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A tax system fit for the future

An economic perspective on Tax Reform

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Context

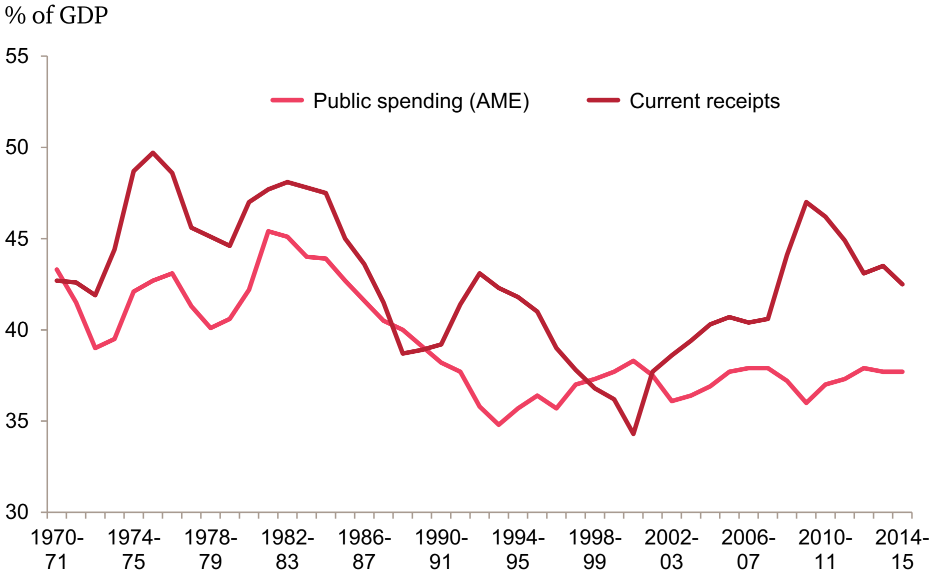
The UK economy, along with other western economies, is being shaped by powerful tides of economic and social change – including globalisation, technology, demographics and major environmental and energy challenges.

These forces of change are already having a significant impact on the way business operates, how people work and spend their time, and on the way in which government needs to operate and finance its activities.

Yet despite this process of economic change, the basic structure of our tax system has not altered significantly for many decades. The last major period of comprehensive tax reform took place in the 1980s. We have recently seen some useful reforming measures in specific areas, such as recent changes to the corporation tax system. But many features of the tax system – for example the range of zero-rated products and services for VAT – have changed very little over the past 30-40 years.

The UK needs a tax system attuned to the economy of the 2010s and 2020s, not the 1970s and 1980s. The way in which government raises money to finance its activities is a very significant influence on our economy. In the UK, government currently spends around 43.5% of GDP and raises about 37% of GDP in revenue[1]. These figures have fluctuated around 40% of GDP since the 1980s (see Chart 1) – and the UK's share of spending and taxation is very close to the OECD average. Tax revenue is projected to be £22,420 for every UK household in 2014/15.

Chart 1: UK public spending and revenue



Source: Office for Budget Responsibility

[1] March 2014 Office for Budget Responsibility Economic and Fiscal Outlook. Figures exclude Royal Mail privatisation and APF transfers from the Bank of England.

An elected government of any political persuasion in the UK will need to raise a broadly similar amount of revenue – close to 40% of GDP – to finance the public services, pension provision and social protection which we rely on to maintain a well-functioning society and economy. But we need a better quality debate about how we ensure the tax system which we rely on to raise such a substantial sum of money each year is attuned to the needs of a modern UK economy.

This paper aims to contribute to that debate by setting the scene for why reform is needed and raising some of the questions that need to be considered. First, it discusses how major economic, social and technological changes are reshaping our economy and how this process is likely to continue into the future. Second, it reviews the current structure of the UK tax system and how it impacts on the British economy. The final section of the paper highlights a number of tax policy issues which flow from this analysis. To find a way forward which commands more general acceptance among the public and in the business community, we need to have a much wider debate on these issues – and ***PwC's Paying for Tomorrow*** project aims to stimulate and contribute to this broader discussion.

How the UK economy is changing

The UK, along with many other economies around the world, is being influenced by powerful global trends affecting the nature and location of economic activity.

PwC analysis highlights five powerful 'megatrends' currently impacting on businesses and the structure of our economies: (1) A continuing shift in the balance of global economic power towards Asia and other emerging and developing countries; (2) The application of new technologies, underpinning the growth of a new 'digital economy'; (3) demographic shifts and ageing populations; (4) the growing importance of cities as economic hubs in both the developed and developing world; and (5) major energy and environmental challenges, linked to the increased pressure of global population on the world's natural resources[2]. These forces have been shaping our economy for some time and will continue to do so as we move towards the 2020s.

These major global trends are changing the structure of the UK economy and have implications for the tax system. In this context, five major economic consequences stand out.

1 Business and economic activity are becoming more internationally mobile

Since the 1990s, the world economy has experienced a period of intense global integration. All the major centres of population in the world are now participating in the world economy in a way that we have not seen in the history of the world before; 94% of the world's population now live in a country which is a member of the World Trade Organisation. There has been a major shift in global manufacturing production towards low-cost economies, with China overtaking the US as the world's leading industrial producer. Flows of trade and investment have increased in importance in relation to the size of the world economy and developing emerging market economies are participating to a much greater extent. World trade has increased from around 18% of world GDP in the early 1990s to over 30% now, and flows of foreign direct investment have risen from 0.7% of world GDP to over 2% over the same period. Emerging market and developing economies are now the recipients of over 50% of the world's foreign direct investment.

[2] For more details on these 5 PwC 'Megatrends', please visit ***www.pwc.co.uk/megatrends***

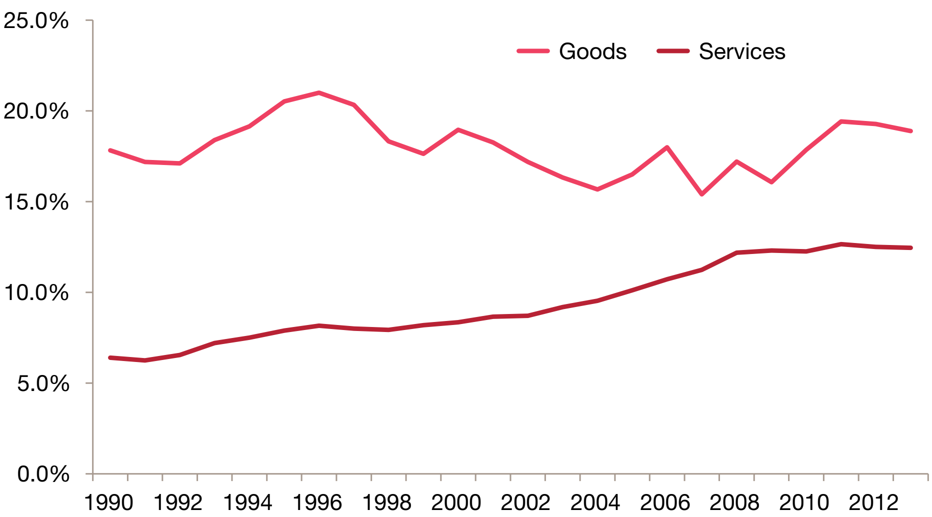
2 Our economy is becoming more virtual and intangible

As manufacturing has shifted to lower cost production centres, the services sector has become increasingly important for the Western economies and Japan. In 1980, the share of services in GDP in the G7 economies was around 60%. Now it is 70-80%, with the UK, France and the US the most service-oriented economies. Services trade has also increased significantly. In the case of the UK, exports of services have doubled their share of GDP – from just over 6% to 12.5% since 1990 (see Chart 2), while the share of goods exports in our economy has been broadly unchanged. In most western economies, manufacturing is no longer a major source of employment and GDP. In the UK it accounts for just 10% of GDP and 8% of employment now, compared with 25-30% in the 1970s. The remaining sources of manufacturing employment and output are mainly high-technology businesses relying on the competitive advantage provided by continual innovation and deploying highly skilled and creative designers and technicians.

Information technology and communications, including the development of the internet, have reinforced this shift towards a more virtual and intangible services-oriented economy. These technologies allow the provision of services and value-creation to be separated geographically, leading to increased mobility of economic activity. This poses particular challenges for tax authorities who rely on the geographical location of business and employment as the basis for levying taxes.

Chart 2: UK goods and services exports

% of GDP



Source: Office for National Statistics

3

Employment is becoming more flexible but income inequality is rising

Since the 1980s, there has been a drive to make the UK labour market more flexible to increase the potential for creating new jobs. The share of both part-time employment and self-employment has increased steadily, as Chart 3 shows. Self-employed and part-time workers now account for over 36% of total jobs now in the UK, compared with less than 30% in the mid-1980s.

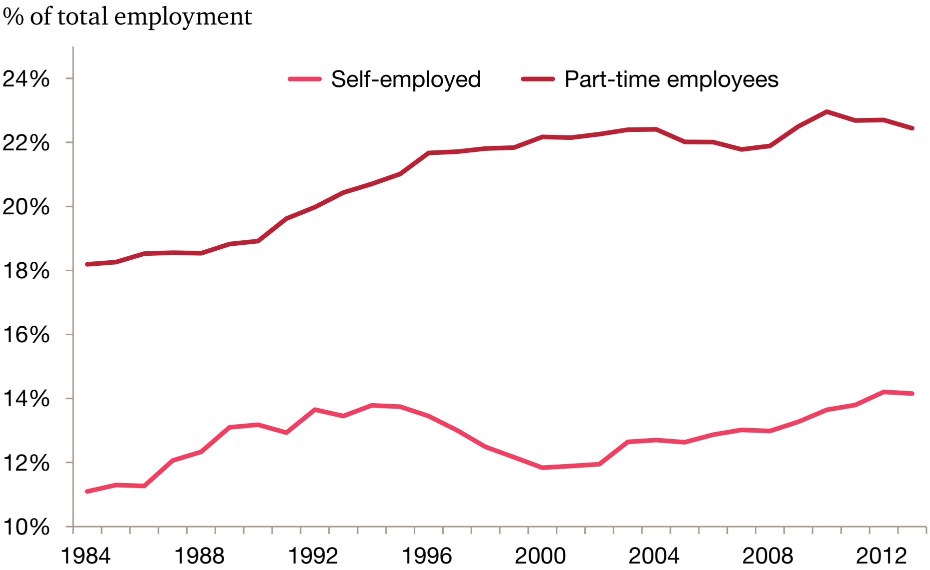
At the same time, however, the forces of globalisation and the impact of new technologies have contributed to rising inequality of incomes for those in work. Lower skilled workers have seen their wages held down by the pressure of international competition, even though the basic cost of living has been rising. Meanwhile, business activity, financial capital and high-skilled workers are becoming much more mobile around the world economy, increasing their earning potential.

Until the 1970s, the main causes of poverty in the UK were old age and persistent unemployment. More recently, as researchers at the Institute for Fiscal Studies point out:

'Poverty has become much more of an in-work phenomenon since the 1970s, as increased earnings inequality in the 1980s and relatively slow growth in earnings since have pushed more low and middle earners into poverty. This shift in poverty from something concentrated among the old and workless to something increasingly felt by employed and self-employed working-age adults is a major socio-economic change.' [3]

OECD analysis shows a rising share of income going to high-earners, with the top one percent of earners in the UK doubling their share of income between 1970 and 2005 – from 7% to 14%[4].

Chart 3: More flexible patterns of employment



Source: ONS Labour Market Survey

[3] Living standards, poverty and inequality in the UK: 2013 by Jonathan Cribb, Andrew Hood, Robert Joyce and David Phillips. Institute for Fiscal Studies Report R81, June 2013

[4] OECD analysis of rising UK income inequality – ***http://www.oecd.org/unitedkingdom/49170234.pdf***

4

Our population is ageing as the demographic profile shifts

Better health is creating an increase in life expectancy in many countries around the world. Together with falling birth rates, this is contributing to an ageing population. The UK is no exception. According to the Office for National Statistics, the number of people aged 65 and over in the UK has already increased by 26 per cent since the mid-1980s – to 10.8 million in 2012. The number of people aged 85 and over more than doubled over the same period to 1.4 million and the percentage aged under 16 fell from 21 per cent to 19 per cent. Population ageing is projected to continue for the next few decades according to official estimates. By 2037 the number of people aged 85 and over is projected to be 2.5 times larger than in 2012, reaching 3.6 million and accounting for 5 per cent of the total population. The population aged 65 and over will account for 24 per cent of the total population in 2037, while the proportion of the population aged between 16 and 64 is due to fall from 64 per cent to 58 per cent.

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We face major energy and environmental challenges

Never before in the history of the world have we faced a situation where our planet has had to sustain over 7 billion people, the vast majority of whom aspire to a rising standard of living. This is putting severe strain on the supply of energy, food and other natural resources with the consequence that we have seen a series of energy and commodity price spikes since the mid-2000s, adding to the squeeze on living standards in the UK and other western economies since the financial crisis. At the same time, scientists are warning about the need for global action to address the growth of greenhouse gas emissions and head off the trend towards global warming. Looking ahead, these energy, resource and environmental challenges look set to loom even larger as we move into the 2020s.

These pressures and forces for change are not unique to the UK. They are affecting many other economies around the world to some extent – particularly in the West. In relation to its peer group of advanced western nations, the UK economy has some advantages which is helping it to adapt to these challenges. We have a **flexible and dynamic services-oriented economy**. Among the G7 economies, the UK is the leading exporter of services – with services exports accounting for over 12% of GDP compared with around 6% in other major EU economies and 4% in the US. This reflects a competitive advantage in services activities which should be a source of economic strength in the increasingly global services-oriented economy we now inhabit. Second, the **UK labour market is relatively flexible** which has helped to sustain high levels of employment when some other European economies and the US have been struggling with historically high unemployment rates. Third, **the UK has not been a high tax/spend economy** since the 1980s. While the recession and slow growth have pushed up public spending in relation to GDP, the public spending share of GDP is close to the OECD average and low in relation to our European peer group. Fourth, we have a **highly international business and financial culture** which allows Britain to tap into the buoyancy of the global economy – though our comparative advantage lies in services and high-value and high-skill manufacturing sectors.

We should not therefore be pessimistic about the outlook for the UK economy as we move towards the 2020s. PwC analysis suggests that the UK has the potential to achieve an economic growth rate of around 2-2.5%, while maintaining a high level of employment. This would be an improvement on the 1.5% growth achieved so far over the recovery since the financial crisis, but not a return to the 3%+ average growth achieved from 1982-2007.

UK public finances and the structure of taxation

Chart 1 showed that public spending in the UK has tended to be just over 40% of GDP creating the need to raise revenue of close to 40%. (The average public spending share of GDP since 1970 is 42.7% and the post-1970 average for government revenues is 39.3%.)

A modest deficit of 2-3% of GDP can be sustained over the medium term to help finance capital expenditure. In a growing economy with low inflation, such a deficit of 2-3% of GDP would still be consistent with a stable or falling ratio of public debt to GDP[5].

There are three broad purposes for which the UK government raises money through taxation. First, it needs tax revenues to fund spending on goods and services provided by the government and to meet international obligations. In 2014/15, this will amount to current spending of around 24% of GDP[6] plus capital spending of 3% of GDP (before depreciation) – though there is a respectable economic argument that because infrastructure and other capital expenditure adds to the economic potential of the nation it should be funded by borrowing.

The second main function of the tax system is to support transfers of income through pensions and the social security system. In 2014/15, £213bn – 12.4% of GDP and close to a third of total current government spending – will be accounted for by social security and tax credits. The third function of the tax system is to service debt interest – which is currently costing just over £50bn a year (about 3% of GDP). It is worth noting, however, that social security payments/tax credits plus debt interest roughly equals the total amount raised by income tax and national insurance payments. The burden of financing public services therefore has to be borne by other taxes.

The UK currently has a wide range of different taxes. In its regular reports, the OBR lists 26 specific taxes or areas of taxation. But the reality is that the UK government relies on a small number of taxes to raise the bulk of its income. As Chart 4 shows, nearly two-thirds of tax revenue comes from three main taxes or levies– income tax, national insurance and VAT. A further four broad categories contribute a further 30% of the total; specific taxes on expenditure, such as fuel, alcohol and tobacco duties; local taxes (Council Tax and business rates); corporation tax, levied on company profits; and other taxes on capital and property (Stamp Duty, capital gains tax and inheritance tax). All other taxes, including environmental levies, make up just 3.5% of the total.

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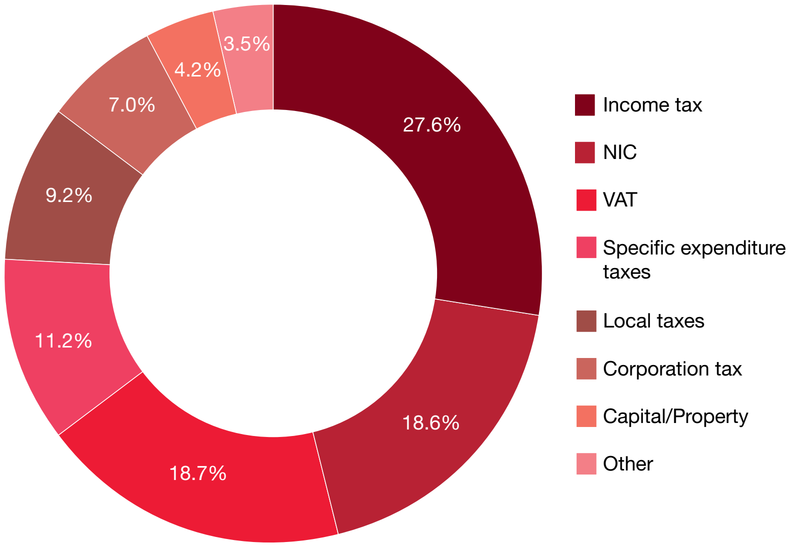
[5] 2% inflation and 2% GDP growth allows public debt to grow by 4% to remain a stable ratio to GDP. With a debt/GDP ratio of 75% (the current figure), this allows the government deficit to be 75% of this figure – i.e. 3% of GDP – without inflating the debt/GDP ratio. A deficit below 3% would allow the debt/GDP ratio to fall.

[6] Figures quoted are from the Office for Budget Responsibility. As measured by the ONS, government current spending on goods and services is around 22% of GDP but this does not include public sector pensions payments, funding for the BBC, universities and similar public bodies plus transfer payments to support international obligations (overseas aid, contributions to EU and some military expenditure).

Chart 4: UK tax revenues 2014/15

% of total tax revenue = £592bn



Source: PwC analysis of March 2014 OBR Economic and Fiscal Outlook

Another way of looking at this picture is to divide these sources of revenue into taxes on personal income and employment, expenditure and profits/capital/property. On this basis personal income and employment taxes generate just under half of the total (46%), expenditure taxes account for 30% and taxes on property, capital and profits (including local taxes) raise just over 20%. Future projections from the Office for Budget Responsibility do not indicate major shifts in the shares of taxation coming from these broad areas of taxation over the next five years.

Issues for tax policy and reform

The shape of the UK tax system described above has evolved over many years.

There have been a number of phases of tax reform – with the Conservative government in the 1980s particularly active in restructuring the tax system with the aim of reducing tax rates and improving incentives to create wealth. More recently, the current coalition government has followed through a programme of corporate tax reform started by its predecessor, aimed at lowering corporate tax rates and creating a more attractive tax environment for businesses located in the UK.

Economists have debated the principles which should underpin taxation for many years – going back to Adam Smith's Wealth of Nations which set out four 'canons of taxation': equity; certainty; convenience and efficiency. These principles still remain valid, but more recent tax reforms have focussed on ensuring that the tax system encourages, rather than discourages, productive wealth creation. In this context, there have been three broad themes underpinning tax reforms applied in the UK and other major economies in recent decades. The first theme is to keep tax rates down by widening the tax base and minimising exceptions and exemptions. A second strand of economic thinking is to focus taxation on expenditure and discouraging socially and environmentally damaging activities, in order to keep down the tax burden on the creation of income and wealth. A third theme is to keep down rates of taxation on internationally mobile economic activities and productive resources so the tax regime attracts these resources and activities and they contribute to the strength of the national economy.

With these principles in mind, the changing global economic environment within which the UK is now operating would seem to indicate ten broad areas of focus for future reform and development of the UK tax system.

Areas of focus for future reform and development of the UK tax system

1) Reliance on personal income and employment taxes

The UK tax system is heavily reliant on personal income and employment taxes to generate nearly half of total revenue. This may not be sustainable in a 2020s world as the businesses and individuals shaping our economy are becoming more mobile, employment patterns are changing and there is increased sensitivity to the tax burden on low income households. However, reducing the reliance on personal income and employment taxes would require alternative sources of tax revenue in their place – for example, increased expenditure taxes, new environmental levies, or additional property taxes.

2) Efficiency and fairness of income redistribution

The analysis above showed that the bulk of income tax and national insurance payments are absorbed by the funding of social security benefits and tax credits. This system of income redistribution has grown up over a long period of time. As labour market conditions change and an ageing population remains economically active, it is important to ensure that the tax/benefit system still operates fairly and efficiently redistributes income.

3) The tax contribution of business

Business is the wealth-generator of the economy. While corporate tax reform is welcome, it has focused on corporation tax. Taxes borne by business also include employer national insurance, business rates and other non-refundable taxes (e.g. excise duties). We need to understand the combined total impact of these taxes on the competitiveness of businesses, both small and large. And we also need to strike the right balance between competitiveness and revenue-raising in an increasingly competitive global economy.

4) Taxation of foreign entities and individuals

As business becomes more international, and high-skilled individuals become more mobile, the UK tax system needs to ensure that its treatment of businesses based overseas and foreign employees/investors is not an impediment to the growth of our economy, whilst increasing public understanding of the reasons for policy changes in this area.

5) Structure and rates of income/employment taxes

UK income tax is progressive, though with a wide range of allowances and exemptions. Employment taxes (NICs) are regressive – with payments starting at a much lower income threshold than income tax, but with a significantly reduced rate applying to employee and self-employed contributions above the upper earnings limit of around £40,000 per year. National insurance does not apply to unearned income which therefore attracts a lower rate of tax than employment income. With income tax and national insurance raising nearly half of total revenue, the structure of these taxes has very important consequences for both work and savings incentives.

6) Structure and rates of expenditure taxes

The taxation of different categories of expenditure in the UK is very uneven. For example, expenditure on motor fuel bears a 150%+ tax rate in terms of the combined impact of excise duty and VAT (raising the price of unleaded petrol from 50p/litre to £1.30). By contrast, VAT zero-rating effectively exempts a wide range of items from any form of expenditure tax. Relative to other EU members, the UK has a much more extensive range of goods and services which are zero-rated for VAT and we also make relatively little use of the lower VAT rate – currently 5%. There are many absurdities and inconsistencies in the current VAT system. Highly priced foods like caviar are taxed at a zero rate while other items much more essential for modern living – like clothing – bear a full rate of VAT. Economic logic would point towards a much flatter expenditure tax system with far fewer differentials and exceptions.

7) Role and nature of property, capital and wealth taxes

Taxes on property, capital and wealth – including local taxes – currently raise about 13% of total revenue. The taxes which the UK has on property and wealth are heavily weighted to property ownership and transactions – Council Tax, business rates and stamp duty. There are arguments for spreading wealth taxes more widely and rationalising the tax treatment of property. But equally a significant expansion of taxation of property and wealth also carries risks if it leads to the perception that the UK is not an attractive place to accumulate wealth-creating assets.

8) Environmental taxation

Environmental taxation in the UK has been piecemeal and opportunistic. Some environmentally damaging activities bear heavy taxes – notably motoring and air travel. Others seem to benefit from favourable treatment. Domestic fuel bears a reduced rate of VAT, even though its carbon emissions are just as damaging to the global atmosphere as those emitted from an exhaust pipe or an aero engine. There are other tax interventions which have been motivated by environmental concerns – like the climate change levy and the landfill tax. But there are no consistent principles governing the UK system of environmental taxation and a thorough review is long overdue.

9) Local and devolved taxes

The UK tax system is highly centralised and local autonomy is highly constrained. Local taxes – Council Tax and business rates – account for less than 10% of total UK tax revenue. Moreover, there is no direct linkage between money raised locally and the spending of local authorities due to the centrally controlled system of local government finance. There are plans to give more tax discretion to some devolved authorities, particularly in Scotland, but there is a strong case for a wider review of the role and scope of local taxes as part of an economic regeneration strategy for the UK regions.

10) Transparency, simplicity and understanding of the tax system

Policy-makers find it easy to add complexity to the tax system and much harder to streamline and simplify. A wide-ranging programme of tax reform would be an opportunity to create a much simpler and more efficient tax structure. PwC's recent Citizen's jury on taxation[7] also highlighted the need for greater transparency and public information on the way in which tax revenues are raised and spent.

[7] Visit ***www.pwc.co.uk/futuretax*** to find out more

Tax reform – The way ahead

Major changes in the global economy, in technology and in our society have a significant bearing on the way in which our tax system needs to operate in the future.

The issues highlighted above cannot be addressed in a piecemeal fashion. We need to think holistically about the structure of our tax system – how it affects incentives to work, save and invest – and how efficiently and effectively it raises revenue to support public services and those on low incomes. A debate on reform of the UK tax system is long overdue. The next Parliament provides an opportunity to start to address the important issues raised in this paper about the future of taxation in the UK.

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