TAXATION IN THE UNITED KINGDOM

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In this set of papers we compare the fiscal systems of several European countries. This chapter is dedicated to the United Kingdom's fiscal system.

We are mostly interested in four aspects of the fiscal systems:

1. The structure of taxation in terms of % of GDP for various taxes and contributions;
2. The taxation structure as described by the Implicit Tax Rate (ITR) as % of taxable income on labour, capital and consumption;
3. Administrative complexity of fiscal systems in terms of bureaucratic procedures and required human resources in man-hours;
4. Level of fiscal decentralization, i.e., fiscal autonomy of local government entities with respect to the central administration.

Because of the European nature of the comparison, we mainly exploit international databases: this will enhance the homogeneity and thus the comparability of the data. There are two main sources of fiscal data for European countries:

1. Eurostat, which publishes data spanning for at least a decade about tax levels, ITR levels, deficits, debt, expenditures, and much more;
2. The World Bank, whose "Doing Business" report estimates the administrative complexity of the fiscal systems.

Some datasets may not be available internationally. In this case local statistical agencies such as, for Italy, ISTAT, can be used, but data may not be homogeneous across countries, and comparison may be more difficult, even when data are available for all the countries of interest.

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Introduction

The United Kingdom is at a crossroads. With a general election in May 2015, the economy is seen by voters as the biggest issue facing the country. To eliminate the UK's stubbornly high budget deficit, the Labour Party and Liberal Democrats have spoken in favour of a combination of spending cuts and tax increases. The Conservative Party on the other hand have said the deficit will be eradicated with spending cuts alone.

None of the suggested tax increases appear to have significant revenue raising potential. The Labour Party favours a new tax on residential property and increased Corporation Tax, increased Bank Levy and an increase in the top rate of Income Tax to 50%. The Liberal Democrats also favour higher taxes on residential property, albeit in a different way.

The Conservative Party have announced significant cuts in Income Tax for lower and middle income earners by increasing thresholds.

As usual, they have all pledged to "clamp down" on tax avoidance. Additional revenues generated from such measures usually fall well short of official estimates.

On the spending front, there is little worth mentioning as the promises to "balance the books" from both major parties are almost totally devoid of detail. Indeed the Conservative Party (which has pledged the speediest fiscal contraction) has pledged to continue exempting the two largest areas of expenditure from cuts: the National Health Service and welfare benefits for pensioners.

History would suggest that there is very little potential for large increases in tax revenue. The fact that revenues have consistently remained around the 36-37% of GDP mark suggests we are at the limit of what is politically and/or economically sustainable. Spending cuts will have to do the overwhelming majority, if not all of the heavy lifting as the UK seeks to repair the public finances.

Level of taxation

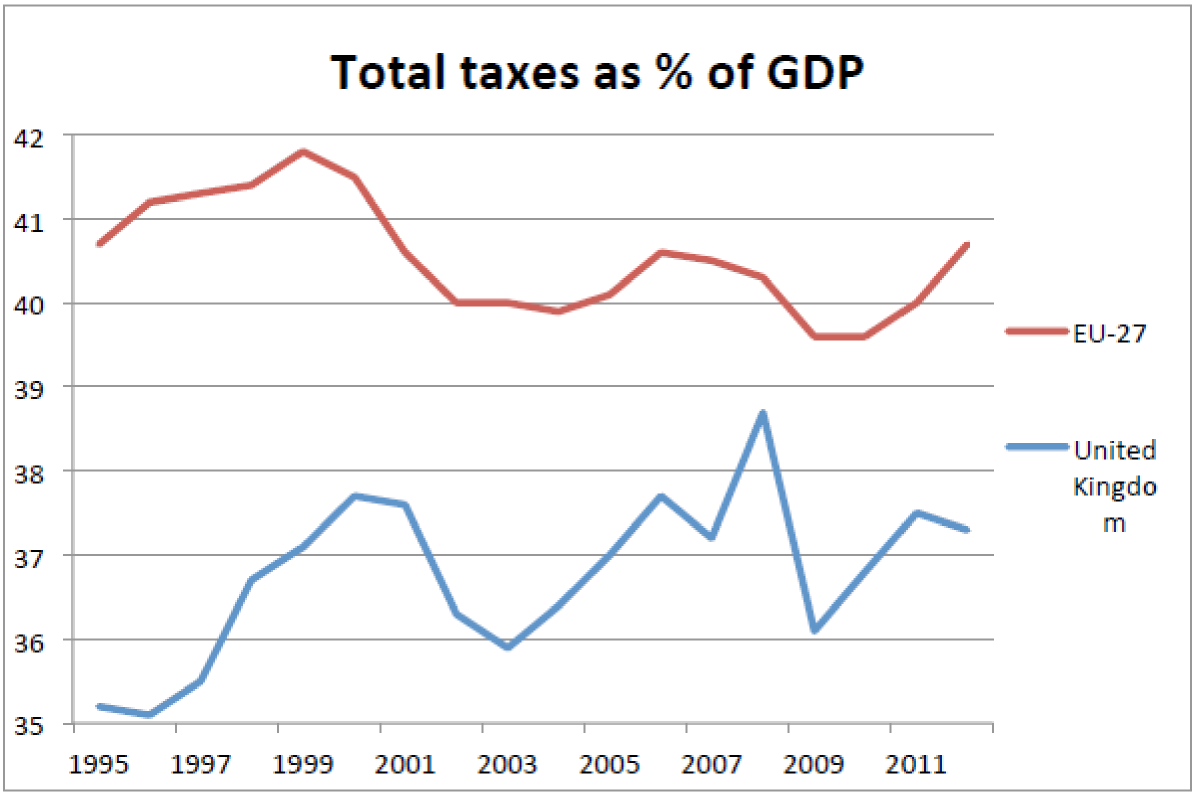
This section shows the total tax revenues by all levels of government in the United Kingdom compared to the average in the EU (excluding Croatia)

Figure 1 shows the tax receipts as percentage of GDP in in UK between 1995 and 2012 compared to the average (arithmetic as opposed to weighted) EU-27 level.

The UK has consistently ranked below to the EU average on this measure since 1995 although the gap has closed since 1996.

In 1996 total taxes in the UK were 35.1 % compared to the EU-27 average of 41.2 – a difference of 6.1 percentage points. By 2012 the same numbers were 37.3% for the UK and 40.7% for the EU 27 – a 3.4 percentage point difference. The closest the UK has come to the EU-27 average since 1995 came in 2008 when the difference fell to 1.6 percentage points.

During this period, receipts increased from €318bn to €717bn. In 2012 the UK was responsible for 13.6% of EU-27 government tax revenues. Only France (€954bn) and Germany (€1,077bn) had higher total tax receipts.



Value Added Tax

Figure 2 shows VAT receipts as a percentage of GDP in the UK and in the EU-27. There are currently 3 different rates of VAT: Standard (20%), reduced (5%), and zero. Additionally some goods and services (eg. Insurance, museum admission charges) are exempt. VAT is the third largest source of revenue for the UK government behind Income Tax and National Insurance.

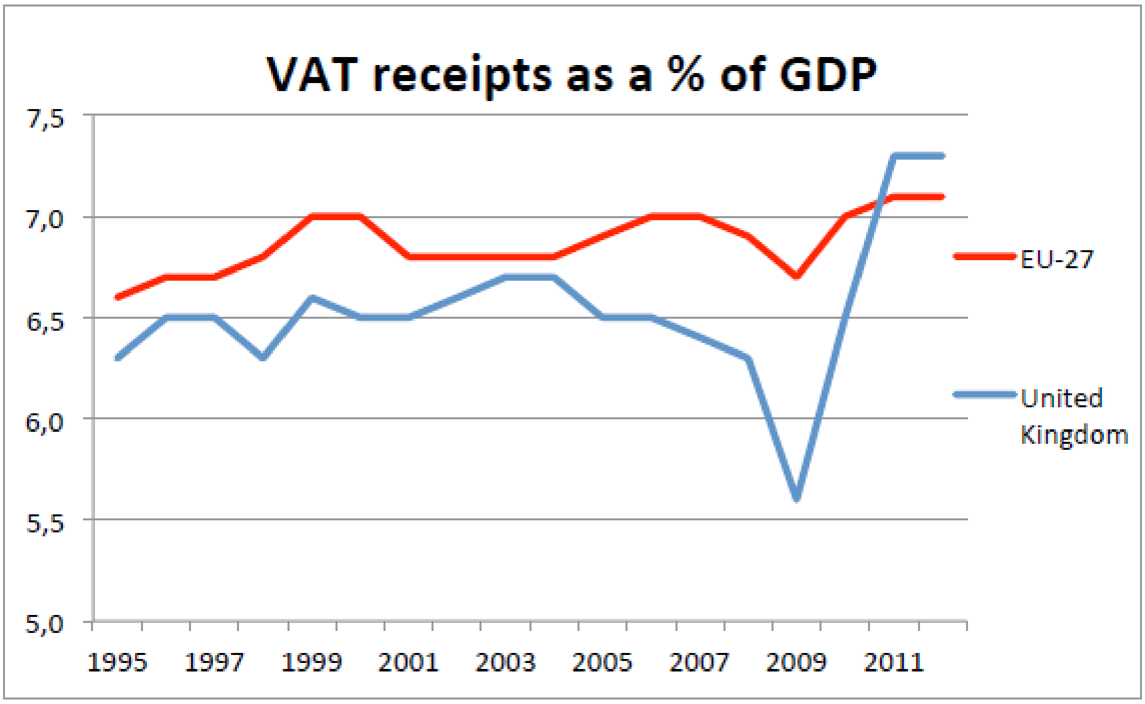
The reduced rate mainly applies goods like mobility aids for the elderly, smoking cessation products, energy saving materials for buildings and most significantly, electricity and gas for residential and domestic use.

Most foods (excepting those typically regarded as unhealthy) are zero rated as are books, newspapers and children's clothes.

The difference between zero-rated and exempt is that zero-rated goods or services count as taxable supplies, but VAT is not added to sale prices. Exempt goods or services are not taxable supplies and no VAT is charged.

Since its introduction, the standard rate of VAT has been between 8% and 20%. The biggest and most infamous increase came in In the run up to the 1979 election the Labour Party claimed that the Conservative Party were planning to double VAT. The Conservative shadow chancellor Geoffrey Howe and the leader of the opposition, Margaret Thatcher rigorously denied they planned to do so. At the 1979 Budget, Howe did not double VAT, but increased it from 8% to 15%.

Since Chancellor of the Exchequer George Osborne increased the standard rate of VAT to 20% in 2010, VAT receipts as a percentage of GDP have for the first time exceeded the EU-27 average for the first time in 20 years.



Income Tax

Income Tax is the largest source of revenue for the UK government generating €180bn in 2012. There are currently 4 rates of Income Tax: savings (10%), basic (20%), higher (40%) and additional (45%).

There is a tax-free allowance of £10,000 (€12,600). The current government has increased this allowance significantly since 2010 when it was £6,475 (€8,160). The additional rate has also been reduced from 50% without any noteworthy reduction in receipts from taxpayers earning more than £150,000. These rates and thresholds are shown in the table below.

Rate	**Threshold in 2014-15**
Starting rate for savings: 10%	£0 - £2,880
Basic rate: 20%	£0 - £31,865
Higher rate: 40%	£31,866 - £150,000
Additional rate: 45%	Over £150,000

Source: http://www.hmrc.gov.uk/rates/it.htm#1b

It should be noted that the thresholds refer to taxable income only. So with a tax-free allowance of £10,000, the basic rate is charged on income between £10,000 and £41,865.

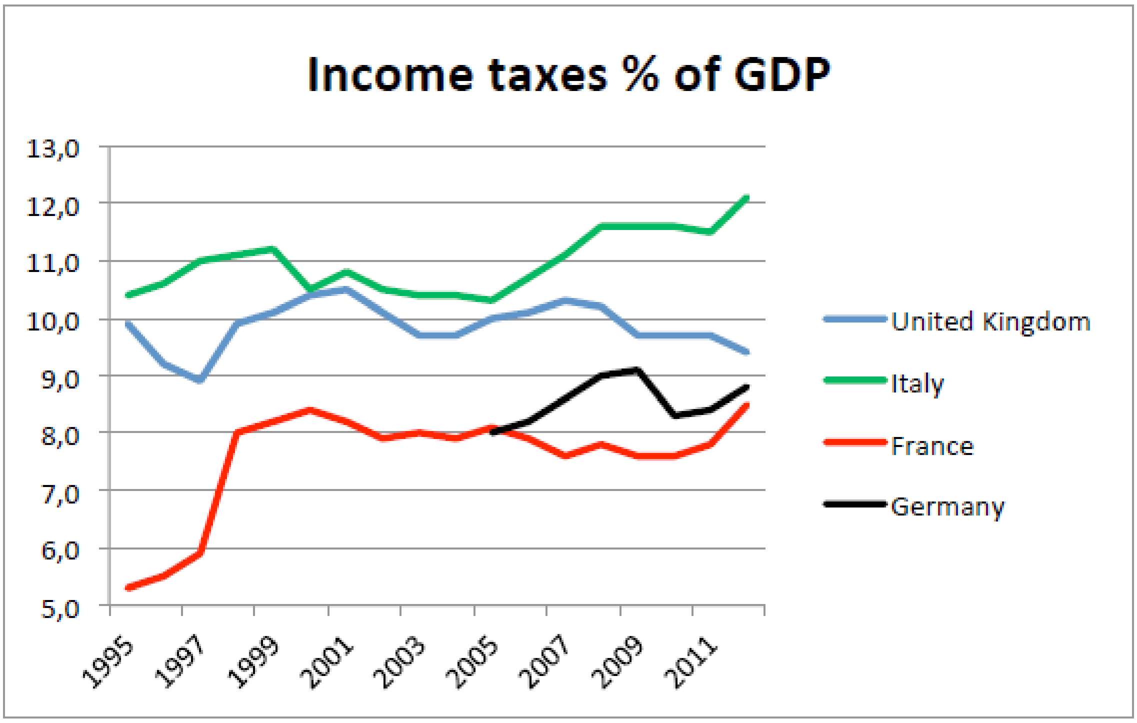
This tax-free allowance is however subject to a "clawback" for individuals with incomes over £100,000 (€126,000). For every £2 earned over £100,000, the tax-free allowance is reduced by £1. This has created effective Income Tax rates of 60% for people earning between £100,000 and £120,000 and been criticized by politically independent economic research bodies such as the Institute for Fiscal Studies (IFS)

Additionally, there are different, lower rates are charged on income from dividends:

Income	**Rate**
Dividend income at or below the £31,865 basic rate tax limit	10%
Dividend income at or below the £150,000 higher rate tax limit	32.5%
Dividend income above the higher rate tax limit	37.5%

http://www.hmrc.gov.uk/taxon/uk.htm

EU-27 averages are not available from Eurostat. The chart below looks at taxes on individual or household income as a percentage of GDP for the 4 largest EU economies



National Insurance

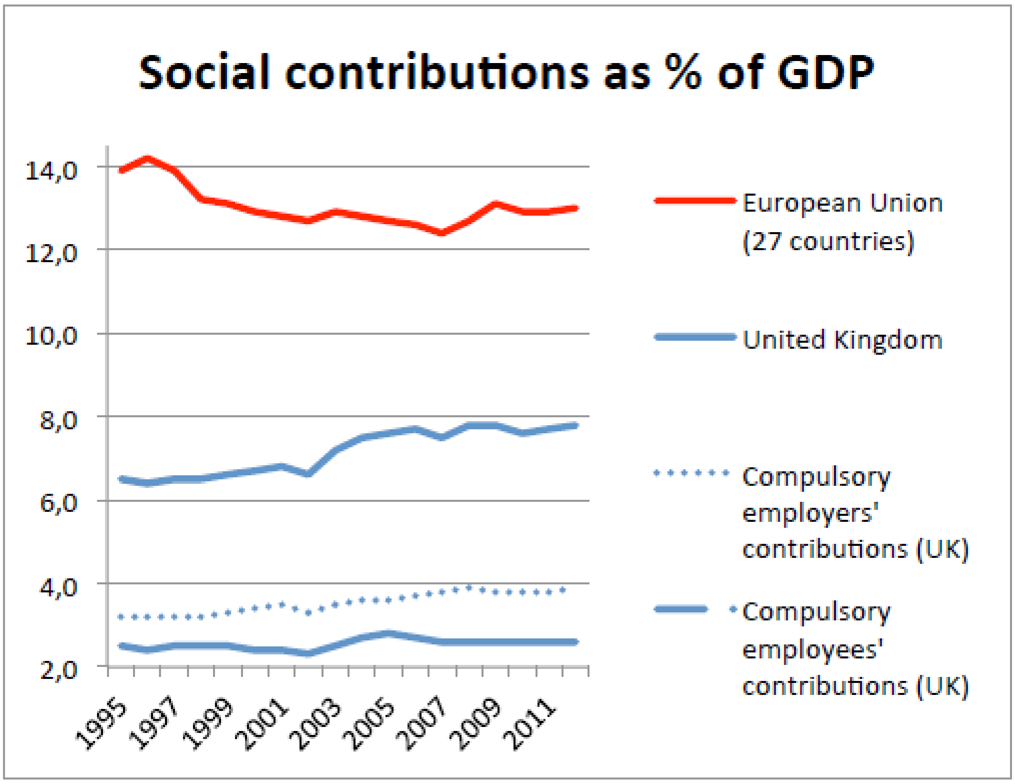
Figure 4 shows social contributions in the UK and the EU. Contributions as percentage of GDP have increased steadily in the UK but are still significantly lower than the EU average. More is paid by employers than employees, although this distinction is purely transactional – the incidence falls on the employee.

The contributory principle which once underpinned National Insurance has now been totally eroded. National Insurance credits effectively mean that those who make no National Insurance Contributions due to maternity, sickness, unemployment etc are credited as doing such entitling people to benefits which they were previously ineligible for.

Additionally a “Lower Earnings Limit” has been introduced which entitles people earning £111 a week to a range of welfare benefits that they were previously ineligible for.

The distinction between National Insurance and Income Tax is now purely academic.

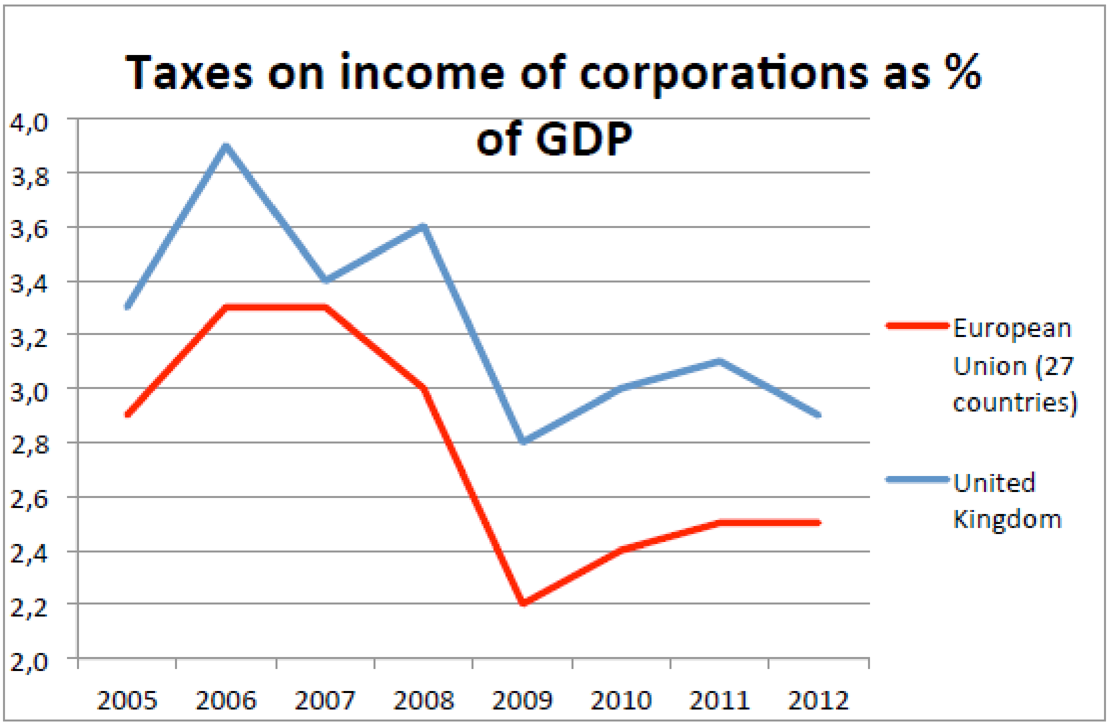
The system has also become extremely complex with myriad different rates and thresholds for different categories of workers such as certain types of fisherman, “volunteer development workers” and other.



Corporation Tax

Taxes on corporate income have consistently raised more as a percentage of GDP in the UK than the average for the EU-27.

The current government has reduced the headline rate of Corporation Tax from 28% to 21% with a further 1 percentage point cut coming into effect in 2015. This will also have the effect of eliminating the difference between the rate charged on small profits (currently 20% on profits of £300,000 or less) and the main rate.



Implicit tax rates

Implicit tax rates (ITR) are provided by Eurostat for consumption, labour and capital. The relevant database is "Implicit tax rates by economic function".

Consumption ITR is the percentage of consumption expenditures which go in taxes. Labour ITR is the percentage of labour income which goes to the government. Capital ITR is the percentage of capital income which goes to the government in taxes.

Capital ITRs are further divided in capital ITR proper, business income ITR (which does not consider wealth taxes), business income ITR for corporations and business income ITR for households and self-employed.

Figures 5-7 show the implicit tax rates on consumption, labour, capital, business income, business income of corporations, and business income of households and self-employed. For capital – and related – ITR there are no average European data.

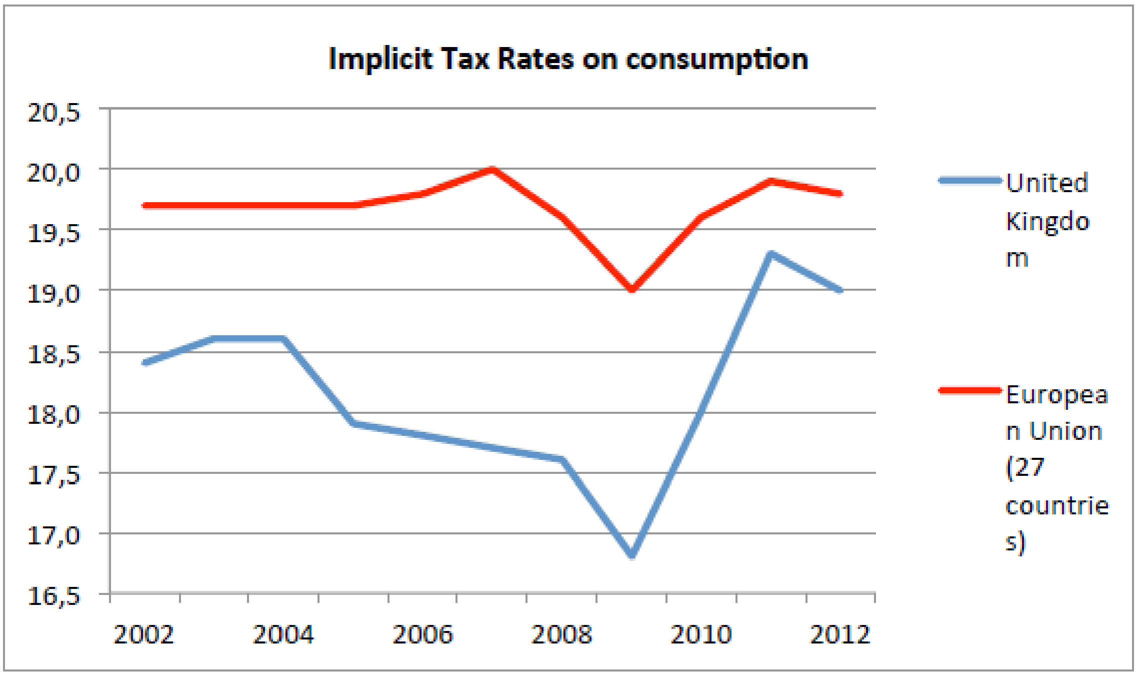


FIGURE 5 – Consumption ITR
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Consumption ITR is very similar to the EU average. The recent narrowing of the gap between the UK and the EU-27 can largely be attributed to the 2010 increase in the standard rate of VAT to 20%.

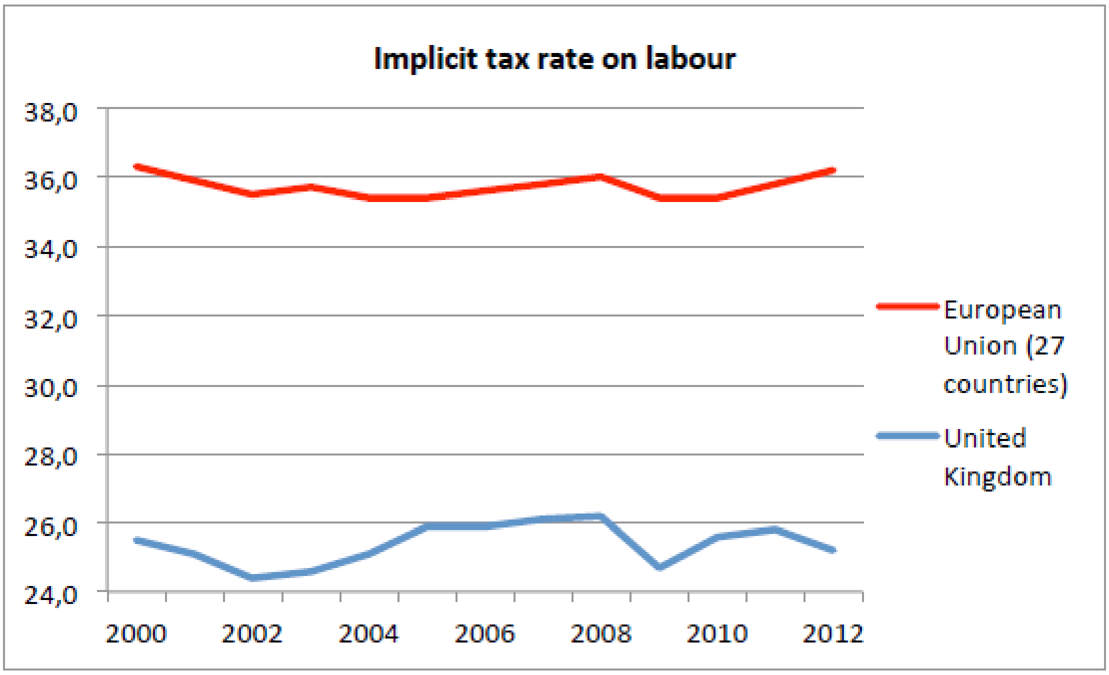


FIGURE 6 – Labour ITR

Labour ITR is significantly lower than the average for the EU-27 – with no major changes in recent time

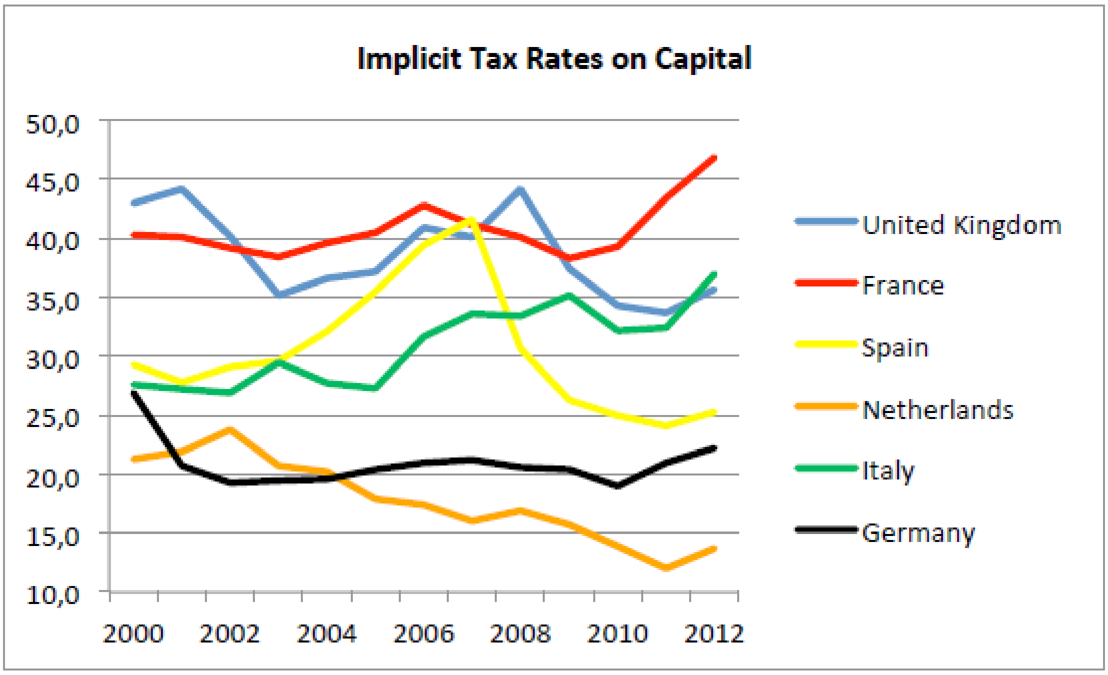


FIGURE 7 – Capital ITRs

Capital ITRs are some of the highest in the EU with France and Italy the only major EU economies with higher implicit rates.

Administrative burden of fiscal procedures

The additional costs incurred by corporations and households because of tax receipts are not the only costs related to the fiscal systems. Paying taxes takes time, requires a certain number of administrative procedures, and may require additional resources, such as those incurred to have the services of accountants.

The table below shows the World Bank's Doing Business data for the member states of the EU concerning the "Paying Taxes" subfield.

It's clear that the UK compares favourably with other European countries on this measure, primarily due to its relatively low Corporation Tax rate. The median ranking for EU member states is 53.5.

Despite performing well compared to other European countries in this index, it should be noted that Europe is far from the global "gold standard" in terms of tax simplicity.

The number of payments is eight: one profit tax (Corporation Tax), one labour tax on the employer (National Insurance contributions) and six other taxes including VAT, Business Rates, Landfill Tax, Vehicle Excise Duty, Insurance Premium Tax and Fuel Duty.

United Kingdom, however it varies where you are in the country:

- Central government
- Devolved governments for Wales, Scotland and Northern Ireland. This level has power over areas such as transport, health, housing and agriculture. These governments do not have taxation powers and are dependent on grants from central government.
- Local Authorities, commonly referred to as "councils." These are further divided as explained below:
    - County councils (upper tier authorities). Responsibilities include education, waste management and social services.
    - District, borough or city councils. Each county council contains a number of smaller, lower tier authorities. Responsibilities include revenue collection, waste collection and housing.

In some parts of the country, there's just 1 tier of local government providing all the local services:

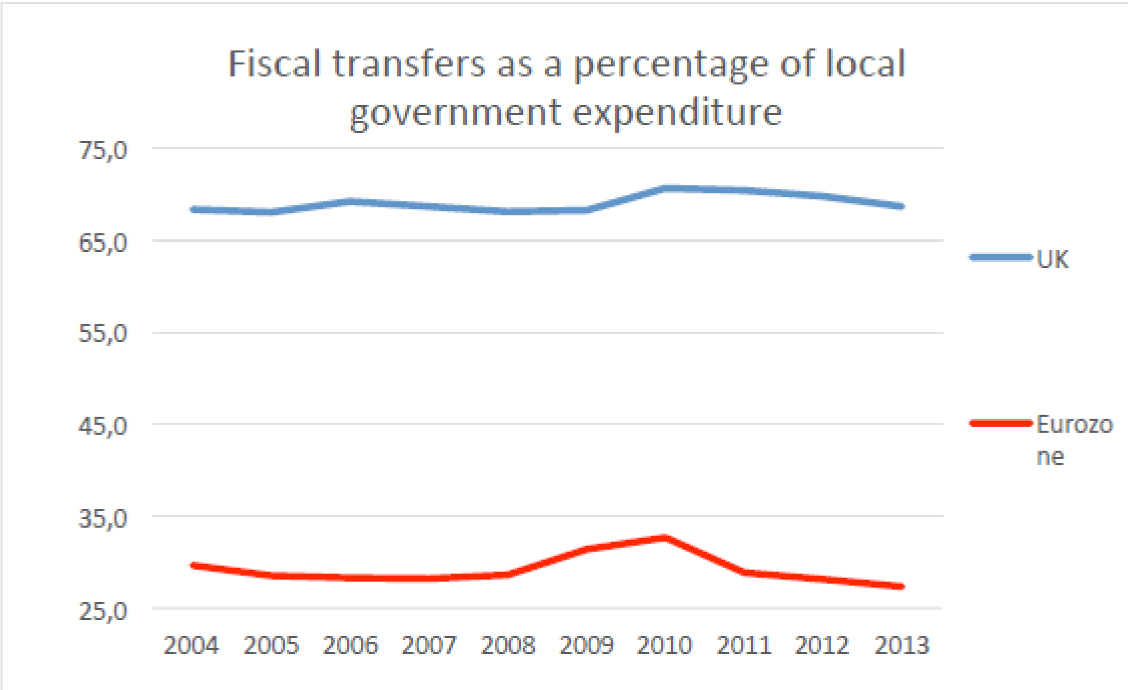
- unitary authorities
- metropolitan boroughs

In London:

- The Greater London Authority (upper tier authority). Responsibilities include policing, transport and fire.
- London Boroughs (lower tier authorities). Responsibilities include education, social services, revenue collection and planning.

Local government is heavily dependent on central government transfers. Councils' only significant revenue stream is Council Tax – an annual levy on residential properties based on 1991 valuations. Typically this only accounts for around one-third of local authorities' revenues.

The chart below shows the UK's "fiscal autonomy index" compared to the Eurozone 17.



Conclusion

The UK compares favourably to many major European countries on a number of measures but as previously mentioned, European countries are not the "gold standard" for simple tax systems which promote entrepreneurship and growth.

The UK's budget deficit remains stubbornly high despite some positive steps being taken by the government. The graph below shows the UK's budget deficit, a large part of which is structural, compared to the EU-27. It remains far too high for comfort and much more work is necessary to build a simpler tax system which encourages growth.