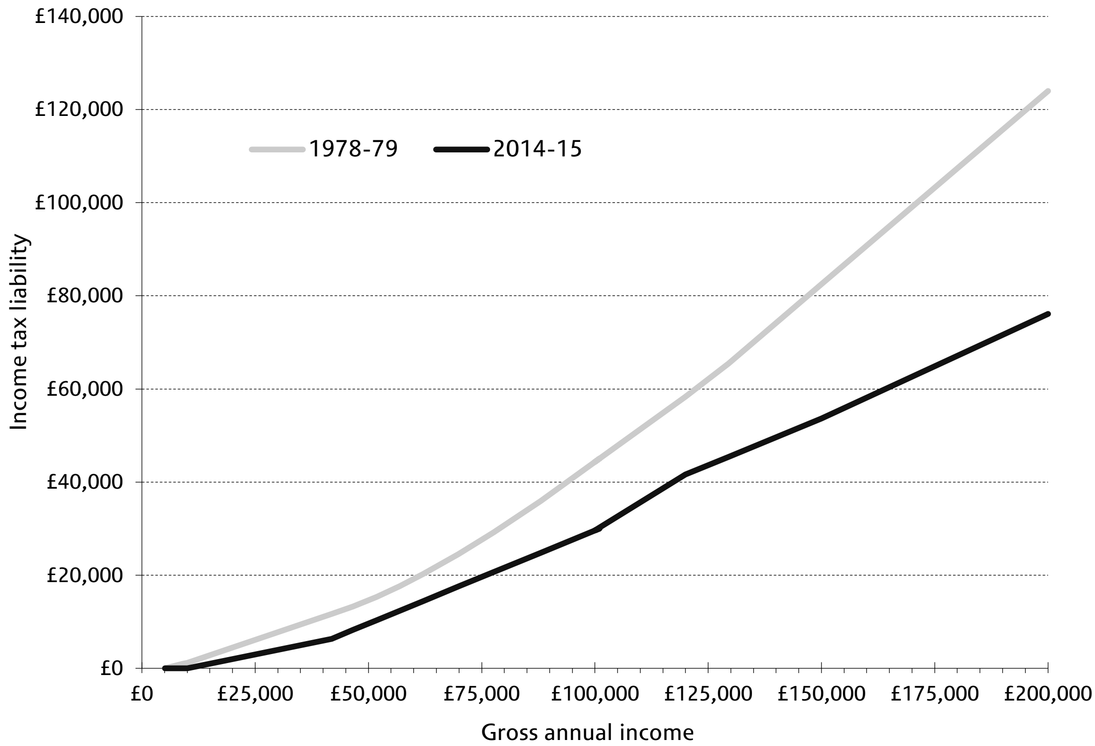
Note: 1990 marked the introduction of independent taxation. Prior to that date, the personal allowance was known as the single person's allowance. For a complete series of allowances in nominal terms, see http://www.ifs.org.uk/ff/income.xls.
Source: HM Revenue & Customs, https://www.gov.uk/government/collections/tax-structure-and-parameters-statistics; RPI used to uprate to April 2014 prices using ONS *Consumer Price Indices* reference sheet, http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-323601.

[48] The basic-rate limit was correspondingly reduced to eliminate any gain from the increased personal allowance for higher-rate taxpayers. The personal allowance was increased only for under-65s; an increase in the allowances for those aged 65 and over was part of the original package announced in Budget 2007. For analysis of these reforms, see S. Adam, M. Brewer and R. Chote, 'The 10% tax rate: where next?', IFS Briefing Note BN77, 2008, http://www.ifs.org.uk/bns/bn77.pdf.

The income levels to which the various tax rates apply have changed significantly, as shown in Table 13. Over the period as a whole, the basic-rate limit, beyond which higher-rate tax becomes due, has failed to keep pace with price inflation, whilst the personal allowance has risen in real terms. Both of these have been particularly true in recent years.

The overall effect of rate, allowance and threshold changes on the shape of the income tax schedule is shown in Figure 3, with 1978–79 values expressed in April 2014 prices for ease of comparison.

Figure 3. Income tax schedule for earned income, 1978–79 and 2014–15



Note: 1978–79 thresholds have been uprated to April 2014 prices using the RPI. Assumes individual is aged under 65, unmarried and without children.
Source: HM Treasury, *Financial Statement and Budget Report*, various years; *Tolley's Income Tax*, various years; National Statistics, https://www.gov.uk/government/statistics/.

Table 14 gives the numbers of people affected by these various tax rates. In 2014–15, out of an adult population in the UK of around 52.4 million, an estimated 29.9 million individuals will be liable for income tax. This is a reminder that attempts to use income tax reductions to help the poorest in the country are likely to fail, since less than two-thirds of the adult population have high enough incomes to pay income tax at all.[49] The

[49] We might be more interested in the proportion of adults who live in a family containing a taxpayer. Authors' calculations using the IFS tax and benefit model,

Table 14. Numbers liable for income tax (thousands)

Year	*Number of individuals paying tax*	*Number of starting-rate taxpayers*	*Number of basic-rate taxpayers*[a]	*Number of higher-rate taxpayers*[b]
1979–80	25,900	—[c]	25,226[c]	674
1984–85	23,800	—	22,870	930
1989–90	25,600	—	24,040	1,560
1994–95	25,300	5,180	18,200	2,000
1999–2000	27,200	2,280	22,354	2,510
2004–05	30,300	3,570	23,333	3,330
2009–10	30,600	163[e]	27,202	3,190
2010–11	31,300	276[e]	27,723	3,256
2011–12	30,800	318[e]	26,621	3,832
2012–13[d]	30,600	264[e]	26,213	4,128
2013–14[d]	29,800	245[e]	24,803	4,701
2014–15[d]	29,900	254[e]	24,715	4,953

[a] Includes those whose only income above the starting-rate limit is from either savings or dividends.
[b] Includes additional-rate taxpayers from 2010–11.
[c] Figure for 1979–80 covers both starting-rate and basic-rate taxpayers.
[d] Projected.
[e] From 2008–09, the starting rate applies only to savings income that is below the starting-rate limit when counted as the top slice of taxable income (except dividends).
Source: HM Revenue & Customs, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/306826/Table_2.1.pdf; table 2.1, *Inland Revenue Statistics 1994*.

number of higher- and additional-rate taxpayers has grown quickly over the last 30 years or so, from less than 3% of the taxpaying population in 1979–80 to around 15% in 2014–15. Some of this growth reflects periods when the threshold above which higher-rate tax is due has not been raised in line with price inflation, some reflects the fact that incomes on average have grown more quickly than prices, and some the fact that the dispersion of incomes has grown, with especially rapid increases in the incomes of those already towards the top of the income distribution, pushing more of them into higher-rate income tax liability. The number of starting-rate taxpayers climbed in the years after 1992 as the width of the starting-rate band was increased, but it fell sharply in 1999–2000 as the

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TAXBEN, run on data from the Family Resources Survey, suggest that this figure stood at 73% for Britain in 2012–13 (the latest year for which data are available): most non-taxpaying adults do not have taxpayers in the family.

10% rate applied over a much narrower range of income than the 20% rate that it replaced. The abolition of the starting rate for non-savings income in 2008–09 massively reduced the number of starting-rate taxpayers, for obvious reasons.

Although less than 16% of income taxpayers face higher rates of income tax, that group pays a very large share of the total amount of income tax that is paid. Table 15 shows that the top 10% of income taxpayers now pay over half of all the income tax paid, and the top 1% (most of whom face the additional 45% marginal tax rate) pay 27% of all that is paid. These shares have risen substantially since 1978–79, despite lower top tax rates.

Table 15. Shares of total income tax liability (%)

Year	*Top 1% of income taxpayers*	*Top 10% of income taxpayers*	*Top 50% of income taxpayers*
1978–79	11	35	82
1981–82	11	35	81
1986–87	14	39	84
1990–91	15	42	85
1994–95	17	45	87
1999–2000	21	50	88
2004–05	21	51	89
2009–10	27	55	89
2010–11	25	54	89
2011–12	25	55	89
2012–13[a]	25	56	89
2013–14[a]	28	59	90
2014–15[a]	27	59	90

[a] Projected.

Source: HM Revenue & Customs, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/306831/Table_2.4.pdf; various *Inland Revenue Statistics*.

The treatment of families

Prior to 1990, married couples were treated as a single unit for income tax purposes. The 1970 Income and Corporation Taxes Act (in)famously announced that, for the purposes of income tax, 'a woman's income chargeable to tax shall … be deemed to be her husband's income and not her income'. Reflecting the 'responsibilities' taken on at marriage, the tax system also included a married man's allowance (MMA). The system had developed over many decades and was widely felt to be unpalatable; a consensus emerged that a new system, neutral in its treatment of men and women, should be introduced. This was a widely-held view by the late 1970s but, despite a series of Green Papers, proved difficult to implement. While equal treatment for men and women was easy to agree upon, it was not easy to agree whether equal treatment should be given to married and unmarried people.

In his 1986 Budget Speech, the then Chancellor, Nigel Lawson, published a Green Paper suggesting that the UK should move to a system of 'transferable allowances', where spouses, regardless of whether husband or wife, could transfer unused allowances between themselves. Two years later, in his 1988 Budget Speech, before the previous proposals had been implemented, he announced the introduction in 1990 of a completely different system. The new system was based on the principle of independent taxation of husbands and wives, but included a married couple's allowance (MCA), which was available to either husband or wife. This established equal treatment of men and women, but not of married and unmarried people. In fact, married and unmarried people with children had been treated equally since 1973 through the additional personal allowance (APA), an allowance for unmarried people with children, which was set equal to the MMA and then the MCA; but unequal treatment persisted for those without children.

Between 1993 and 2000, the MCA and APA were reduced in value, and they were eventually abolished in April 2000 (except the MCA for people aged 65 or over at that date). A year later, children's tax credit was introduced, reducing the tax liability of those with children by a flat-rate amount (tapered away for higher-rate taxpayers) but making no distinction between married and unmarried people. Meanwhile, in-work support for low-paid families with children was brought within the tax system when working families' tax credit (WFTC) replaced family credit from October 1999.[50] Children's tax credit and WFTC (along with parts of some state benefits) were replaced in April 2003 by child tax credit and working tax credit (see Section 3.1), neither of which depends on marriage. (Universal credit, which is due to replace these tax credits, will

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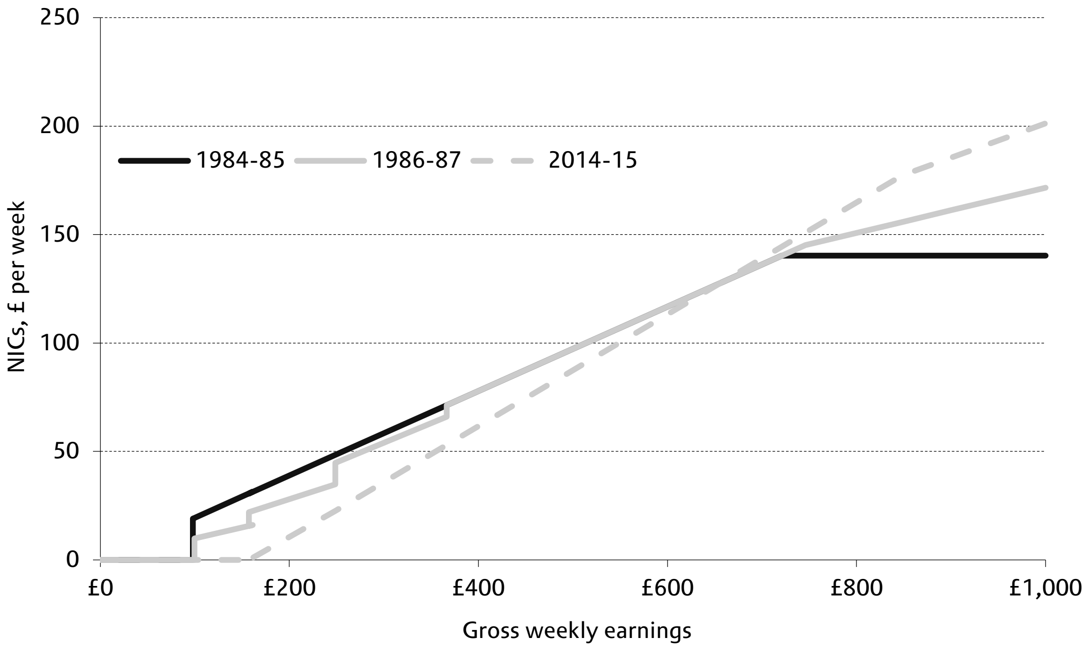
[50] For more information on these two programmes, see A. Dilnot and J. McCrae, *Family Credit and the Working Families' Tax Credit*, IFS Briefing Note BN3, 1999, http://www.ifs.org.uk/bns/bn3.pdf.

not change this feature.) The marriage transferable allowance, due to begin in April 2015, actually contradicts this trend by reintroducing a recognition of marriage into the tax system. Nevertheless, over the past 30 years, the UK income tax has moved away from providing support for marriage and towards providing support for children.

National Insurance contributions

The National Insurance system has its roots as far back as 1911, and until 1961 contributions continued as a (typically) weekly lump-sum payment by employers and employees to cover the cost of certain social security benefits – in particular, the flat-rate pension, unemployment benefits and sickness benefits. Since 1961, however, NI has steadily moved towards being simply another income tax. The link between the amount contributed and benefit entitlement, which was once close, has now almost entirely gone, and substantial progress has been made in aligning the NI rate structure and tax base with those of income tax. Most of this has occurred in the last 30 years.

Figure 4. The changing structure of National Insurance contributions



Note: Previous years' thresholds have been uprated to April 2014 prices using the RPI. Assumes employee contracted into State Earnings-Related Pension Scheme (SERPS) or state second pension (S2P). The 1984–85 schedule excludes the 1% National Insurance surcharge abolished in September 1984.
Source: HM Treasury, *Financial Statement and Budget Report*, various years; *Tolley's National Insurance Contributions*, various years; National Statistics, https://www.gov.uk/government/statistics/.

Figure 4 shows the structure of the combined employee and employer NI system before and after the important 1985 reforms and as it stands in 2014–15. To enable comparison, thresholds from earlier systems have been uprated to April 2014 prices.

In 1984–85, no NI was due for those earning less than the lower earnings limit of £98.08.[51] For those earning at least this amount, employees paid contributions of 9% and employers 10.45% of total employee earnings, including earnings below the LEL. This meant a jump in contributions from zero to £19.08 at the LEL, and it is not surprising that this discontinuity led to significant bunching of earnings just below the LEL. The 1985 reform reduced the jump in NICs at the LEL to £9.95 (5% each from employee and employer), introducing a number of graduated steps instead. The 5% 'entry rate' was later cut to 2% for employers, and in 1999 the entry rate was removed altogether so that the earnings threshold in NI now operates in a similar way to the income tax personal allowance, essentially being discounted from taxable earnings. Furthermore, between 2001–02 and 2007–08, the earnings threshold for both employers and employees was set at the same level as the income tax personal allowance. The increase in the personal allowance announced in May 2008 (see page 43) decoupled it from the NI earnings threshold, and in April 2011 the earnings threshold for employees was increased by more than that for employers, meaning that the three thresholds were all at different levels. However, the upper earnings limit has been aligned with the income tax higher-rate threshold since 2009–10 and the primary and secondary earning thresholds (for employees and employers respectively) have been realigned for 2014–15.

The NI treatment of high earners has also come to resemble their treatment under income tax more, in that there is no longer an upper limit on payments. In 1984–85, no NI was payable on earnings above the UEL of £721.14, giving a maximum weekly contribution of £140.26. The 1985 reform abolished the UEL for employers, and although the UEL is still in place for employees, it no longer acts as a cap on contributions. Instead, earnings above the UEL incur NI contributions at a lower rate of 2%.

The abolition of the entry rate, the alignment of thresholds with those for income tax and the abolition of the cap on contributions have made NI look

[51] All figures are given in April 2014 prices.

more like income tax. Important differences remain: in particular, the self-employed face a very different, and much less onerous, NI system (see Section 3.2). NI also has a different tax base: it is a tax on earnings only, whereas income tax is paid on income under a broader definition. However, the NI base has expanded to match the income tax base more closely; this can be seen, for example, in the extension of the NI system to partially cover benefits in kind.

Economically, there is little rationale for having separate income tax and NI systems. Their separate existence is largely a matter of historical accident and makes the tax system unnecessarily opaque, complex and administratively expensive, while differences remaining between the two systems are distortionary and inequitable. But the political advantages of having a separate NI system make it likely that it will continue: both the government and the electorate appear to like this separate tax. That being the case, the substantial problems caused by the lack of integration of the two systems have been somewhat reduced by their increased alignment.

4.3 Taxation of savings and wealth

The income tax treatment of savings has changed significantly over the last 30 years or so. The radical reforms to the rate structure of income tax, reducing the top marginal rate on savings income from 98% to 45%, are discussed above. But there have also been major changes to the tax treatment of different savings vehicles, with some forms of savings becoming more generously treated and some less so.

The two most significant changes widening the base of income tax have been the abolition of life assurance premium relief in 1984, which had given income tax relief on saving in the form of life assurance, and the steady reduction and final abolition of mortgage interest tax relief (MITR). Until 1974, MITR had been available on any size of loan, but in that year a ceiling of £25,000 was imposed. In 1983, this ceiling was increased to £30,000, which was not enough to account for general price inflation and much too little to account for house price inflation. From 1983, the ceiling remained constant, steadily reducing its real value. From 1991, this erosion of the real value of MITR was accelerated by restricting the tax rate at which relief could be claimed, to the basic rate of tax in 1991 (25%), 20% in 1994, 15% in 1995 and 10% in 1998, with the eventual abolition of the relief in April 2000.

The main extension of relatively tax-favoured savings came in 1988 with the introduction of personal pensions, which allowed the same tax treatment for individual-based pensions as had been available for employer-based occupational pensions (tax relief on contributions, no tax on fund income, tax on withdrawals apart from a lump sum not exceeding 25% of the accumulated fund). The other main extensions were the Personal Equity Plan (PEP) and the Tax-Exempt Special Savings Account (TESSA), introduced in 1987 and 1991 respectively. The PEP was originally a vehicle for direct holding of equities, but it was reformed to allow holdings of pooled investments such as unit trusts. The TESSA was a vehicle for holding interest-bearing savings accounts. Both PEP and TESSA benefited from almost the reverse tax treatment to that of pensions: saving into a PEP or TESSA was not given any tax relief, there was no tax on income or gains within the fund and there was no tax on withdrawals. The PEP and TESSA have now been superseded by the Individual Savings Account (ISA), which is similar in most important respects.

For those (very few) who can and wish to save more than £15,000 per annum (the current ISA limit) in addition to any housing or pension saving, capital gains tax (CGT) is potentially relevant. Prior to 1982, CGT was charged at a flat rate of 30% on capital gains taking no account of inflation. Indexation for inflation was introduced in 1982 and amended in 1985, and then in 1988 the flat rate of tax of 30% was replaced by the individual's marginal income tax rate. The 1998 Budget reformed the CGT system, removing indexation for future years and introducing a taper system which reduced the taxable gain for longer-held assets by up to 75%, depending on the type of asset. The taper system created predictable distortions and complexity, and the 2007 Pre-Budget Report announced the abolition of both tapering and indexation from April 2008 and a return to a system like that before 1982, in which gains are taxed at a flat rate, now 18%, with no allowance for inflation.[52] The coalition government that came to office in 2010 increased the rate of CGT for higher- and additional-rate taxpayers to 28%, in part in recognition of the fact that the large difference between the CGT rate of 18% and the higher income tax rate of

[52] These reforms are discussed in S. Adam, 'Capital gains tax', in R. Chote, C. Emmerson, D. Miles and J. Shaw (eds), *The IFS Green Budget: January 2008*, IFS Commentary C104, 2008, http://www.ifs.org.uk/budgets/gb2008/08chap10.pdf.

40% gave higher-rate taxpayers a strong incentive to engage in activities where remuneration could be obtained through capital gains rather than income. However, the extension of entrepreneurs' relief which accompanied this change limited the extent to which this reform succeeded in reducing this distortion.[53]

Capital is taxed not only directly by taxes levied on investment income and capital gains, but also by stamp duty on transactions of securities and properties and by inheritance tax on bequests.[54] The current form of inheritance tax was introduced in 1986 to replace capital transfer tax. When capital transfer tax had replaced estate duty 11 years earlier, gifts made during the donor's lifetime had become taxable in the same way as bequests. But differences in treatment were soon introduced and then widened, until finally the new inheritance tax once again exempted lifetime gifts except in the seven years before death, for which a sliding scale was introduced (see Table 7 in Section 3.5) in an attempt to prevent people avoiding the tax by giving away their assets shortly before death.

With all of these capital taxes, the 1980s saw moves to reduce the number of rates and/or align them with income tax rates. Thus in 1978 capital transfer tax had no fewer than 14 separate rates; since 1988 its successor, inheritance tax, has been charged (above a tax-free threshold) at a single 40% rate, equal to the higher rate of income tax. As mentioned above, capital gains tax was charged at the individual's marginal income tax rate from 1988. Four rates of stamp duty on properties were replaced by a single 1% rate in 1984. Stamp duty on shares and bonds was almost abolished entirely: the rate fell from 2% to 0.5% during the 1980s, and in 1990 the then Chancellor John Major announced that stamp duty on shares and bonds would be abolished in 1991–92 when the London Stock Exchange introduced a paperless dealing system known as TAURUS.

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[53] Entrepreneurs' relief (described in Section 3.5) was originally introduced as a concession following an angry reaction to the proposals in the 2007 Pre-Budget Report from business organisations. Originally, only the first £1 million of gains were eligible, but this was subsequently increased to £2 million in the March 2010 Budget, to £5 million in the June 2010 Budget and then to £10 million in Budget 2011.

[54] Corporation tax is also relevant for capital invested in companies, and council tax or business rates for capital invested in property. These taxes are discussed in Section 3.6 and in Sections 3.9 and 3.10 respectively.

However, this system was never introduced and stamp duty on shares and bonds remained.

Labour's first Budget following the party's election in 1997 announced the reintroduction of graduated rates of stamp duty on properties. The higher rates were subsequently increased and an additional higher rate for residential properties worth more than £1 million was introduced in 2010–11. A further rate for residential properties worth more than £2 million was introduced by George Osborne in Budget 2012, so that the rates of stamp duty land tax (as it has been known since 2003) are now 1%, 3%, 4%, 5% and 7%.[55] However, what did most to bring SDLT, along with inheritance tax, to public attention was rapid growth in house prices. From 1997 to 2005, house price inflation averaged more than 10% a year, far outstripping both the inheritance tax threshold (which has typically increased in line with general price inflation) and the stamp duty zero-rate threshold (which has typically been frozen in cash terms).

Table 16 illustrates the implications of this. When Labour came to power in 1997, around half of property transactions attracted stamp duty; over the following six years, this proportion rose to almost three-quarters as house prices doubled while the stamp duty threshold was unchanged. The link between house prices and inheritance tax is less direct, but since housing makes up about half of total household wealth, house prices are clearly an important determinant of how many estates are affected by inheritance tax. A widely-reported concern was that rising house prices were making inheritance tax into a tax on 'ordinary people' instead of only on the very wealthy. However, although the proportion of death estates liable for inheritance tax more than doubled in a decade – increasing from 2.3% of the total in 1996–97 to 5.9% in 2006–07 – it remained small. Since then, policy reforms have counteracted the spread of stamp duty and inheritance tax: the SDLT threshold was doubled in April 2005, temporarily increased by a further £50,000 for one year only from 3 September 2008, and then doubled again for first-time buyers for two years starting 25 March 2010; and in October 2007, unused inheritance

[55] As noted in Section 3.5, an additional 15% rate of stamp duty applies where a property worth more than £500,000 is owned by certain types of company or acquired for the purposes of a collective investment scheme.

Table 16. Stamp duty, inheritance tax and house prices

Year[a]	*Average house price*[b]	*Inheritance tax threshold*	*Stamp duty (land tax) zero-rate threshold*[c]	*Death estates liable for inheritance tax*	*Property transactions liable for stamp duty*[d]
1993	£62,333	£150,000	£60,000	2.7%	42%
1994	£64,787	£150,000	£60,000	3.0%	43%
1995	£65,644	£154,000	£60,000	3.1%	43%
1996	£70,626	£200,000	£60,000	2.3%	45%
1997	£76,103	£215,000	£60,000	2.5%	49%
1998	£81,774	£223,000	£60,000	2.9%	53%
1999	£92,521	£231,000	£60,000	3.2%	58%
2000	£101,550	£234,000	£60,000	3.6%	62%
2001	£112,835	£242,000	£60,000	3.8%	69%
2002	£128,265	£250,000	£60,000	4.4%	73%
2003	£155,627	£255,000	£60,000	5.1%	73%
2004	£180,248	£263,000	£60,000	5.5%	71%
2005	£190,760	£275,000	£120,000	5.7%	60%
2006	£204,813	£285,000	£125,000	5.9%	63%
2007	£223,405	£300,000	£125,000	4.4%	65%
2008	£227,765	£312,000	£125,000/£175,000[e]	2.8%	51%
2009	£226,064	£325,000	£125,000/£175,000[e]	2.7%	46%
2010	£251,174	£325,000	£125,000[f]	2.8%	56%
2011	£245,319	£325,000	£125,000[f]	3.3%	54%
2012	£246,032	£325,000	£125,000	3.9%	63%
2013	£250,768	£325,000	£125,000	4.5%	67%

[a] Years are fiscal years (so 1993 means 1993–94) except for average house prices, which are for calendar years.
[b] Simple average, not mix-adjusted, so changes reflect changes in the types of property bought as well as changes in the price of a given type of property.
[c] Threshold for residential properties not in disadvantaged areas.
[d] Excludes Scotland. Other columns are UK-wide.
[e] Stamp duty threshold was increased to £175,000 for one year from 3 September 2008 and then extended until 31 December 2009.
[f] Stamp duty threshold for first-time buyers was increased to £250,000 for two years from 25 March 2010.
Source: Average house prices from Office for National Statistics, 'House price index', annual table 23; numbers of taxpayers from https://www.gov.uk/government/statistics/numbers-of-taxpayers-and-registered-traders; total number of registered deaths from *Vital Statistics: Population and Health Reference Tables - Summer 2014 Update & Mortality Statistics: deaths registered in England and Wales*, http://www.ons.gov.uk/ons/datasets-and-tables/index.html; property transactions liable for stamp duty from https://www.gov.uk/government/statistics/numbers-of-uk-property-transactions-by-liable-and-non-liable.

tax nil-rate bands became transferable to a surviving spouse or civil partner, reducing the number of estates liable to tax by a third and removing the threat of future inheritance tax for many couples.

4.4 Indirect taxes

Value added tax

As noted in Section 4.1, the most dramatic shift in revenue-raising over the last 35 years has been the growth in VAT, which has doubled its share of total tax revenue. The bulk of this change occurred in 1979, when the incoming Conservative government raised the standard rate of VAT from 8% to 15%, to pay for reductions in the basic rate and higher rates of income tax. The rate was increased from 15% to 17.5% in 1991, to pay for a reduction in the community charge (poll tax), and then again from 17.5% to 20% in January 2011 as part of the coalition government's deficit reduction package.

There have been a number of (mostly minor) extensions to the base of VAT over the years. Perhaps the most significant was the extension of VAT to cover domestic fuel and power from April 1994, then at a reduced rate of 8%. The original intention was to increase this to the full rate (then 17.5%) a year later, but this second stage of reform was abandoned in the face of fierce political opposition. In fact, the reduced rate was cut from 8% to 5% in 1997, fulfilling a pre-election promise by the Labour Party. The reduced rate has since been extended to cover a few other goods that were previously subject to VAT at the standard rate.

Two general issues arise in the context of VAT: incentives and redistribution. It is frequently suggested that a revenue-neutral shift from direct to indirect taxation, such as that introduced in 1979, will reduce tax-induced disincentives to work. But if the attractiveness of working relative to not working, or working an extra hour as opposed to not doing so, is determined by the amount of goods and services that can be bought with the wage earned, a uniform consumption tax and a uniform earnings tax will clearly have very similar effects. Cutting income tax will not increase the attractiveness of work if the price of goods and services rises by an equivalent amount because of the increase in consumption tax. It may be, of course, that the shift will reduce the burden of taxation for one group and raise it for another, and that this redistribution will affect incentives. But this has little to do with the choice between direct and indirect taxes.

The second general issue concerning VAT relates to redistribution. As described in Section 3.3, many goods in the UK are zero-rated for VAT, with food and children's clothing being examples. This zero-rating is often defended on distributional grounds, because those with low incomes allocate a large proportion of their expenditure to these items. But VAT should not be considered in isolation from the rest of the tax and welfare system. Since the UK government is able to levy a progressive income tax and pay welfare benefits that vary according to people's needs and characteristics, this will generally prove a much more effective means of meeting its equity objectives – although the better-off spend a smaller proportion of their incomes on these goods, they spend larger amounts of money and are therefore the main cash beneficiaries of zero rates of VAT.[56] Removing zero-rating would also have the advantage of removing the distortions in people's consumption decisions that result from differential tax rates for different goods.

Excisable goods

Table 17 shows the total rate of indirect tax (VAT and excise duty) on the principal goods subject to excise duties. Figure 5 shows how real levels of excise duties have changed over time: between 1979 and 2000, taxes on cigarettes rose steadily, while those on petrol and diesel increased much more sharply. Both these commodity groups were covered by government commitments to substantial annual real increases in excise duty in the 1990s. From 2000 to 2008, however, duty on cigarettes barely kept pace with inflation, while fuel taxes fell by around a fifth in real terms. Nevertheless, real duty rates on cigarettes and fuel remain substantially higher than 30 years ago, in addition to the increase in VAT from 8% to 20% – although the pre-tax price of cigarettes has also increased sharply, so tax as a percentage of price has not increased as much as might be expected.

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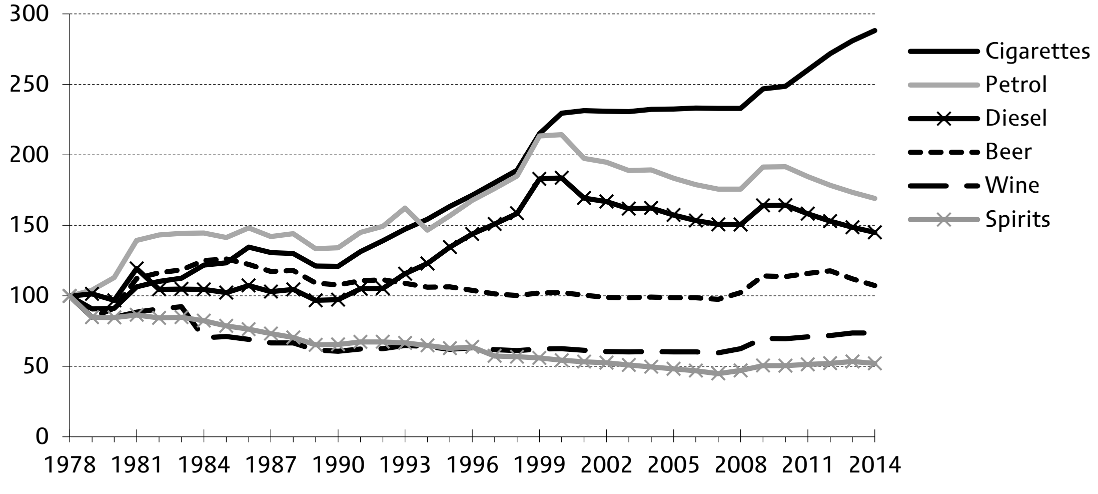
[56] Indeed, the Mirrlees Review of the UK tax system demonstrated that it is possible to apply a uniform VAT rate with a revenue-neutral compensation package that ensures that the overall reform is broadly distributionally neutral and does not significantly weaken work incentives. See chapter 9 of J. Mirrlees, S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles and J. Poterba, *Tax by Design: The Mirrlees Review*, Oxford University Press for IFS, 2011, http://www.ifs.org.uk/publications/5353.

Table 17. Total tax as a percentage of retail price

Year[a]	*Cigarettes*[b]	*Beer*[c]	*Wine*[d]	*Spirits*[e]	*Petrol*[f]	*Diesel*[g]
1978	72	30	45	78	47	49
1988	77	35	48	69	68	63
1998	81	30	50	63	76	82
2008	79	29	55	60	62	58
2014	78	31	65	66	62	59

[a] Figures are for April of each year, except that wine and spirits figures for 1998 are for January.
[b] Packet of 20.
[c] Pint of bitter (3.9% abv) in licensed premises.
[d] 75cl bottle of table wine (not exceeding 15% abv) in a retail outlet.
[e] 70cl bottle of whisky (40% abv) in a retail outlet.
[f] Litre of fuel: leaded (4*) in 1978 and 1988, premium unleaded in 1998 and ultra-low sulphur in 2008 and 2014.
[g] Litre of fuel: ultra-low sulphur in 2008 and 2014.
Source: Duty (and VAT) rates as for Figure 5. Prices – cigarettes and beer from National Statistics, 'Consumer price indices', https://www.gov.uk/government/statistics/, except that the 1978 prices are estimated by downrating the prices for 1987 using the relevant sub-indices of the RPI; wine and spirits from HMRC Alcohol Bulletin, https://www.uktradeinfo.com/Statistics/Statistical%20Factsheets/AlcoholFactsheet1013.xls, with the wine and spirits 2014 prices uprated from 2012 prices using the wine and spirits sub-index of the RPI, except that 1978 prices come from HM Treasury (2002), *Tax Benefit Reference Manual 2002–03 Edition*, with the wine price downrated from the 1979 price by the wine and spirits sub-index of the RPI; petrol and diesel from HM Treasury (2002) for 1978 and 1988 and table 4.1.1 of Department of Energy and Climate Change, 'Quarterly energy prices', https://www.gov.uk/government/collections/quarterly-energy-prices for 1998, 2008 and 2014.

Figure 5. Real levels of excise duties (1978=100)



Note: Assumes beer at 3.9% abv, wine not exceeding 15% abv and spirits at 40% abv; petrol is leaded (4*) up to 1993, premium unleaded from 1994 to 2000 and ultra-low sulphur from 2001 onwards; diesel is ultra-low sulphur from 1999 onwards. Calculations are for April of each year, except that wine and spirits are for January from 1995 to 1999.
Source: Duty rates – HMRC website, https://www.gov.uk/government/organisations/hm-revenue-customs; HM Treasury, *Tax Benefit Reference Manual 2002–03 Edition*; various HMRC / HM Customs and Excise Annual Reports. RPI from National Statistics, https://www.gov.uk/government/statistics.

The pattern for alcoholic drink is very different. The tax rate on beer has changed little, while the real level of duty on spirits has fallen steadily and is now little more than half what it was in 1978. Duty on wine fell in real terms through the 1980s and has changed little since; but as the pre-tax price of wine has fallen sharply over time and VAT has risen, tax makes up more of the price of a bottle now than it did 30 years ago. As shown in Table 18, implied duty rates per litre of pure alcohol are now much closer together than they were in 1978, but some variation persists. Budget 2008 increased all alcohol duties by 6% above inflation and announced further real increases of 2% a year until 2013,[57] but did not change the relativities between different forms of alcohol. Budget 2013 cancelled the planned duty rise for 2014–15, while Budget 2014 scrapped the escalator on wine altogether.

Table 18. Implied duty rates per litre of pure alcohol (April 2014 prices)

Item	*1978*	*1988*	*1998*	*2008*	*2014*
Beer	£17.45	£20.61	£17.51	£17.88	£18.74
Wine[a]	£30.88	£20.62	£18.95	£19.34	£22.78
Spirits	£54.06	£38.15	£30.76	£25.51	£28.22

[a] Wine of strength 12% abv.

Source: Authors' calculations from duty rates sourced as for Figure 5.

The existence of relatively high tax rates in the UK on some easily portable commodities could lead to loss of revenue through cross-border shopping. While it is possible that the UK tax rates are so high that reductions in those rates would encourage enough additional consumption to produce a net increase in revenue, the available evidence suggests that this is unlikely.[58] Only in the case of spirits is it likely that the current tax rate is high enough for a reduction to have little or no revenue cost, which might help explain why duty on spirits was frozen in nominal terms (cut in real terms) every year between 1997 and 2008.

[57] These real increases were extended to 2013 and 2014 in the March 2010 Budget.

[58] See I. Crawford, Z. Smith and S. Tanner, 'Alcohol taxes, tax revenues and the Single European Market', *Fiscal Studies*, 1999, 20, 305–20, and C. Walker and C-D. Huang, *Alcohol Taxation and Revenue Maximisation: The Case of Spirits Duty*, HM Customs and Excise Forecasting Team Technical Note *Series A*, 10, 2003.

Environmental taxes

Environmental taxes are difficult to define precisely, since all taxes affect economic activity and almost all economic activity has some environmental impact. However, a classification is attempted in the ONS's *Environmental Accounts*; on that basis, environmental taxes raised £43.0 billion in 2013, some 7.5% of revenue from total taxes and social contributions in the UK or 2.7% of GDP.[59] These percentages are somewhat reduced from a peak in the late 1990s. Over 60% of this revenue is accounted for by fuel duty, and the other sizeable chunk is vehicle excise duty. Thus taxes on motoring account for about 75% of environmental tax revenues. Since 1994, several new environmental taxes have been introduced, including air passenger duty (1994), landfill tax (1996), climate change levy (2001), aggregates levy (2002) and the carbon price floor (2013). These are described in Section 3.4, but even air passenger duty – by far the largest of them – is forecast to raise only £3.2 billion in 2014–15.

The amount of revenue raised is rather limited as an indicator of the environmental impact of a tax. The more successful the tax is in changing behaviour, the less revenue it will raise. It also matters how well the tax targets environmentally-damaging behaviour rather than some broader activity. For example, differential fuel duty rates have been used extensively to encourage a switch to cleaner fuels. Vehicle excise duty changed in 1999 from a flat-rate charge to one dependent on engine size, and then in 2001 to one based on vehicle emissions; since then, the differential between high-emission and low-emission vehicles has repeatedly been widened. Similarly, since November 2009, rates of air passenger duty have depended on distance travelled rather than on whether the destination is within the EU. Such reforms can be designed either to increase or to reduce revenues while encouraging less environmentally-harmful activities. Nevertheless, it remains fair to say that environmental taxation in the UK is dominated by taxes on motoring.

[59] See http://www.ons.gov.uk/ons/rel/environmental/uk-environmental-accounts/2014/stb-stat-bulletin.html#tab-Environmental-taxes. The classification has been substantially revised since the previous edition of this briefing note.

4.5 Taxes on companies

In the 18 years of Conservative government prior to 1997, the biggest reform to corporation tax was the 1984 Budget. This announced a series of cuts in the main corporation tax rate, taking it from 52% to 35% (further reduced to 33% by 1991–92), and a very generous system of deductions for capital investment (100% of investment in plant and machinery could be deducted from taxable profits in the year the investment was made) was replaced by a less generous one (25% of the remaining value each year for plant and machinery). The 1984 reform was intended to be broadly revenue-neutral.

The taxation of company profits changed significantly after 1997. The incoming Labour government changed the way that dividend income was taxed: dividend tax credits – a deduction from income tax given to reflect the corporation tax already paid on the profits being distributed – ceased to be payable to certain shareholders (notably pension funds) that were already exempt from income tax. In its first five years in office, the Labour government also cut the main corporation tax rate from 33% to 30% and the small profits rate from 23% to 19%.

In April 2000, a 10% lower rate was introduced for companies with less than £10,000 of taxable profits, and this lower rate was cut to zero in April 2002. This last tax cut came as a surprise, with costs potentially running into billions of pounds if self-employed individuals registered as companies to reduce their tax liabilities.[60] Having apparently failed to anticipate this effect, the government swiftly reversed the reform. In April 2004, the zero rate was abolished for distributed profits, removing much of the tax advantage but at a cost of greater complexity; and so in December 2005, the zero rate was abolished for retained profits as well. This takes us back to precisely where we were before April 2000, with the standard small companies' rate applying to all firms with profits up to £300,000, regardless of whether the profits are paid out as dividends or retained by the firm. In the mean time, there has been unnecessary upheaval in the tax system, and thousands of individuals have incurred effort and expense to set up legally incorporated businesses that they

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[60] More information about these changes can be found in L. Blow, M. Hawkins, A. Klemm, J. McCrae and H. Simpson, 'Budget 2002: business taxation measures', IFS Briefing Note BN24, 2002, http://www.ifs.org.uk/bns/bn24.pdf.

would not otherwise have set up. This episode provides a clear lesson in how not to make tax policy.

The 2007 Budget cut the main rate further to 28% and reduced capital allowances for most plant and machinery from 25% to 20%; but, at the same time, it departed from the previous trend by announcing that the small profits rate would rise in stages from 19% to 22% and that an annual investment allowance would be introduced, which would allow the first £50,000 (later increased to £100,000) of investment in plant and machinery each year to be immediately deductible from profits. However, the final stage of the increase in the small profits rate was repeatedly delayed, and then cancelled by the incoming coalition government in June 2010, who instead cut the small profits rate to 20% in 2011–12. The new coalition government's reforms to corporation tax are much in the same vein as those of its predecessors – statutory rates have been cut over the Parliament and the tax base broadened. The main rate of corporation tax has been reduced to 21% in 2014–15 and will be cut further to 20% in 2015–16. The June 2010 Budget reduced allowances for plant and machinery from 20% to 18% and the annual investment allowance from £100,000 to £25,000 from 2012–13. This was subsequently increased temporarily to £250,000 from January 2013, and then to £500,000 from April 2014.[61]

The other substantial company tax in the UK system is business rates. Prior to the local government tax reforms introduced in 1990, business rates were under the control of local authorities. Since 1990, they have been set at the national level: business rates are no longer a local tax in any meaningful sense, and it is now more obvious that they are a slightly surprising tax, though the current government has announced an intention to return the power for setting business rates to local councils. Business rates are effectively an intermediate tax that bears heavily on productive activities that are property-intensive. As such, they seem ripe for the reformer's attention, or at least they would be if they attracted more public interest.

[61] The allowance is due to revert to £25,000 in January 2016.

4.6 Local taxation

Thirty years ago, local taxes in the UK consisted of domestic rates (on residential property) and business rates (on business property). However, this was changed dramatically in 1990 when business rates were taken from local to national control and domestic rates were replaced by the community charge (poll tax), a flat-rate per-person levy.[62] The poll tax was introduced in April 1990 in England and Wales after a one-year trial in Scotland, but was so unpopular that the government quickly announced that it would be replaced. The tax was based on the fact that an individual lived in a particular local authority, rather than on the value of the property occupied or the individual's ability to pay (subject to some exemptions and reliefs). In the 1991 Budget, the government increased VAT from 15% to 17.5% to pay for a large reduction in the poll tax, with a corresponding rise in the level of central government grant to local authorities. The poll tax was abolished in 1993 to be replaced by the council tax, which is based mainly on the value of the property occupied, with some exemptions and reliefs (outlined in Section 3.9).

The result of these changes, and particularly the centralisation of business rates, is that local services are now largely financed by central government, with the only significant local tax left – the council tax – financing only around one-sixth of total local spending (although councils also raise around one-tenth of spending from service charges).[63] This leaves UK taxation unusually centralised, with less than 5% of tax revenues raised locally. At the margin, spending an extra pound locally requires the raising of an extra pound locally, giving local authorities appropriate incentives overall. But this extra money must come entirely from council tax, which bears particularly heavily on those groups (such as pensioners) with high property values relative to their incomes and hence limits local authorities' willingness to increase expenditure. Furthermore, while universal capping of local authority spending ended in 1999–2000,

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[62] These reforms were not introduced in Northern Ireland, which retained a system of locally-varying business and domestic rates.

[63] See chart 2.1b in Department for Communities and Local Government, *Local Government Financial Statistics England No. 24*, 2014 https://www.gov.uk/government/statistics/local-government-financial-statistics-england-2014.

strengthened selective capping powers were retained, and have been used in a few cases since 2004–05. The Localism Act 2011 abolished the power for central government to cap local authorities, but councils wishing to implement increases in council tax that the central government deems 'excessive' would have to have these approved in a local referendum.

5. Conclusions

Despite clear attempts to reform various aspects of the UK tax system over the last 30 years or so, with varying degrees of success, there remain many areas still in need of attention. This briefing note has set out the features of the current UK tax system, described the major changes in those features over time and highlighted some of the areas potentially in need of a reformer's beady eye.