TAC0031

Written evidence submitted by Professor David Heald (Professor of Public Sector Accounting at Adam Smith Business School, University of Glasgow) [1]

Reforming Taxation in the Disunited Kingdom

Introduction

1. I welcome the Treasury Committee's (2020) decision to hold a wide-ranging inquiry on 'Tax after Coronavirus'.

2. The Committee's inquiry has been prompted by the massive damage inflicted upon UK public finances by the COVID-19 pandemic and the public health response. However, it is important to recognise that reform of the UK taxation system was required long before this unexpected crisis. COVID-19 might act as a catalyst to address fundamental problems or it might embed them further.

3. Depressingly, however, the Call for Evidence mentions neither the taxation powers of the Devolved Administrations nor of local authorities. The Committee specification of scope therefore risks making the same error as the Mirrlees Review (Mirrlees et al., 2011), in contemplating tax reform as if the UK were a unitary state. Part of the UK's governance problem is that it is the most fiscally centralised democracy among advanced economies, with the diminution of local government, particularly in England, having accelerated since the 2008 global financial crisis.

4. Fiscal transparency requires that governments publish timely, consistent and accessible information about public finances. Heald (2012) distinguished two sets of obstacles to fiscal transparency: those that are **intrinsic** (such as complexity and the difficulty in comprehending extremely large numbers) and those that are **constructed**. On the revenue side of public finances, successive UK Governments have pretended that high levels of public services can be provided at low levels of taxation. There has been recourse to devices such as not increasing income tax rates but increasing National Insurance Contributions (NICs), essentially a second income tax on a narrower tax base. Governments should not aggravate the intrinsic obstacles by opportunistic recourse to constructed obstacles, but regularly do so notwithstanding professed commitments to fiscal transparency. Such practices mar the substantial progress on fiscal transparency that the UK has made since the 1995 decision to adopt accruals accounting across the public sector (IMF, 2016).

[1] Sole responsibility for the contents of this memorandum rests with the author.

The Tension between Neutrality and Subsidiarity

5. Two of the core principles for the design of tax systems are **neutrality** and **subsidiarity** (Smith and Barents, 1996). Neither can be absolute because of tensions between them and because other principles and political and administrative feasibility will constrain their application:
   a) **Neutrality** refers to minimising the distortionary costs of taxation arising from induced behavioural change by firms and households. Except where taxes are explicitly intended to change behaviour (e.g. environmental taxes), fiscal economists strongly support neutrality, almost irrespective of their views about the desirable size of the state. In contrast, neutrality seems to have a low weight among politicians and electors. The wide and persistent gulf between expert views and public opinion on taxation has been demonstrated by Lim et al. (2013) who compared US survey responses at three historical dates (1934, 1994 and 2013). Unfortunately, there are no comparable UK surveys, but the conclusions resonate. Whereas fiscal experts generally favour broad-based taxes and rates as low as possible consistent with revenue targets, politicians respond to pressure group demands for exceptions which multiply in number and lead to higher economic distortions. Transaction taxes are less visible and affect a smaller proportion of the electorate at any one time, but increase revenue volatility and are severely distortionary. For example, Stamp Duty Land Tax in England (transaction tax on house sales) is more distortionary than an annual tax on occupation, but it is much less visible to electors than is council tax[2] that is still levied on 1991 valuations in England and Scotland,[3] notwithstanding massive shifts since then in relative house prices
   b) **Subsidiarity** refers to the match between expenditure responsibilities and revenue resources in a governmental system with tiers of government (e.g. central, devolved and local). There are two main ideas. First, that fiscal decisions on expenditure and taxation taken at a lower level might better reflect citizen preferences when there are geographical variations in those preferences. Second, that elected sub-national governments should be fiscally accountable to their own electors by directly raising some of their own revenues rather than depend exclusively on grants from higher-level governments. A degree of Vertical Fiscal Imbalance is inevitable in a welfare state providing education, health and social security benefits, but

[2] Northern Ireland does not have council tax but regional and district rates, to which parallel issues apply.
[3] Valuations in Wales are from 2003 and in Northern Ireland from 2005.

its extent should be constrained. The proportion of own revenues at the state/provincial level in federal countries varies enormously: for example, high in Canada and low in Germany.

6. The Muscatelli (2008, p. 7) Expert Group to the Commission on Scottish Devolution set out six guiding principles (Equity, Autonomy, Accountability, Stability/Predictability, Simplicity/Transparency and Efficiency) but recognised that there are trade-offs. Subsidiarity relates to Autonomy and Accountability while Neutrality is an important element of Efficiency. The tax policy problem is how to manage the conflicts between principles, particularly in the context of multi-level government.
7. Inquiries into UK tax reform and subsequent policy design should recognise the tension between neutrality (minimising economic damage) and subsidiarity (facilitating the accountability of sub-national governments by conferring a degree of tax discretion). Whereas the need to manage this tension is understood in some federations (notably Canada, Switzerland and the USA), the paradox of the last two UK decades has been the granting of taxation powers to Devolved Administrations while undermining the financial basis of local government. Particularly in relation to England, the typical response to the failures of centralisation has been for Governments to tighten both policy and fiscal control.
8. Two policy questions which are fundamentally political are:
    a) The desired size of the state, proxied by the public expenditure/GDP ratio
    b) The degree of progressiveness of the tax system as a whole, as focusing on particular taxes in isolation is misleading[4]

    Substantial tax reform is unlikely unless the tax system is considered as a whole, and the resulting design commands a broad measure of support across the political spectrum while allowing for future political choices on the trade-offs. Otherwise, there would be strong resistance to tax reform stemming from fears that there would later be piecemeal changes that unwound political compromises.[5] COVID-19 has reinforced existing social and economic inequalities but it remains too early to know whether there will be long-term attitudinal shifts on taxation. Conventional wisdom is that losers protest about tax reform while winners are silent or do not notice their gains. The usual timing for major tax reform is when public finances are

[4] A progressive tax system might include individual taxes with regressive incidence, for example, tobacco and some environmental taxes.
[5] For example, broadening of the UK's narrow VAT base, as recommended by Mirrlees et al. (2011), might be compensated by changes to other taxation (income tax or NICs) and through higher welfare benefits. However, the 2010s' austerity experience might fuel fears that compensatory measures would later be reversed.

abundant and the loss to losers can be moderated through phased implementation and/or direct compensation. The present circumstances are dramatically different.

Specific Issues

9. Some key issues for the Committee's inquiry are briefly listed below:
   a) Improving the public policy community's understanding that effective incidence (who bears the burden) differs from the nominal incidence (who pays the tax bill). For example, taxes on companies, whether Corporation Tax or Employer NICs, may be shifted backwards to employees and/or forwards to consumers, rather than being entirely borne by shareholders
   b) It is essential that tax authorities, particularly Her Majesty's Revenue & Customs (HMRC) are resourced to the extent required by their operational tasks and the tax reform agenda. Without the enhancement of systemic implementation capacity, tax reform might suffer the debacles of Universal Credit. Computerisation and digitalisation have been routes to HMRC cost reduction, without sufficient regard for enforcement and resilience. The issue is not just lost tax revenue through the Tax Gap, but one of public trust in the fairness of the tax system. The notion that taxes are 'voluntary' for some is destructive, encouraging non-compliance and resistance to reform. Moreover, the division of policy responsibilities between the Treasury and HMRC should be reviewed, and the mandate of the Office of Tax Simplification enhanced
   c) In a world where global companies are so important and digital technologies make location of economic activity more difficult to establish and monitor, corporate taxation is highly problematic. Progress in this arena depends on international co-operation, for example through the OECD's BEPS project[6] and through policy initiatives by the European Union. The deteriorating climate of international relations between major powers does not lead to optimism
   d) The inequalities highlighted by COVID-19 have drawn renewed attention to the higher proportion of total income accruing to the Top 1%, leading to discussion of a possible wealth tax. Wealth taxes are difficult to manage, particularly in a globalised world. Unintended consequences of a wealth tax levied on net assets excluding main residence and pensions could be further diversion of private wealth into such protected forms
   e) The relationship between Income Tax and NICs which are a second income tax on a narrower base but which Governments have assumed to be less politically sensitive to rate changes.[7]

[6] Domestic Tax Base Erosion and Profit Shifting.

The lower threshold for NICs has also created problems for the operation of the Scottish Parliament's devolved income tax powers (Heald, 2020)

f) There should be agreement between the UK, Scottish and Welsh Governments for a synchronised revaluation of the tax base for council tax. Assuming the banding system is retained, there should be more bands at the top end. Given that existing valuations in England and Scotland will then be more than 30 years out of date there would have to be safety nets
g) Long-term economic changes such as the growth of online retailing have undermined Business Rates which require a fundamental rethink across the UK
h) The removal of EU regulation of VAT will make the UK's existing narrow base for VAT more vulnerable to lobbying pressure, thereby threatening revenues. An effective VAT system is required to fund the welfare state and to repair the fiscal damage done by COVID-19.

Conclusion

10. UK tax reform must respect asymmetric devolution and must repair at least some of the damage which has been inflicted upon the viability and capacity of local government.

11. Probably due to its publication in 2011 at the height of austerity, the Mirrlees Review did not stimulate the intended debate on UK tax reform. If the Treasury Committee's inquiry were to provoke a post-COVID-19 debate which then led to well-designed tax reform, that would be a major contribution to public policy in a domain characterised by structural inertia and tactical short-termism.

References

Heald, D. (2012) 'Why is transparency about public expenditure so elusive?', *International Review of Administrative Sciences*, Vol. 78(1), pp. 30-49.

Heald, D. (2020) 'The politics of Scotland's public finances', in M. Keating (ed.) *The Oxford Handbook of Scottish Politics*, Oxford, Oxford University Press, pp. 512-42.

IMF (2016) *United Kingdom Fiscal Transparency Evaluation*, Country Report 16/351, Washington DC, International Monetary Fund.

Lim, D., Slemrod, J. and Wilking, E. (2013) 'Expert and public attitudes towards tax policy: 2013, 1994, and 1934', *National Tax Journal*, Vol. 66(4), pp. 775-806.

Mirrlees, J., Adam, S., Besley, T., Blundell, R., Bond, S., Chote, R., Gammie, M., Johnson, P., Myles, G. and Poterba, J. (2011) *Tax by Design: The Final Report of the Mirrlees Review*, Oxford, Oxford University Press.

Muscatelli, A. (2008*) First Evidence from the Independent Expert Group to the Commission on Scottish Devolution*, Edinburgh, Heriot-Watt University.

Smith, S. and Barents, R. (1996) *Neutrality and Subsidiarity in Taxation*, London, Kluwer International.

Treasury Committee (2020) 'Call for evidence: Tax after coronavirus', available at: https://committees.parliament.uk/call-for-evidence/206/tax-after-coronavirus/ (last accessed 28 August 2020).

[7] As evidenced by the latest increase in the UK basic rate of income tax being for 1975-76.

August 2020