briefing notes

A SURVEY OF UK TAX SYSTEM

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Contents

1. Introduction

This paper 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 25 years. 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; local (council) tax; and business rates (non-domestic rates). The information given in these sections relates, where possible, to the tax system for the fiscal year 2003–04.

In Section 4, we set the current system in the context of reforms that have taken place over the last 25 years. The section examines the changing structure of income tax and National Insurance contributions and developments in the taxation of saving, indirect taxation, corporation tax and local taxes. More information on historical tax rates can be found on the IFS website at www.ifs.org.uk/taxsystem/index.shtml.

Much of the tax rate information contained in this Briefing Note is taken from the Inland Revenue website (www.inlandrevenue.gov.uk/rates) or the Customs and Excise website (www.hmce.gov.uk). Tax statistics come from the Inland Revenue website (www.inlandrevenue.gov.uk/stats). Information relating to tax receipts is from the 2003 Budget Report (www.hm-treasury.gov.uk/Budget/bud_bud03/bud_bud03_index.cfm).

2. Revenue raised by UK taxes

Total government receipts are forecast to be £428.3 billion in 2003–04, or 38.6% of UK GDP. This is equivalent to roughly £9,020 for every adult in the UK, or £7,240 per person. Table 1 summarises the breakdown of UK government revenue.

In 2003–04, the largest single source of revenue for the government will be taxes on income, both personal and corporate. Approximately £122.1 billion, or 28.5% of total current receipts, will be raised from income tax, with a further £74.5 billion from National Insurance contributions and £30.8 billion from corporation tax. Together, these three sources will account for over 50% of total government revenue. Taxes on expenditure will raise £136.2 billion, or 31.8% of revenue, with VAT accounting for £66.6 billion of this, council tax for £18.6 billion and excise duties on petrol, alcohol and tobacco for £38.4 billion. Taxes on capital will provide a further £11.5 billion for the exchequer.

Table 1: Sources of government revenue, 2003–04 forecasts

Source of revenue	**Forecast 2003–04 (£bn)**	**Proportion of total (%)**
Income tax (gross of refundable income tax credits)	122.1	28.5
National Insurance contributions	74.5	17.4
Value added tax	66.6	15.5
Other indirect taxes		
Fuel duties	23.0	5.4
Tobacco duties	8.0	1.9
Alcohol duties	7.4	1.7
Betting and gaming duties	1.3	0.3
Vehicle excise duty	4.8	1.1
Air passenger duty	0.8	0.2
Insurance premium tax	2.2	0.5
Landfill tax	0.7	0.2
Climate change levy	0.9	0.2
Customs duties and levies	1.9	0.4
Capital taxes		
Capital gains tax	1.2	0.3
Inheritance tax	2.4	0.6
Stamp duties	7.9	1.8
Company taxes		
Corporation tax	30.8	7.2
Petroleum revenue tax	1.5	0.4
Business rates	18.6	4.3
Council tax	18.6	4.3
Other taxes and royalties	11.9	2.8
Interest and dividends	4.0	0.9
Gross operating surplus, tax credits, other receipts and adjustments	17.2	4.0
Current receipts	**428.3**	**100.0**

Note: Percentages may not sum exactly due to rounding.
Source: HM Treasury, *Financial Statement and Budget Report*, 2003 (www.hm-treasury.gov.uk/budget/bud_bud03/budget_report/bud_bud03_repbc.cfm).

3. The tax system

3.1. Income tax

Income tax liabilities

Over 30 million individuals pay income tax in the UK, but not all income is subject to tax. The primary forms of taxable income are earnings from employment and self-employment, jobseeker's allowance, retirement pensions, profits from business, 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. the basic state pension), but some (notably child benefit) are not. Income tax is also not paid on employer or employee pension contributions (up to a limit) or on income from certain savings products, such as National Savings Certificates and Individual Savings Accounts.

Income tax is forecast to raise £122.1 billion in 2003–04.

Allowances, bands and rates

Income tax in the UK 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. Taxpayers under 65 years old receive a personal allowance of £4,615, while older people are entitled to higher personal allowances (see Table 2). If income for those aged 65 or over exceeds a certain limit (£18,300 in 2003–04), then the allowance becomes subject to a taper of 50% (meaning that every pound earned above the £18,300 threshold reduces the personal allowance by 50 pence), which gradually reduces it to a minimum level equal to the allowance for the under-65s.

Table 2: Personal allowances, 2003–04

Type of allowance	Allowance (£ per year)
Aged under 65	4,615
Aged 65–74	6,610
Aged 75 or over	6,720

Source: Inland Revenue, www.inlandrevenue.gov.uk/rates/it.htm.

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. For those remaining claimants, the MCA no longer acts to increase the personal allowance; instead, it reduces final tax liability by a flat-rate amount – £556.50 in 2003–04 (£563.50 for those aged 75 or over). Couples may choose which of them claims the MCA, or they can claim half each.

Taxable income is subject to different tax rates depending upon the 'tax band' within which income falls. The first £1,960 of taxable income (i.e. income above the personal allowance) is taxed at the starting rate of 10%. The next £28,540 is subject to the basic rate of 22%. Taxable income above the basic-rate limit of £30,500 is subject to the higher rate of 40%. Table 3 summarises these marginal tax rates and bands.

Table 3: Tax bands and rates, 2003–04

Taxable income (£ per year)	Rate of tax (%)
0–1,960 (starting-rate band)	10
1,961–30,500 (basic-rate band)	22
Over 30,500 (higher-rate band)	40

Source: Inland Revenue, www.inlandrevenue.gov.uk/rates/it.htm.

Savings and dividend income are subject to slightly different rates of tax. Interest on savings is taxed at 10% in the starting-rate band and 40% in the higher-rate band, like other income; but savings income in the basic-rate band is taxed at a lower rate of 20% instead of the 22% basic rate. Dividend income is taxed at 10% up to the basic-rate limit and 32.5% above that. However, this is offset by a dividend tax credit, which reduces the effective rates to 0% and 25% 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.

Table 4 shows the income tax liabilities of starting-, basic- and higher-rate taxpayers. Of a UK adult population of 47.5 million, it is estimated that there will be 30.7 million taxpayers in 2003–04. Of them, 14% will pay tax at only the starting rate, 75% at the basic rate and 11% at the higher rate.

Table 4: Projected income tax liabilities of starting-, basic- and higher-rate taxpayers, 2003–04

Group of taxpayers	Number (000s)	Tax revenue (£m)	Tax revenue as a percentage of total (%)
Starting-rate taxpayers[a]	4,300	1,010	0.8
Basic-rate taxpayers	23,100	56,640	45.6
Higher-rate taxpayers	3,310	66,430	53.5
Total	30,700	124,090	100.0

[a]Includes those whose only income above the starting-rate limit is from either savings or dividends.
Note: Figures may not sum exactly due to rounding.
Source: Inland Revenue, www.inlandrevenue.gov.uk/stats/income_tax/it_t01_1.htm and www.inlandrevenue.gov.uk/stats/income_tax/it_t06_1.htm.

Bands and allowances are increased every year in line with statutory indexation provisions, unless Parliament intervenes. Their increase is announced at the time of the annual Budget, and is 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 nearest multiple of £10. The increase in the basic-rate limit is rounded up to the nearest multiple of £100.

Tax credits

The last five years have seen 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 universal child benefit. It combines support previously provided by children's tax credit, child credits in working families' tax credit (WFTC),[1] child additions to most non-means-tested benefits,[2] and child

[1]Children's tax credit and working families' tax credit are described in Section 4.2.

elements (child additions and family premiums) of income support and income-based jobseeker's allowance.[3] Families are eligible for CTC if they have at least one child aged under 16, or aged 16–18 and in full-time education. CTC is made up of a number of elements: a family element of £545 per year (doubled for families with a child under the age of 1), a child element of £1,445 per child per year, a disabled child element worth £2,155 per child per year and a severely disabled child supplement worth £865 per child per year. 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.

Working tax credit (WTC) provides in-work support for low-paid working adults with or without children. It replaces the adult and childcare elements of WFTC, disabled person's tax credit and the New Deal 50-plus employment credit, and further extends in-work support to those without children. WTC consists of a basic element worth £1,525 per year, with an extra £1,500 for couples and lone parents (i.e. everyone except childless single people) and an extra £620 for those working at least 30 hours a week (30 hours in total for couples). Families with children and workers with a disability are eligible for WTC provided at least one adult works 16 or more 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 and for those over 50 returning to work. 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 £135 for families with one child, or £200 for families with two or more children (i.e. up to £94.50 or £140). Unlike the rest of the WTC, the childcare credit is paid directly to the main carer.

A means test applies to the child tax credit and working tax credit together. Families with pre-tax family income below £5,060 per year (£13,230 for families eligible only for child tax credit) 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 37p for every £1 of family income above this level. The main WTC entitlement is withdrawn first, then the childcare element of WTC and finally the child elements of the child tax credit. The family element of the child tax credit, however, is not withdrawn unless family income exceeds £50,000 per year; above that level, it is reduced by £1 for every additional £15 of income.[4]

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[2]These benefits are: carer's allowance, incapacity benefit, retirement pension and widowed parent's allowance. For details of these and the other benefits mentioned here, see A. Leicester and J. Shaw, *A Survey of the UK Benefit System*, IFS Briefing Note 13, 2003 (www.ifs.org.uk/taxsystem/benefitsurvey.pdf).

[3]Between April 2003 and April 2004, families on income support or jobseeker's allowance can choose whether to receive child tax credit or to receive an identical amount through income support / jobseeker's allowance. This is for administrative reasons only.

[4]For more information on the child tax credit and the working tax credit, see M. Brewer, *The New Tax Credits*, IFS Briefing Note 35, 2003 (www.ifs.org.uk/taxben/bn35.pdf).

Taxation of charitable giving

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

Covenanting is a means by which individuals (and companies) can donate a fixed sum of money to a specified charity each year, and receive relief from income tax (or corporation tax) on their donations (provided the covenant runs for at least three years). Donations are made net of tax and the charity claims back the basic-rate tax paid on it; higher-rate taxpayers can claim back from the Inland Revenue (and keep) the difference between basic-rate and higher-rate tax. There is no upper limit on the amount that can be donated by covenants.

Established in 1990, Gift Aid gives individuals (and companies) tax relief on one-off donations. Initially, donations had to be above a minimum threshold, but the threshold was abolished in April 2000, so that all donations made through the Gift Aid scheme are now tax-free. The operation of Gift Aid is very similar to that of covenants: donations are made net of tax, the charity recovers basic-rate tax, and higher-rate taxpayers may claim additional tax relief on the grossed-up amount.

Under a payroll giving scheme (Give-As-You-Earn), employees nominate the charities to which they wish to make donations and authorise their employer to deduct a fixed amount from their pay. This requires the employer to contract with an Inland Revenue-approved collection agency, and tax relief is given by deducting donations from pay before calculating tax due. On its introduction in 1987, gifts made under payroll giving schemes could not exceed £120 a year, but this limit was raised over time and abolished eventually in April 2000. Until April 2004, donations made through payroll giving schemes receive a 10% government supplement.

Payments system

Most income tax is deducted at source: by employers through the Pay-As-You-Earn (PAYE) system, or by banks etc. for any interest payments. The UK income tax system is cumulative in the sense that total tax payable for a particular financial year depends upon total income in that year. Thus, 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. For those with stable incomes, this system will be little different from a non-cumulative system (in which only income in the current period is considered). For those with volatile incomes, however, the cumulative system means that, at the end of the tax year, the correct amount of tax should have been deducted, whereas under a non-cumulative system, an end-of-year adjustment might be necessary. To enable employers to deduct the right amount of tax, the Inland Revenue supplies employers with a 'tax code' for each employee, which describes the allowances the employee is entitled to. If individual circumstances change (starting to receive a pension, for example), the Revenue issues a new tax code for that individual.

Most people need do nothing more: for those with relatively simple affairs, the cumulative system means that no end-of-year adjustment to the amount of tax paid is necessary. Those with more complicated affairs, however, such as higher-rate taxpayers, the self-employed, company directors and landlords, must fill in a self-assessment tax return, setting down their incomes from different sources and any tax-privileged spending such as pension contributions or gifts to charity. Taxpayers may send their returns to the Inland Revenue before 30 September each year, and the Inland Revenue will calculate the tax owed, given the information on income sources provided by the taxpayer. Alternatively, for those wishing to calculate their own tax bill, the deadline is the following 31 January, which 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. In recent years, the number of people filling in tax returns has increased, driven partly by the changing nature of employment and the increasing number of higher-rate taxpayers, but the majority of employees still pay tax through the cumulative system and do not fill in tax returns.

3.2. National Insurance contributions

National Insurance contributions (NICs) act like a tax on earnings, but their payment entitles individuals to certain ('contributory') social security benefits.[5] 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. Contributions are paid into the National Insurance (NI) Fund; a small, fixed proportion of this is allocated to the National Health Service, and the remainder is used to finance contributory benefits. The NI Fund is not a true fund in the sense that it has no significant balance available for investment: current contributions finance current benefits, with the fund merely being a device to prevent cash-flow problems. Officially, the fund should not fall below one-sixth of NI expenditure, to ensure there is enough money available to pay benefits. Historically, this has been achieved through a grant from central taxation, although during the mid-1980s, the high level of economic activity expanded contribution levels, resulting in the grant being abolished in 1990. The subsequent recession reduced contributions and raised the costs of benefits so that the grant had to be reintroduced in 1993–94. It subsequently declined and the fund is now in surplus.

In 2003–04, National Insurance contributions are forecast to raise £74.5 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). Since 1975, Class 1 contributions for employers and employees have been 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 level at which employers start paying NI was increased to the level of the income tax personal allowance. The level set for employees increased more slowly, meaning employees and employers were no longer subject to the same earnings floor. The two floors were named, respectively, the primary threshold (PT) and the secondary threshold (ST). In April 2001, the PT and ST were aligned at the level of the income tax personal allowance, and they have remained so since. 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 is that individuals who would have been entitled to these benefits before 1999 should not lose eligibility due to the over-indexation of the NI earnings floor.

[5]For details of contributory benefits, see A. Leicester and J. Shaw, *A Survey of the UK Benefit System*, IFS Briefing Note 13, 2003 (www.ifs.org.uk/taxsystem/benefitsurvey.pdf).

Employee and employer NIC rates were both increased by one percentage point in April 2003. Employees now have to pay NI at a rate of 11% on any earnings between the PT (£89 per week in 2003–04) and the upper earnings limit (UEL, £595 in 2003–04), and at 1% on earnings above the UEL. Employers pay NI contributions for each employee who earns over the ST (also set at £89 per week in 2003–04), at a rate of 12.8% of all earnings above this level. Table 5 summarises the Class 1 contribution structure for 2003–04.

Table 5: National Insurance contribution (NIC) rates, 2003–04 (%)

Total weekly earnings (£)	Employee NICs		Employer NICs	
	Standard rate	Contracted-out rate	Standard rate	Contracted-out rate
0–77 (LEL)	0	0	0	0
77–89 (PT/ST)	0	0	0	0
89–595 (UEL)	11	9.4	12.8	9.3
595 or more	1	1	12.8	12.8

Notes: Rates shown are marginal rates, and hence apply to the amount of weekly earnings within each range. Contracted-out rate applies to defined benefit pension schemes, i.e. contracted-out salary-related schemes (COSRSs). The rates applying to defined contribution pension schemes – i.e. contracted-out money-purchase schemes (COMPSs) – vary according to age.
Source: Inland Revenue, www.inlandrevenue.gov.uk/rates/nic.htm.

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 private pension scheme. The reduction depends on the type of pension scheme that an individual has joined. For defined benefit pensions, the percentage levied on earnings between the PT/ST and the UEL is currently reduced by 1.6 percentage points for employee contributions and by 3.5 percentage points for employer contributions. The equivalent rebates for those who have opted out into a defined contribution pension scheme depend on their age.

The self-employed pay two different classes of NI contributions – Class 2 and Class 4. Class 2 contributions are paid at a flat rate (£2.00 per week for 2003–04) by those whose earnings (i.e. profits, since these people are self-employed) exceed the small earnings exception, currently £4,095 per annum. Class 4 contributions are paid at 8% on any profits between the lower profits limit (£4,615 per annum for 2003–04) and the upper profits limit (£30,940 per annum for 2003–04), and at 1% 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 £6.95 per week for 2003–04.

3.3. Value added tax (VAT)

VAT is a proportional tax paid on all sales. Before passing the revenue on to Customs and Excise, 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 is 17.5%. In 1994–95, a reduced rate was introduced for domestic fuel and power, originally 8% but now 5%; since 2001, the reduced rate has also applied to women's sanitary products, children's car seats and certain residential conversions. 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 effectively liable to lower rates of VAT (between about 4% and 7%, depending upon the firm's cost structure and suppliers). Approximately 56% of

Table 6: Estimated costs of zero-rating, reduced-rating and exempting goods and services for VAT revenues, 2002–03

	Estimated cost (£m)
Zero-rated:	
Food	9,350
Construction of new dwellings[a]	3,400
Domestic passenger transport	1,750
International passenger transport	250
Books, newspapers and magazines	1,450
Children's clothing	800
Water and sewerage services	950
Drugs and medicines on prescription	800
Supplies to charities[a]	200
Ships and aircraft above a certain size	500
Vehicles and other supplies to people with disabilities	400
Reduced-rated:	
Domestic fuel and power	1,850
Women's sanitary products	35
Children's car seats	5
Lower rate on certain residential conversions	100
VAT-exempt:	
Rent on domestic dwellings[a]	2,750
Rent on commercial properties[a]	450
Private education	150
Health services[a]	650
Postal services	400
Burial and cremation	100
Finance and insurance[a]	2,350
Betting, gaming and lottery	900
Businesses with low turnover	400
Total	**29,990**

[a]Figures for these categories are subject to a wide margin of error.
Sources: HM Treasury, *Financial Statement and Budget Report*, 2003 (www.hm-treasury.gov.uk/budget/bud_bud03/budget_report/bud_bud03_repa.cfm); table A.11 of HM Treasury, *Financial Statement and Budget Report*, 2001 (www.hm-treasury.gov.uk/budget/budget_2001/budget_report/bud_bud01_repchapa.cfm); table A.13 of HM Treasury, *Financial Statement and Budget Report*, 2000 (www.hm-treasury.gov.uk/budget/budget_2000/budget_report/bud_bud00_chapa.cfm).

consumers' expenditure is taxable at the standard rate and 3% is taxable at the reduced rate. The remaining expenditure is on zero-rated and VAT-exempt items. Table 6 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. VAT is expected to raise £66.6 billion in 2003–04.

3.4. Other indirect taxes

Excise duties

Excise duties are levied on five major goods: beer, wine, spirits, tobacco and fuel. 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 22% of the total retail price (including the flat-rate duty and VAT). 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 7 shows the rates of duties levied in 2003–04.[6] Excise duties are forecast to raise £38.4 billion in 2003–04.

Table 7: Excise duties, 2003–04

Good	Duty (pence)	Total duty as a percentage of price (%)	Total tax as a percentage of price (%)[a]
Packet of 20 cigarettes:			
specific duty	194	67.2	82.1
ad valorem (22% of retail price)	94		
Pint of beer	27	13.8	28.7
Wine (75cl bottle)	119	35.8	50.7
Spirits (70cl bottle)	548	44.5	59.4
Ultra-low sulphur petrol (litre)	47[b]	62.1	77.0
Ultra-low sulphur diesel (litre)	47[b]	61.2	76.1

[a]Includes VAT.
[b]Increased from 46p in October 2003.
Notes: Assumes beer (bitter) at 3.9% abv, wine not exceeding 15% abv, spirits (whisky) at 40% abv. Percentages are calculated for October 2003 prices.
Sources: HM Customs and Excise, website (www.hmce.gov.uk/business/othertaxes/othertaxes.htm) and *Annual Report 2001–02* (www.hmce.gov.uk/about/reports/ann-report-stats.htm); National Statistics, www.statistics.gov.uk; authors' calculations.

Vehicle excise duty

In addition to VAT and excise duties, revenue is raised through a system of licences. The main licence is vehicle excise duty (VED), levied annually on road vehicles. For cars and vans registered before 1 March 2001, there are two bands. VED is £110 per vehicle for vehicles with engines smaller than 1,550cc; above this size, VED is £165. Cars and vans registered on or after 1 March 2001 are subject to a new VED system

[6]For more information on the taxation of petrol, see Z. Smith, *The Petrol Tax Debate*, IFS Briefing Note 8, 2000 (www.ifs.org.uk/consume/petrol.pdf).

based primarily on carbon dioxide emissions. For petrol cars or vans, VED ranges from £60 per vehicle (least polluting) to £160 per vehicle (most polluting). Different rates apply for diesel vehicles and for other types of vehicles, such as motorbikes, caravans and heavy goods vehicles. In 2003–04, VED is forecast to raise about £4.8 billion.

Insurance premium tax

Insurance premium tax (IPT) 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, income replacement and travel insurance). Long-term insurance (such as life insurance) is exempt. Since 1 July 1999, IPT has been levied at a standard rate of 5% of the gross premium. 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 17.5%. 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 5%) and reducing, by an equal amount, the price of the good or service (subject to VAT at 17.5%). Insurance premium tax is forecast to raise around £2.2 billion in 2003–04.

Air passenger duty

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). Currently, the air passenger duty rate on economy flights is £5 for destinations in the EU and £20 for other destinations. The rates for those travelling first or club class are £10 within the EU and £40 elsewhere. In 2003–04, air passenger duty is forecast to raise £0.8 billion.

Landfill tax

Landfill tax was introduced on 1 October 1996. It is currently levied at two rates: a lower rate of £2 per tonne for disposal to landfill of inactive waste (waste that does not decay or contaminate land) and a standard rate of £14 per tonne for all other waste. The standard rate will increase to £15 per tonne in April 2004 and by a further £3 to £18 per tonne in April 2005. The tax is forecast to raise £0.7 billion in 2003–04.

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 is 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 2003–04, the rates are 0.43 pence per kilowatt-hour for electricity, 0.15 pence per kilowatt-hour for coal and natural gas, and 0.07 pence per kilowatt-hour for liquefied petroleum gas. Energy-intensive sectors that have concluded climate change agreements that meet the government's criteria are charged a reduced rate equal to 20% of the standard climate change levy. The levy is forecast to raise around £0.9 billion in 2003–04.

Betting and gaming duties

From 1 January 2002, general betting duty was replaced with a 15% gross profits tax 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 is liable to pool betting duty at the current rate of 17.5%.

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. 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 2.5% and 40% according to the amount of gross gaming yield.

Duties on betting and gaming are forecast to raise £1.3 billion in 2003–04.

3.5. Capital taxes

Capital gains tax

Capital gains tax was introduced in 1965 and is levied on gains arising from the disposal of assets by individuals (including personal representatives of deceased persons) 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 a threshold below which capital gains tax does not have to be paid. In 2003–04, this 'exempt amount' is £7,900 for individuals and £3,950 for trusts. This is subtracted from total capital gains to give taxable capital gains. Taxable capital gains are in effect subject to income tax as if they were savings income: treated as the top slice of income, capital gains are taxed at 10% below the starting-rate limit, 20% between the starting- and basic-rate limits, and 40% above the basic-rate limit. In practice, most capital gains are subject to 40% tax.

Capital gains tax was reformed in the March 1998 Budget by the introduction of a taper system and removal of the previous indexation allowance (given to reflect increases in the price of assets over time solely due to inflation). As Table 8 illustrates, the taper system reduces the amount of capital gains tax paid the longer an asset is held. The holding period for capital gains tax taper relief for non-business assets is 10 years. For business assets (assets used wholly or partly for trading purposes, and shares and securities in a company), the taper length is two years. It was reduced from 10 to four years in the 2000 Budget and down to its current level in the 2002 Budget. The regime is more generous (a smaller percentage of the gain is chargeable) for business assets than for non-business assets.

The key exemption from capital gains tax is gains arising from the sale of a main home. Private cars and certain types of investment are also exempt, as are transfers to a spouse and gifts to charity. Some consecutive short-term investments, where the gains are reinvested, can be treated as a single long-term investment for the purposes of taper relief.

Table 8: The capital gains tax taper, 2003–04

Number of complete years after 5 April 1998 for which asset held	Non-business assets		Business assets	
	Percentage of gain chargeable	Equivalent tax rate for higher-rate taxpayer	Percentage of gain chargeable	Equivalent tax rate for higher-rate taxpayer
0	100	40	100	40
1	100	40	50	20
2	100	40	25	10
3	95	38	25	10
4	90	36	25	10
5	85	34	25	10
6	80	32	25	10
7	75	30	25	10
8	70	28	25	10
9	65	26	25	10
10 or more	60	24	25	10

Source: *Tolley's Tax Data 2003–04*.

It is estimated that in 2003–04, capital gains tax will raise £1.2 billion in revenue. 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 part of their income into capital gains in order to reduce their tax liability. In 2003–04, approximately 80,000 people will pay 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 (£255,000 in 2003–04). Above this threshold, inheritance tax is charged at a single rate of 40% for transfers made on death or during the three previous years. 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 subject to inheritance tax. This is set out in Table 9. Some transfers of wealth are exempt from inheritance tax, including those between spouses, to charities and to political parties. Other assets, particularly those associated with farms and small businesses, are eligible for relief. Relief reduces the value of the asset by 50% or 100% depending on the type of property transferred, and tax is assessed on the reduced value. The estimated number of taxpaying death estates in 2003–04 is 29,500, equivalent to around 5% of all deaths. The estimated yield from inheritance tax in 2003–04 is about £2.4 billion.

Table 9: Inheritance tax reductions for transfers before death, 2003–04

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

Sources: *Tolley's Tax Data 2003–04*; *Tolley's Inheritance Tax 2003–04*.

Stamp duty

Stamp duty is payable on many legal and commercial documents. It is so named because stamps on documents, following their presentation to the Stamp Office, indicate its payment (unless an arrangement operates whereby the document has a printed indication of the amount of duty payable). The main stamp duties are levied on stock and share transactions and on conveyances and transfers of land and property. Table 10 gives stamp duty rates as they stand currently. For most land and property transactions, there is a threshold of £60,000 below which no stamp duty is paid. A different threshold – £150,000 – applies to non-residential properties and, from December 2003, to residential properties in certain designated disadvantaged areas. Non-residential properties in disadvantaged areas are exempt altogether from stamp duty. For land and property above the threshold, rates of duty apply to the whole purchase price, including the part below the threshold. For stocks and shares, there is no threshold and stamp duty is levied at 0.5% of the price of the shares. The total duty payable is always rounded up to the next multiple of £5.

Total stamp duties (including stamp duty reserve tax – see below) are forecast to raise £7.9 billion in 2003–04. Approximately two-thirds of this will come from sales of land and property, and the remainder from sales of stocks and shares (the bulk of which will be stamp duty reserve tax).

Table 10: Rates of stamp duty, 2003–04

Transaction	Rate (%)[a]
Land and buildings:	
Up to and including £60,000[b]	0
Above £60,000 but not exceeding £250,000[b]	1
Above £250,000 but not exceeding £500,000	3
Above £500,000	4
Stocks and shares	0.5

[a]Total duty payable is rounded up to the next multiple of £5.
[b]The zero rate extends to £150,000 for non-residential properties and (from December 2003) residential properties in certain designated disadvantaged areas. Non-residential properties in disadvantaged areas are exempt altogether.
Source: Inland Revenue, www.inlandrevenue.gov.uk/rates/stamprates.htm.

Stamp duty reserve tax

Stamp duty reserve tax was introduced in 1986 and applies to certain transactions in securities that are not liable to stamp duty because there is no physical transfer of ownership – for example, the sale of shares held in electronic accounts. It also applies to the purchase of securities registered in the name of a nominee who acts for both buyer and seller, as well as to the purchase of securities that are resold before they are transferred to the buyer. Stamp duty reserve tax applies at the same rate as stamp duty on stocks and shares.

3.6. Corporation tax

Corporation tax is charged on the global profits of UK-resident companies, public corporations and unincorporated associations. Firms not resident in the UK pay corporation tax only on their UK profits. The profit on which corporation tax is charged comprises income from trading, investment and capital gains. Trading losses may be carried back for one year to be set against profits earned in that period or carried forward indefinitely.[7] The standard rate of corporation tax in 2003–04 is 30%, with a reduced rate of 19% on profits under £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 32.75% is levied on profits in excess of £300,000. This acts to increase the average tax rate gradually until it reaches 30%. A zero rate applies for profits up to £10,000, with an effective marginal rate of 23.75% levied on profits between £10,000 and £50,000 to bring the average tax rate gradually up to 19%. Table 11 presents marginal and average corporation tax rates.

Table 11: Rates of corporation tax, 2003–04

Profits (£ p.a.)	Marginal tax rate (%)	Average tax rate (%)
0–10,000	0	0
10,001–50,000	23.75	0–19
50,001–300,000	19	19
300,001–1,500,000	32.75	19–30
1,500,000 or more	30	30

Broadly speaking, current expenditure is deductible from taxable profits, while capital expenditure 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, set against future profits, or carried back for up to three years. Different classes of capital expenditure attract different capital allowances:

- Expenditure on plant and machinery may be 'written down' on a 25% declining-balance basis.[8] A higher, 40%, allowance is available in the first year

[7]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 30, 2002 (www.ifs.org.uk/corptax/bn30.pdf).

[8]The declining-balance method means that for each £100 of investment, taxable profits are reduced by £25 in the first year (25% of £100), £18.75 in the second year (25% of the remaining balance of £75)

for expenditure by small and medium-sized companies.

- Expenditure on industrial buildings and hotels is written down on a straight-line basis of 4% per year.
- Expenditure on commercial buildings may not be written down at all.
- 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 50% (allowing companies to deduct a total of 150% 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 loss-making firms. Firms can give up the right to offset losses equivalent to 150% 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 16% of the losses given up (up to a certain limit). An R&D tax credit for large companies was introduced in April 2002. This credit applies at a rate of 25%, allowing 125% of qualifying expenditure to be deducted from taxable profits.

In all cases, to claim R&D tax credit, companies must incur eligible current R&D expenditure of at least £10,000 (reduced from £25,000 in 2003) in a 12-month accounting period; but the tax credit is then payable on all eligible expenditure, not just the amount above the £10,000 threshold.

Before April 1999, firms paid their total tax bill nine months after the end of the accounting year unless profits had been distributed to shareholders in the form of dividends. In that case, firms had to pay advance corporation tax (ACT), which could then, in most cases, be deducted from the total due nine months after the end of the accounting year. In April 1999, ACT was abolished apart from certain transitional arrangements. Large companies are now required to pay corporation tax in four equal quarterly instalments on the basis of their anticipated liabilities for the accounting year, making the first payment six months into the accounting year. Small and medium-sized companies still pay their total tax bill nine months after the end of the accounting year.

Corporation tax will raise approximately £30.8 billion in 2003–04.

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and so on. The straight-line method with a 4% rate simply reduces profits by £4 per year for 25 years for each £100 of investment.

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.[9] All of these taxes are levied on measures of profit, but there are some differences in allowances and permissible deductions.

Corporation tax is the same as on the mainland, except that it is ring-fenced, so that losses on the mainland cannot be offset against profits from a continental-shelf field.

The supplementary charge is levied on broadly the same base as corporation tax, except that certain financing expenditure is disallowed. It was introduced in the 2002 Budget, and is set at a rate of 10% on all fields.

PRT is only payable on oil fields approved before 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 allowances and licence royalties) arising in each chargeable period. PRT is forecast to raise £1.5 billion in 2003–04. It is treated as a deductible expense for both the corporation tax and the additional charge.[10]

3.8. 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). Property bandings are currently based on assessed market values as at 1 April 1991; a revaluation will take effect from April 2005 in Wales and April 2007 in England, though no revaluation is currently planned in Scotland.[11] Table 12 shows the eight value bands and the proportion of dwellings in England in each band. There is a range of exemptions and reliefs, including a 25% reduction for properties with only one resident adult and a 50% reduction if the property is empty or a second home.[12] Properties that are exempt from council tax include student halls of residence and armed forces barracks. Council tax is expected to raise £18.6 billion in 2003–04, providing around a quarter of local authority revenue.

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[9]Until January 2003, some oil fields were also subject to licence royalties, a revenue-based tax.

[10]For more information on North Sea taxation, see L. Blow, M. Hawkins, A. Klemm, J. McCrae and H. Simpson, *Budget 2002: Business Taxation Measures*, IFS Briefing Note 24, 2002 (www.ifs.org.uk/corpact/bn24.pdf).

[11]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 still applies.

[12]Since 2003, however, councils have the power to charge second homes up to 90% of council tax and empty homes 100%. Some empty properties are entirely exempt from council tax, e.g. those left empty by patients in hospitals and care homes.

Table 12: Value bands for England, March 2003

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	25.8
B	$^{7}/_{9}$	£40,000 to £52,000	19.3
C	$^{8}/_{9}$	£52,000 to £68,000	21.5
D	1	£68,000 to £88,000	15.0
E	$1^{2}/_{9}$	£88,000 to £120,000	9.4
F	$1^{4}/_{9}$	£120,000 to £160,000	5.0
G	$1^{2}/_{3}$	£160,000 to £320,000	3.6
H	2	Above £320,000	0.6

Source: Table 2.2c of Office of the Deputy Prime Minister, *Local Government Finance Statistics (England) 2003* (www.local.odpm.gov.uk/finance/stats/lgfs/2003/chapter2.pdf).

3.9. Business rates

National non-domestic rates, or business rates, are a tax levied on non-residential property, including shops, offices, warehouses and factories. They were transferred from local to national control in 1990. Companies pay a fixed proportion (currently 44.4% in England, 44.0% in Wales and 47.8% in Scotland[13]) of the officially estimated market rent of properties they occupy. Some types of property qualify for reductions, including unoccupied buildings, small rural shops, and agricultural land and associated buildings. Properties are revalued every five years, with the next revaluation scheduled to take place in 2005. Major changes in business rates bills caused by revaluation are generally phased in through a transitional relief scheme. Such schemes operated for the 1990, 1995 and 2000 revaluations. Business rates are expected to raise £18.6 billion in 2003–04.

4. Summary of recent trends

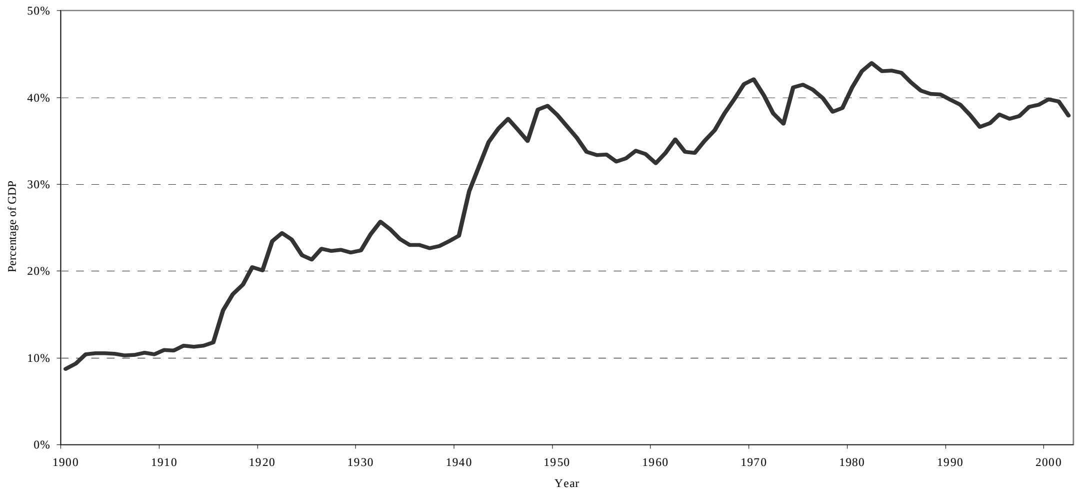
4.1. How did we get here?

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 the last 25 years. 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 over the twentieth century. 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 return 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

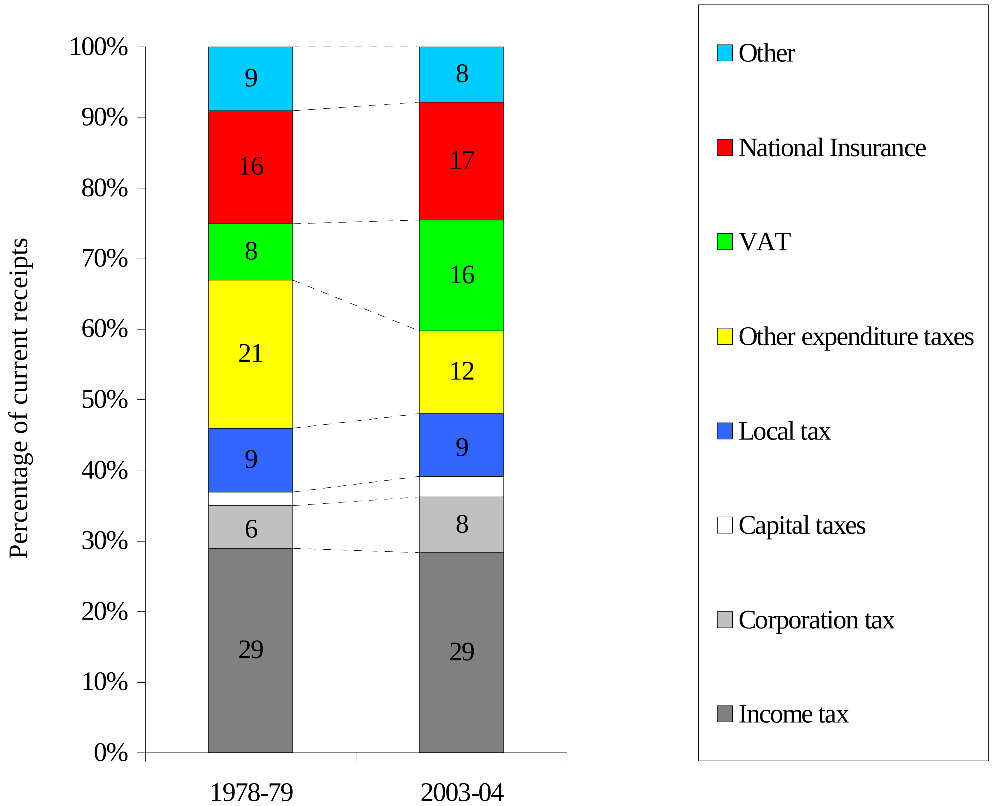
[13]Northern Ireland operates a slightly different system of regional rates and locally varying district rates. The average combined rate in 2003–04 is 42.1%: see www.derrycity.gov.uk/rates/REGIONAL RATES 2003 - LEAFLET 2003-04 (FINAL).doc for details.

Figure 1: Government receipts as a proportion of GDP, 1900–2002



Note: Figures are for general government net receipts.
Sources: T. Clark and A. Dilnot, *Long-Term Trends in British Taxation and Spending*, IFS Briefing Note 25, 2002 (www.ifs.org.uk/public/bn25.pdf); National Statistics, www.statistics.gov.uk/statbase/tsdtimezone.asp.

Figure 2: The structure of general government receipts, 1978–79 and 2003–04



Notes: Local tax is composed of local authority rates, both domestic and business, for 1978–79 and of council tax plus (national) business rates for 2003–04. 2003–04 figures are forecasts.
Sources: HM Treasury, *Financial Statement and Budget Report*, 1979 and 2003 (www.hm-treasury.gov.uk/Budget/bud_bud03/bud_bud03_index.cfm); Inland Revenue Statistics (www.inlandrevenue.gov.uk/stats/tax_receipts/g_t02_1.pdf).

Table 13: Summary of main reforms, 1979–2003

Income tax	Basic rate 33% down to 22% Top rate 98% (unearned income), 83% (earnings) down to 40% Starting rate 25% down to 10% Independent taxation introduced Married couple's allowance abolished 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 11% Employer contribution rate reduced from 13.5% to 12.8% Ceiling abolished for employer contributions Ceiling for employees raised and contributions extended beyond it 'Entry rate' abolished and floor aligned with income tax allowance Imposition of NI on benefits in kind
VAT	Higher rate of 12.5% abolished Standard rate increased from 8% to 17.5% Reduced rate introduced for domestic fuel and a few other goods
Other indirect taxes	Large real rise in duties on road fuels Smaller increase in tobacco duties Slight real decrease in duties on beer, larger decline for spirits Small real increase in duties on wine Climate change levy introduced
Corporation tax	Rate cut from 52% to 30% Small companies' rate cut to 19% Lower rate introduced and cut to 0% R&D tax credits introduced 100% first-year allowance replaced by 25% writing-down allowance Advance corporation tax and refundable dividend tax credit abolished
Local taxes	Domestic rates replaced by council tax (via poll tax) Locally varying non-domestic rates replaced by national non-domestic rates

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

(partly reflecting large fluctuations in economic growth), fell steadily as a proportion of national income from the early 1980s until the mid-1990s, but have begun to rise again under the current government and now stand at just under 40% of GDP.[14]

Table 13 lists some of the most important changes seen since 1979. 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 saving has been repeatedly adjusted, the National Insurance contributions system has been overhauled, the VAT rate has

[14]For further information, see T. Clark and A. Dilnot, *Long-Term Trends in British Taxation and Spending*, IFS Briefing Note 25, 2002 (www.ifs.org.uk/public/bn25.pdf).

more than doubled, some excise duty rates have risen sharply while others have fallen, the corporate income tax system has been subject to two wholesale reforms and many smaller changes, and local taxation is unrecognisable. Figure 2 shows the effect that these changes have had on the composition of aggregate government revenue.

The most dramatic shifts have been a doubling of the share of revenue flowing from VAT and a substantial reduction in revenue from other expenditure taxes. This pattern is mirrored across the developed world, with governments moving away from indirect taxes levied on specific goods towards general consumption taxes such as VAT. The shares of revenue from income tax and National Insurance contributions have remained virtually unchanged, despite radical structural changes. Corporation tax provides a larger share of total revenue in 2003–04 than in 1978–79, though much of this simply reflects being at different stages in the business cycle. Overall, the balance between direct taxes and indirect taxes has changed little.

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 14. 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.

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).

Table 15 gives the number of people affected by these various tax rates. In 2003–04, out of an adult population in the UK of 47.5 million, an estimated 30.7 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.[15] The total number of income taxpayers has increased slowly over the years,

[15]We might be more interested in the proportion of adults that live in a family containing a taxpayer. Authors' calculations using the IFS tax and benefit model, TAXBEN, run on data from the Family Resources Survey, suggest that this figure stood at 74% for Britain in 2001–02 (the latest year for which data are available): most non-taxpaying adults do not have taxpayers in the family.

while the number of higher-rate taxpayers has grown much more quickly, from less than 3% of the taxpaying population in 1979–80 to more than 10% in 2003–04. 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. Table 16 shows that, 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, especially in the mid-1980s.

Table 14: Income tax rates on earned income, 1978–2004

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 2003–04	10	22	40

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).
Sources: Various *Tolley's Income Tax*.

Table 15: Numbers liable for income tax (thousands)

Year	Number of individuals paying tax	Number of starting-rate taxpayers	Number of basic-rate taxpayers	Number of higher-rate taxpayers
1979–80	25,900	—[a]	25,226[a]	674
1984–85	23,800	—	22,870	930
1989–90	25,600	—	24,040	1,560
1994–95	25,300	5,180	18,170	2,000
2000–01	29,300	3,830[d]	22,600	2,880
2001–02[b]	29,000	3,960[d]	22,100	2,940
2002–03[b]	29,400	3,910[d]	22,500	3,050
2003–04[c]	30,700	4,300[d]	23,100	3,310

[a]Figure for 1979–80 covers both starting-rate and basic-rate taxpayers.
[b]Provisional.
[c]Projected.
[d]Includes those whose only income above the starting-rate limit is from either savings or dividends.
Sources: Inland Revenue, www.inlandrevenue.gov.uk/stats/income_tax/it_t01_1.htm and table 2.1 in *Inland Revenue Statistics 1994*.

Table 16: Personal allowance and basic-rate limit in real terms (April 2003 prices)

Year	Personal allowance (£ p.a.)	Basic-rate limit (£ p.a.)
1979–80	3,888	33,372
1984–85	4,098	31,480
1989–90	4,415	32,816
1994–95	4,329	29,781
2000–01	4,671	30,253
2001–02	4,747	30,776
2002–03	4,759	30,836
2003–04	4,615	30,500

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 www.ifs.org.uk/taxsystem/income.xls.
Source: Inland Revenue, www.inlandrevenue.gov.uk/stats/tax_structure/menu.htm; RPI used to uprate to April 2003 prices, *Monthly Digest of Statistics* (www.statistics.gov.uk/statbase/TSDtimezone.asp).

The number of starting-rate taxpayers climbed in the years after 1992 as the width of the starting-rate band was increased, but fell sharply in 1999–2000, as the new 10% rate applies over a much narrower range of income than the 20% rate that it replaced.

Although only 11% of income taxpayers face the higher rate, that group pays a very large share of the total amount of income tax that is paid. Table 17 shows that the top 10% of income taxpayers now pay over half of all the income tax paid, and the top 1% pay 22% of all that is paid. These shares have risen substantially since 1978–79, despite reductions in the higher rates.

Table 17: 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
1993–94	16	44	87
1996–97	20	48	88
1998–99	21	49	88
2000–01	22	52	89
2001–02[a]	23	53	89
2002–03[a]	23	53	89
2003–04[b]	22	52	89

[a]Provisional.
[b]Projected.
Sources: Inland Revenue, www.inlandrevenue.gov.uk/stats/income_tax/it_t04_1.htm and *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.[16] 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. In short, over little more than a decade, the UK has moved from a tax system that provided financial support particularly to married couples to one that provides financial support particularly to those with 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

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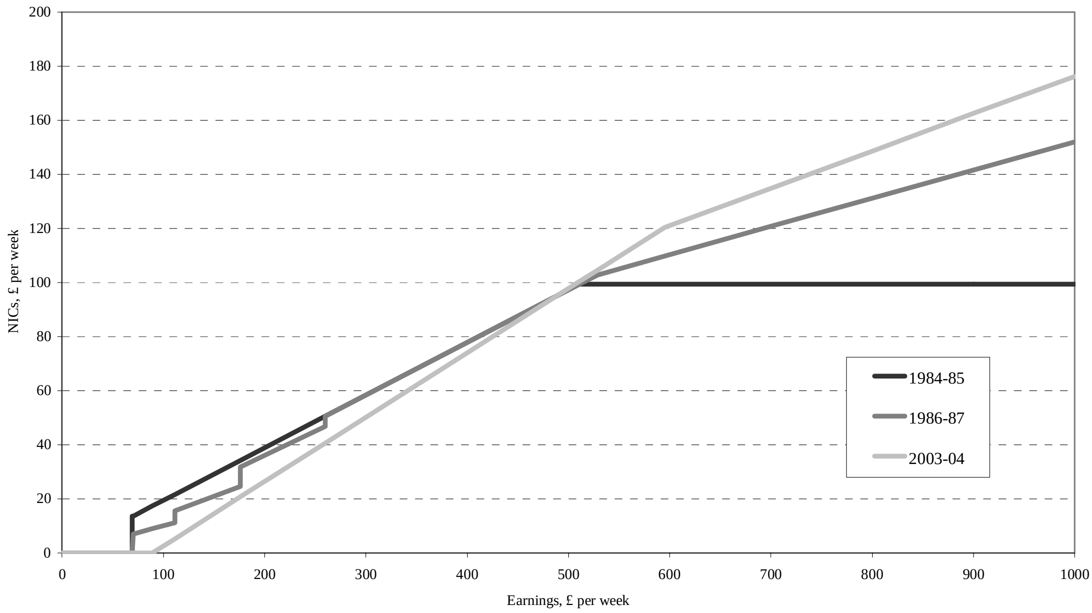
[16]For more information on these two programmes, see A. Dilnot and J. McCrae, *Family Credit and the Working Families' Tax Credit*, IFS Briefing Note 3, 1999 (www.ifs.org.uk/labmarket/wftc.pdf).

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 20 years.

Figure 3 shows the structure of the combined employee and employer NI system before and after the important 1985 reforms and as it stands in 2003–04. To enable comparison, thresholds from earlier systems have been uprated to April 2003 prices.

Figure 3: The changing structure of National Insurance contributions



Note: Previous years' thresholds have been uprated to April 2003 prices using the retail price index.
Sources: HM Treasury, *Financial Statement and Budget Report*, various years; *Tolley's National Insurance Contributions*, various years; National Statistics, www.statistics.gov.uk.

In 1984–85, no NI was due for those earning less than the lower earnings limit (LEL) of £69.50.[17] 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 £13.52 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 £7.05 (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 the post-1997 Labour government has removed the entry rate altogether so that the earnings threshold in NI now operates in the same way as the income tax personal allowance, essentially being discounted from taxable income. Furthermore, since April 2001, the earnings threshold for both employers and employees has been set at the same level as the income tax personal allowance, currently £89. This is somewhat higher than the LEL, currently £77, which is no longer used as the starting point for contributions.

The NI treatment of high earners has also come to resemble their treatment under income tax more, in that there is no longer a limit on payments. In 1984–85, no NI was payable on earnings above the upper earnings limit (UEL) of £511.03, giving a

[17] All figures are given in April 2003 prices.

maximum weekly contribution of £99.40. The 1985 reform abolished the UEL for employers. The UEL is still in place for employees, but no longer acts as a cap on contributions: the one percentage point rise in NI rates in April 2003 extended employee NICs to earnings above the UEL.

The abolition of the entry rate, the alignment of the earnings threshold with the income tax personal allowance, and the abolition of the cap on contributions have made NI look 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 all income. 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 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 much reduced by their increased alignment.

4.3. Taxation of saving

The last 25 years have seen a significant reduction in the extent to which the tax system distorts the return on different savings vehicles. There are three reasons for this. First, one of the most difficult areas in the taxation of saving is the treatment of inflation. At the levels of inflation seen during the 1970s and 1980s, distortions created by variations in the treatment of inflation were large. At the inflation rates seen in the last decade, however, this is a far less severe problem, and if rates remain close to the 2.5% target, it will become even less important. Secondly, the dispersion of tax rates (especially income tax rates) has narrowed. If a particular form of saving attracted tax relief at, say, 83%, its underlying performance could be quite poor and yet it could still provide an attractive return. As the number of tax bands has fallen and the highest rates have come down, the distortion caused by the taxation of different forms of savings has also fallen. Thirdly, there have been a series of reforms that have reduced the tax advantage of previously highly tax-privileged savings, and others that have removed tax disadvantages of other forms of savings, leading to a general levelling of the tax treatment of saving.

The two most significant changes in the taxation of saving were the abolition of life assurance premium relief in 1984, which had given income tax relief on savings in the form of life assurance, and the steady reduction and final abolition of mortgage interest tax relief (MITR). Until 1974, MITR was 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 effective level. 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 saving 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.

Housing, pensions and ISAs cover the saving activity of the bulk of the population, and over the last two decades we have moved from an incoherent tax regime for saving to one that seems much more satisfactory. It has rarely been the case that a clear strategy has been evident, but the power of the practical arguments for similar tax treatment of all saving seems to have been great. From April 2004 (when dividend tax credit stops being payable on UK equities held in ISAs), we will have a situation where for housing, and for equity and cash held in ISAs, saving is out of taxed income and there is no tax on returns and no tax on withdrawals, while for pensions, saving is out of untaxed income, fund income is untaxed but withdrawals are taxed. These two regimes produce the same effective tax rate of zero on the real return to saving. The one obvious exception is the existence of the tax-free lump sum in pensions, which makes the effective tax rate on the return to pensions saving negative. In addition, employers' pension contributions are particularly tax-favoured since they are not subject to either employer or employee National Insurance at the point of contribution or at the point of withdrawal. There is still some way to go to reach a system that is neutral in its effects, but we are far closer to it now than we were a decade ago.

For those (very few) who can and wish to save more than £7,000 per annum (the current ISA limit) in addition to any housing or pension saving, capital gains tax (CGT) is potentially relevant. In 2003–04, an estimated 80,000 individuals will pay CGT. 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 and introducing a tapering system, with the declared objective of encouraging longer-term holding of assets.

4.4. Personal indirect taxes

Value added tax

As noted earlier, the most dramatic shift in revenue-raising over the last 25 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 a reduction 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). Since then, there have been a number of small extensions to the base of VAT, and the introduction of a reduced rate of VAT on domestic fuel and a few other goods.

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 due to 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, books 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. Although this argument is superficially persuasive, it needs to be balanced by the recognition that, 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. Reversing the argument, if we sought the best-targeted way of allocating resources to the needy, identifying goods that absorbed a large share of their spending and then cutting the indirect tax rates for these goods is unlikely to be the most effective form of targeting. Other considerations, such as particular concerns over, say, children's clothes, may be relevant, but it is important to realise that the distributional argument for zero rates of VAT is not obviously a powerful one.

Excisable goods

Table 18 shows the total rate of indirect tax (VAT and excise duty) on the principal goods subject to excise duties. Tax on cigarettes has risen steadily, while those on petrol and diesel have increased much more sharply. Both these commodity groups have been covered by government commitments to substantial annual real increases in excise duty.

The pattern for alcoholic drink is more diverse. There has been a tendency for the rate of tax on spirits to fall, and the tax rate on spirits is now very much lower than it was in 1979. The tax rate on wine has shown relatively little trend, while that on beer has tended to fall since 1983. As shown in Table 19, implied tax rates per litre of pure alcohol are now much closer together than they were in 1979, though substantial variation does persist. This may seem puzzling since a natural starting point for a tax regime for alcoholic drink would be to impose the same level of tax per unit of alcohol, regardless of the form in which it is consumed. Variation in tax rates might be justified if one form of alcohol were more likely to lead to anti-social behaviour, for example, but such arguments are rarely made. The truth appears to be that the current system is more a product of history than of a coherent rationale, and there is obvious merit in reviewing it.

Table 18: Total tax as a percentage of retail price

Year	Cigarettes	Beer	Wine	Spirits	Leaded petrol	Unleaded petrol[a]	Diesel[a]
1979	70	34	47	77	49	—	49
1980	71	34	49	79	48	—	47
1981	74	38	51	78	54	—	51
1982	75	38	52	75	58	—	50
1983	74	38	53	74	56	—	50
1984	75	36	46	73	55	—	51
1985	75	36	49	73	53	—	48
1986	75	35	48	72	60	—	57
1987	74	34	47	71	64	—	63
1988	75	34	48	69	67	63	63
1989	74	33	47	66	63	58	61
1990	74	32	47	66	64	60	62
1991	76	33	48	65	68	64	65
1992	76	33	48	66	70	66	66
1993	76	33	49	64	71	67	66
1994	76	31	50	65	75	71	68
1995	78	31	51	67	76	73	73
1996	78	31	51	65	77	76	74
1997	79	30	49	62	79	75	74
1998	79	30	51	63	80	79	79
1999	79	30	51	61	86	85	85
2000	80	30	52	62	—[b]	76	75
2001	80	29	51	61	—	75	74
2002	83[c]	30	50	61	—	75	74
2003	82	29	51	59	—	77	76

[a]Ultra-low sulphur from 2000 onwards.
[b]Retail sales of leaded petrol stopped from 1 January 2000.
[c]This rise does not represent a real rise in duty rates. The discontinuity arises because the ONS measure of average cigarette prices changed in 2002 to include more, cheaper, brands.
Notes: Percentages relate to April/May for all years up to and including 1993, to January from 1994 to 2000, to April in 2001 and 2002, and to October in 2003. 'Cigarettes' refers to a packet of 20 king-size cigarettes, 'beer' to a pint of bitter (3.9% abv) in licensed premises, 'wine' to a 75cl bottle of table wine (not exceeding 15% abv) in a retail outlet, 'spirits' to a 70cl bottle of whisky (40% abv) in a retail outlet, and 'petrol' and 'diesel' refer to a litre of fuel.
Sources: HM Customs and Excise, website (www.hmce.gov.uk/business/othertaxes/othertaxes.htm) and various *Annual Reports*; National Statistics, www.statistics.gov.uk; authors' calculations.

Table 19: Implied duty rates per litre of pure alcohol (October 2003 prices)

Form of alcohol	1979	1989	2003
Beer	£10.49	£13.02	£12.22
Wine[a]	£18.60	£13.06	£13.22
Spirits	£32.35	£24.08	£19.56

[a]Wine of strength 12% abv.
Sources: HM Customs and Excise, website (www.hmce.gov.uk/business/othertaxes/othertaxes.htm) and various *Annual Reports*; National Statistics, www.statistics.gov.uk; authors' calculations.

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.[18] Only in the case of spirits is it likely that the current tax rate is close to being high enough for a reduction to have little or no revenue cost.

4.5. Taxes on companies

Corporation tax – the principal UK tax on companies – has been through two major reforms in the last 25 years, one in 1984 and the second since Labour came to power in 1997. In 1984, the main corporation tax rate was cut from 52% to 35% (reduced to 33% by 1991–92), and a very generous system of deductions for capital investment (100% first-year allowances for investment in plant and machinery) was replaced by a less generous one (25% annual writing-down allowances). The 1984 reform was intended to be broadly revenue-neutral, but may possibly have raised extra revenue by increasing the number of taxpaying companies more than expected.

The incoming Labour government of 1997 changed the way that dividend income was taxed, no longer allowing certain tax-exempt shareholders, such as pension funds and other companies, to reclaim the value of their dividend tax credit. This was followed in 1999 with a reform of the system for corporation tax payments (see Section 3.6). Since coming to power, the Labour government has also cut the main corporation tax rate from 33% to 30% and the small companies' rate from 24% 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 register as companies to reduce their tax liabilities.[19]

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. 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.

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[18] See I. Crawford, Z. Smith and S. Tanner, 'Alcohol taxes, tax revenues and the Single European Market', *Fiscal Studies*, 1999, vol. 20, pp. 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* no. 10, 2003 (www.hmce.gov.uk/business/othertaxes/alcohol-supp-paper.pdf).

[19] 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 24, 2002 (www.ifs.org.uk/corpact/bn24.pdf). For a discussion of possible future reforms, see S. Bond and A. Klemm, *Corporation Tax Reform: A Response to the Government's August 2003 Consultation Document*, IFS Briefing Note 40, 2003 (www.ifs.org.uk/corptax/bn40.pdf).

4.6. Local taxation

During the period considered here, local taxation has moved from the rates system, based largely on property values, to the community charge (poll tax) based on individuals, to the council tax, once again based largely upon property values, but with an individual element. These changes have been inspired by attempts to control local expenditure, which was far outstripping local revenue. The result is that the only local tax left – the council tax – provides only around a quarter of total local spending, leaving local authorities with little genuine control over their budgets: a 1% increase in local authority spending typically requires a 4% increase in council tax. Universal capping of local authority spending has ended, but this seems unlikely to remove a large degree of central control since the threat of capping is still very present.

The experience with the poll tax itself provides an interesting lesson in policy-making and implementation. It 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 burden of the poll tax, which resulted in 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 upon the value of the property occupied, with some exemptions and reliefs (outlined in more detail in Section 3.8).

5. Conclusions

Despite clear attempts to reform various aspects of the UK tax system over the last 25 years, 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.